WILLIAM & MARY LAW SCHOOL

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

Re: Public Comment regarding Proposal to Adopt a New NYSE Arca Rule 8.900-E to Permit It to List and Trade Managed Portfolio Shares and to List and Trade Shares of the Royce Pennsylvania ETF and Royce Premier ETF and Royce Total Return ETF; File Number SR-NYSE-Arc-2018-04

Dear Mr. Fields:

I submit this letter to provide public comment on the above-referenced proposal (the "Proposal") to permit the listing and trading of Managed Portfolio Shares (often labeled Shares).[1] This letter follows up on the comment letter I submitted late last year (the "Initial Letter") addressing the most recent prior version of the Proposal.[2] The "new" Proposal does not address the legal issues relating to the selective disclosure of material, non-public information that I raised in the Initial Letter. This letter therefore seeks to ensure that these issues remain in front of the Commission as it considers the Proposal. It does so by providing relevant background (including a description of how the Proposal fails to address the legal issues raised), followed by a straightforward framework for considering those issues. That framework calls for an examination of both the identified legal concerns themselves, as well as the broader economic ones with which they intersect.

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[1] The Proposal was filed on January 8, 2018. It is closely connected to an application for exemption from various provisions of the Investment Company Act of 1940. That application, as most recently amended (the "Exemptive Application"), was filed on December 4, 2018, and can be found at File No. 812-14405. Unless established here as new shorthand terms, capitalized terms of art are borrowed from the Proposal and/or Exemptive Application. When I use these terms, I do so as they are there defined. More generally, I assume familiarity with both the Proposal (including earlier versions) as well as the Exemptive Application (including its previous iterations). Below references to the Proposal include those relating to the exhibits filed with it. My citations are to the overall Proposal along with the relevant page number from the single overall filing, which is numbered from 1 to 99.

[2] *See* Exhibit 1 (Initial Letter). Because this letter builds on the Initial Letter, readers should turn to the latter first. They should also note the disclosure on potential conflicts found in its Introduction.

I. RELEVANT BACKGROUND

In my Initial Letter, I focused on the legal issues presented by the then-operative proposal's contemplated selective disclosure of confidential information. The confidential information at issue there (and in the current version of the Proposal) is that relating to the current composition of a Fund's portfolio holdings and the changes to the same from the prior business day (the "Portfolio Composition and Trading Information").[3] In the Initial Letter, I explained why the selective disclosure of this information and its proposed use are inconsistent with significant aspects of federal securities law and policy.

The selective disclosure concerns at issue for the Proposal arise from the proposed disclosure by the Funds of their Portfolio Composition and Trading Information to Authorized Participant Representatives (referred to in shorthand as AP Representatives, and also sometimes labeled Trusted Agents in the past) for trading by the AP Representatives on behalf of their customers that are Authorized Participants (hereafter referred to as "APs"). A Fund's Portfolio Composition and Trading Information would be disclosed to AP Representatives on a current basis each business day. In contrast, Fund holdings would be disclosed to the rest of the market only at quarter-end, with a delay of up to 60 days beyond then. In my Initial Letter, I described several reasons why the proposed selective disclosure of a Fund's confidential Portfolio Composition and Trading Information and the proposed use of such information are inconsistent with federal securities law and policy. Some of those reasons, as shown below, require careful legal analysis. Others, such as the points I made as to why the broker-dealers performing the AP Representative/Trusted Agent function should not be trusted with a Fund's confidential Portfolio Composition and Trading Information under any realistic view of the world, had broader reasoning. These concerns built on earlier-expressed SEC and commenter concerns along the same lines.[4]

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[3] *See, e.g.*, Proposal, at 11-12 (noting that the information at issue will consist of "the identities and quantities of portfolio securities that will form the basis for a Fund's calculation of NAV per Share at the end of the Business Day, as well as the names and quantities of the instruments comprising a 'Creation Basket' or the 'Redemption Instruments' and the estimated 'Balancing Amount' (if any)").

[4] In a letter from the SEC addressing an earlier version of the Proposal, the agency stated the following: "Even more fundamental, this [proposed selective] disclosure would seem to run afoul of a foundational federal securities law 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." SEC letter to W. John McGuire re Precidian ETFs Trust, et al.; File No. 812-14405 (Apr. 17, 2015), at 4-5. For an example of a commenter's expressed concern on the record, *see* Professor

To be more precise, my Initial Letter detailed three significant areas of concern:

- Those relating to Section 10(b) and Rule 10b-5's prohibition on insider trading;
- Those relating to Reg FD and related SEC guidance restricting tiered dissemination of material, non-public information by registered funds; and
- Those relating to best-execution requirements that seek to protect investor principals from being taken advantage of by their broker agents.

Five days after I submitted the Initial Letter articulating these concerns, on December 20, 2017, the Proposal's applicants withdrew the previous version of the Proposal. Two and a half weeks later, on January 8th of this year, the applicants filed the new Proposal. Gone are the Trusted Agents—or at least that nomenclature used to describe them. Still present, however, is the selective disclosure of Portfolio Composition and Trading Information and all of my concerns relating to the same. In fact, the Proposal does not address even a single one of the legal issues I raised with any kind of particularity whatsoever. Instead, the applicants continue to rely on two broad, and rather porous, proposed safeguards infused throughout the Proposal, one relating to information walls and the other to contractual restrictions on the use of the Portfolio Composition and Trading Information.

What's the underlying problem, and why are the Proposal's "we'll build a wall" refrain and proposed contractual restrictions insufficient? Answering this question requires a little more background on the Proposal itself.

The Proposal calls for AP Representatives (now labeled exclusively as such) to facilitate in-kind purchases and redemptions of Creation Units of Fund Shares by APs without the APs knowing the identity of the securities involved, referred to as the Fund's "Creation Basket."[5] The AP Representative intermediation contemplated in the

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James Angel, Comment Letter (May 25, 2017), available at https://www.sec.gov/comments/sr-nysearca-2017-36/nysearca201736-1774133-152313.pdf. ("The Trusted Agents will have information the general market does not have, and the humans entrusted with this information will be tempted to profit from that information, either by front running fund trades or by passing the information on to their customers and friends. The ongoing difficulties that the SEC has in enforcing insider trading rules make it most unwise to create yet more valuable secret information that could corrupt humans on trading desks.").

[5] The Proposal provides that the names and quantities of securities used in a Fund's purchase and redemption transactions on a given day would be identical, and are expected to mirror the Fund's portfolio holdings pro rata. *See, e.g.,* Proposal, at 23.

Proposal involves the accumulation and liquidation of the Creation Basket securities in the proper amounts and ratios by an AP Representative on behalf of its AP customer. More specifically, this intermediation centers on two rather mechanical tasks. The first relates to Creation Unit purchase transactions. In Creation Unit purchase transactions, an AP would direct its AP Representative to buy the securities constituting the current Creation Basket so that they could be transferred in kind to the Fund to purchase one or more Creation Units of Shares for the AP. The purchased Shares, from the time acquired, would be beneficially owned by the AP. The second relates to Creation Unit redemption transactions. In Creation Unit redemption transactions, an AP would redeem Shares, again in Creation Unit quantities, from the Fund. In return, the Fund would provide the AP, through its AP Representative, with Creation Basket securities corresponding in value to the Creation Units redeemed.[6] The AP Representative then would sell the Creation Unit securities, and provide the AP with the cash value that the redemption generates.

There could be an additional layer of complication in these transactions. In each type, the AP may be buying or redeeming Shares through its AP Representative either for the AP's own behalf or for the benefit of the AP's customers. In either case, the ultimate party buying or redeeming Shares would generally be a market maker, other arbitrageur, securities dealer with a broader focus, or more general investor.

This proposed arrangement of course stands in contrast to the typical purchase and redemption of mutual fund shares. Typically, purchases of mutual fund shares involve a straightforward transfer of cash from the share purchaser to the fund. In return, the purchaser receives fund shares. Redemptions involve the opposite—fund shareholders send back their fund shares in return for cash. In both purchases and redemptions, there is no in-kind transfer of the underlying fund securities (i.e., the securities held by the fund in its portfolio). In contrast, the Proposal calls for the in-kind transfers described above, and hence for the AP Representative intermediation described above. The proposed structure, we are told by the applicants, will have performance, tax, and other advantages for Fund investors.[7]

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[6] Although the Proposal contemplates distributions in cash or at least part in cash at times, it also states that the typical case will involve only distributions in kind. *See id.* at 22 ("[A] Fund will generally distribute [the underlying portfolio] securities in-kind.").

[7] *See, e.g., id.* (noting the tax-avoidance goal that depends on in-kind exchanges).

As I have described the Proposal thus far, the Funds look much like other ones the SEC has allowed—namely, existing actively managed ETFs that disclose their holdings each day. But here is the rub. Different from today's transparent active ETFs, the Funds don't want to reveal their special sauce to the market.[8] Understandably, they want to protect themselves and their shareholders against other market participants front-running the Fund's trades and free-riding on the Fund's market insights. But maintaining the confidentiality of Fund holdings potentially comes at a big cost—the Funds cannot engage in the in-kind exchanges necessary to obtain the purported benefits of the Shares without somehow revealing what's in the Creation Basket (and the portfolio as a whole, since the Creation Basket is expected to mirror Fund holdings pro rata).

This is where the Proposal creatively turns to the selective disclosure of portfolio information to AP Representatives who will operate Confidential Accounts on behalf of APs. In particular, it calls for the Funds to share their Portfolio Composition and Trading Information with the AP Representatives each business day, but to have those representatives swear to secrecy and sit behind a wall at their trading desks.[9] However, as described in detail in my Initial Letter, sharing the Portfolio Composition and Trading Information with AP Representatives for trading on behalf of APs involves the selective disclosure of material, non-public information inconsistent with federal securities law and the policies behind it. This conclusion holds even where AP Representatives are restricted in their use of the information by contract and walled off from others.

While the Proposal and Exemptive Application set forth in reasonable detail how the proposed Funds would operate, I include the above summation for two main reasons. First, the description laid out above provides necessary background for the points I make below in this letter. Second, from the first sentence on, the Proposal repeatedly states that Managed Portfolio Shares "are shares of actively managed exchange-traded funds ('ETFs') for which the portfolio is disclosed in accordance with

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[8] *See, e.g.,* Proposal, at 10.

[9] *See, e.g., id.* at 9 ("Authorized Participants . . . creating or redeeming Managed Portfolio Shares will sign an agreement with an agent ("AP Representative") to establish a confidential account for the benefit of such Authorized Participant that will deliver or receive all consideration from the issuer in creation or redemption. An AP Representative may not disclose the consideration delivered or received in a creation or redemption.").

standard mutual fund disclosure rules."[10] However, the defining feature of the Shares that makes them unique is omitted from this repeated description: that they will NOT be traded in accordance with standard ETF disclosure rules. Thus, the defining statement should be modified to include the following italicized, bracketed alteration: Managed Portfolio Shares "are shares of actively managed exchange-traded funds ('ETFs') for which the portfolio is disclosed in accordance with standard mutual fund disclosure rules[*, but not in accordance with standard ETF disclosure rules.*]" The Commission and Staff know the full history relating to the Proposal and the related Exemptive Application. But it is still important to make this fundamental point clear for the larger public audience of this letter.

II. A FRAMEWORK FOR CONSIDERATION OF THE LEGAL ISSUES RAISED IN THE INITIAL LETTER

In this second part of this follow-up letter, I provide a framework for considering the extent to which the legal issues I raised in my Initial Letter cut against allowing this Proposal and Exemptive Application to go any further—assuming that such further consideration is even necessary given the broad scope of the Proposal's identified deficiencies. By providing this framework, I hope to help ensure that those legal issues are, if necessary, considered in full.

The framework I set forth here calls for both analysis of the primary legal issues raised, as well as the impact they have on the broader economic concerns voiced by the SEC and commenters in the past. In the first section below, I use an insider-trading-law example to show the type of focus on primary legal issues that I think is appropriate. In the second, I do the same, albeit with an example relating to best-execution law to focus on the intersection of primary legal concerns and the broader economic ones. In using these examples, I also emphasize my previous concerns relating to these two examples. But due to the limited scope of this letter, each is offered merely to illustrate the importance of those found in a broader set of concerns and how I think those concerns should be addressed.

[10] *Id.* at 3.

A. FOCUSING ON THE PRIMARY LEGAL CONCERNS THEMSELVES

To see the need to focus on the primary legal concerns I have raised, think about one of the insider-trading problems I pointed out in my Initial Letter— relating to the law on "possession equals use"—and how the Proposal ignores it.[11]

In the Initial Letter, I explained why there is reason to believe that the contemplated AP Representative trading would itself violate the law, and why it would involve closely related behavior that does the same.

Take the former point first. Under Rule 10b5-1 and related case law, mere *possession* of material, non-public information while trading in relevant securities is considered to involve *use* of that information.[12] For this reason, market participants who possess such information while engaging in trading in relevant securities have presumptively committed illegal insider trading. (Other elements of the criminal charge or civil cause of action must also be met, as I discuss below. The point here is that the major element involving the use of material, non-public information is met by possession alone during the time of that trading.)

The Proposal expressly provides for the AP Representatives to engage in purchases and sales of Creation Basket securities while in *possession* of the Portfolio Composition and Trading Information. To be clear, this means that the AP Representatives will be trading in securities while possessing material, non-public information relating to them. Moreover, they will be in possession of the Portfolio Composition and Trading Information throughout every moment of every trading day. Thus, the very accumulation and liquidation of the Creation Basket securities by the AP Representatives themselves might constitute a violation of the law—meaning that the proposed arrangement itself can be interpreted as one that calls for an illegal scheme.

To be sure, the Proposal provides for a contractual relationship through which the owners of the Portfolio Composition and Trading Information (the Funds) authorize the AP Representatives to trade in Creation Basket securities for the narrow purpose of facilitating their AP customers' in-kind purchases and redemptions of Fund Shares. For this reason, such trading might not meet all of the elements required for prosecution

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[11] *See* Exhibit 1 (Initial Letter), at 6 et seq.

[12] *See id.*; Rule 10b5-1(b), 17 CFR 240.10b5-(b) ("[A] purchase or sale of a security of an issuer is 'on the basis of' material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.").

under Section 10(b) and Rule 10b-5. In particular, the requisite breach of a duty might be absent. But there will still be much room for finding such breaches, and therefore violations, in even just this trading. For example, think about the situation in which an AP Representative is selling Creation Basket securities to facilitate an AP's redemption transaction, and where the Portfolio Composition and Trading Information gives the AP Representative reason to suspect that the Fund will be purchasing certain securities (say, technology stocks) that day. To the extent the AP Representative meets its AP customer's sell orders by purchasing for its firm's own account some or all of the technology stocks in the Creation Basket, it is *illegally trading* such shares. Or, to the extent it fills the AP customer's sell orders in part by directing the sale of tech-stock shares to friendly traders at other firms, the same would be the case. Finding the quid pro quo that the AP Representative received in return from, respectively, their intra-firm colleagues or members of their extra-firm trading network might be difficult for the government to show at times. But there is clearly much reason to believe that at least the DOJ and federal judges would find these transactions to involve breaches of duties owed by the AP Representatives sufficient for there to be a successful misappropriation prosecution. It is also clear that this behavior involves more than just some technical violation of an SEC rule. Indeed, the SEC or private litigant could show a violation here even without the "possession equals use" law in 10b5-1 and related case law.

Notably, the revised Proposal does not touch on these "possession equals use" and related insider-trading problems with the Proposal. To the contrary, the only part of the Proposal that can be said to address the concerns I have raised is that of the wall and related contractual restrictions mentioned above. Proposed Commentary .05(b) provides the basic contours of the wall protection. That commentary reads:

> If an AP Representative . . . is registered as a broker-dealer or affiliated with a broker-dealer, such AP Representative . . . will erect and maintain a 'fire wall' between such AP Representative . . . and personnel of the broker-dealer or broker-dealer affiliate, as applicable, with respect to access to information concerning the composition and/or changes to such Investment Company portfolio.[13]

As demonstrated in the example immediately above, an AP Representative could engage in illegal insider trading without even breaching the proposed fire wall. Further,

[13] *See* Proposal, at 98 (setting forth Proposed Commentary .05(b)).

the Proposal is silent on whether or how a Fund would seek to ensure that the AP Representatives are, in fact, complying with their fire wall-related representations. No wonder, since it's hard to envision how any sort of surveillance or other compliance assurance system to be employed by the Funds might possibly work. Seemingly, the Proposal contemplates a "trust me" approach to protection from damaging leaks of confidential portfolio information, which would be disseminated to a potentially broad network of broker-dealers on a daily basis.

Beyond the proposed fire wall, the Proposal describes contractual protections against disclosure or misuse of Portfolio Composition and Trading Information by AP Representatives, summarized in the Exemptive Application as follows:

> Pursuant to a contract (the "Confidential Account Agreement"), the AP Representative will be restricted from disclosing . . . the portfolio securities of a Fund. In addition, the AP Representative will undertake an obligation not to use the identity of the portfolio securities for any purposes other than facilitating creations and redemptions for a Fund.[14]

Here again, there is no mention of how a Fund would seek to ensure the AP Representatives' compliance with the terms of their Confidential Account Agreements, suggesting again a "trust me" approach. To repeat a point I made in my Initial Letter, the compliance history of the broker-dealer industry offers countless examples of why disseminating valuable trading information in confidence to a large number of broker-dealers on a recurring basis, and then trusting them not to misuse such information, may not be a good idea.

Despite the applicants' assurances about fire walls and traders' "obligation not to use the identity of the portfolio securities for any purposes other than facilitating creations and redemptions for a Fund,"[15] it is clear that, if approved, the Proposal will trigger the types of Section 10(b) and Rule 10b-5 violations that I have described, and that it will do so with considerable frequency.

Still, this is not the Proposal's only insider-trading problem. Indeed, it is not even it's only 10b5-1 insider-trading problem. The same information possession at issue poses a problem in connection with trading activity by AP Representatives outside that

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[14] *See* Exemptive Order, at 10.

[15] *See id.* at p.10.

relating to AP creations and redemptions. I made this point in my Initial Letter,[16] and will not repeat it in detail here. Suffice it to say that the broad scope of the Funds' Portfolio Composition and Trading Information, *possessed* by AP Representatives all day throughout each trading day, will essentially handcuff the AP Representatives from engaging in *any* other trading in the securities held by the Funds.[17] It follows that, for the contemplated trading structure to stay consistent with insider-trading law, it would have to call for the AP Representatives to be barred from doing any other trading in any Fund portfolio security at any time. If the Proposal's sponsors achieve their commercial objective of widespread adoption of the Managed Portfolio Shares structure, AP Representatives could face a lonely existence, excluded from trading in the overwhelming majority of all equity securities outside of their business representing APs.

To be sure, the Proposal does set out contractual restrictions that would put AP Representatives on notice of the need to walk a fine line while in possession of the Portfolio Composition and Trading Information:

> In selecting entities to serve as AP Representatives, a Fund will obtain representations from the entity related to the confidentiality of the Fund's Creation Basket portfolio securities, the effectiveness of information barriers, and the adequacy of insider trading policies and procedures. In addition, as a broker-dealer, Section 15(g) of the Act requires the AP Representative to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, nonpublic information by the AP Representative or any person associated with the AP Representative.[18]

But whatever the level of assurance provided by these general representations of planned compliance with the law, it is clear that the Proposal does not address this second insider-trading issue either. In this way, in at least their spirit, the above promises are not being upheld even before Managed Portfolio Share trading begins.

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[16] *See* Exhibit 1 (Initial Letter), at 6 et seq.

[17] *See id*.

[18] *See* Proposal, at 63, n.23.

It is possible that applicants have a simple answer to this problem—namely, that AP Representatives will be barred from engaging in any other trading in the Funds' securities holdings while in possession of Portfolio Composition and Trading Information. Of course, this essentially means that they are barred from doing any trading in such securities other than mere portfolio accumulation and liquidation trades in connection with, respectively, Share creation and redemption transactions on behalf of their AP customers. If that is the case, there are other implications for the viability of the Proposal, as I discuss in the next section of this letter. Moreover, such a finding would in no way cure the more basic Rule 10b5-1 problem I've reiterated and emphasized above. Nor would it cure the more obvious broader insider-trading problems raised by others and articulated in my Initial Letter.[19].

Also, Rule 10b5-1 has affirmative defenses that would have to be considered in any complete analysis of its application to the trading at issue here. But those defenses are narrow. They generally allow trading while in possession of material, non-public information that is otherwise prohibited only when the trader made all of his or her trading decisions *before* becoming aware of information.[20] And here, the Proposal calls for trading decisions that are made on a daily basis, *after* the AP Representatives have the information in their hands. Further, even if one concluded that an affirmative defense applies to the first Rule 10b5-1 problem discussed above, the defense still likely would not apply to the second one. Also, even if it applied to both, the result would merely be a loss of the possession-equals-use presumption. The more general prosecution under Section 10(b) and Rule 10b-5 noted earlier could still be brought.[21]

Three final considerations are appropriate here.

First, in light of the above concerns, it is important to think about whether courts would accept any positive conclusion about the consistency of the Proposal with Rule 10b5-1, Rule 10b-5, and Section 10(b). It should be recognized that such practices could be challenged even if the Division of Trading Markets, the Division of Investment Management, and the Commission deem the above issues to be insufficiently problematic. Barring a change to Rule 10b-5 or Rule 10b5-1 by the Commission (which, almost needless to say, is very unlikely), it is the federal courts that interpret their

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[19] *See supra* note 4 and accompanying text.

[20] *See, e.g.*, Rule 10b5-1(c), 17 CFR 240.10b5-1(c).

[21] The same general analysis provided in this paragraph applies with respect to the rebuttal allowed in the relevant case law. *See* SEC v. Adler, 137 F.3d 1325 (11th Cir. 1998).

coverage. And even if the SEC interpretations have much power with respect to Rule 10b5-1, the case law in *SEC v. Adler* predates that rule. Litigants could thus challenge the contemplated trading by AP Representatives under that law. Such a challenge could be asserted against both their strict accumulation- and redemption-facilitating trade activity, as well as any broader trading in a Fund's portfolio securities while in possession of the Fund's Portfolio Composition and Trading Information. The same basic points hold with respect to more general analysis under Section 10(b) and Rule 10b-5.

Second, the SEC should consider what approving this Proposal would do to its ability to enforce insider-trading and selective disclosure laws. Just think about what adopting the Proposal would mean for the agency's ability to use 10b5-1. Imagine that the SEC approves the Proposal, despite the trading practices described above and the fact that the possession of material, non-public information while trading constitutes use of it under Rule 10b5-1 and case law. The agency could then be viewed as allowing broker-dealers serving as AP Representatives to trade in the relevant securities (perhaps even outside of creation/redemption-facilitating trades) while in possession of material, non-public information. That would presumably weaken the agency's ability to put the possession-equals-use doctrine to use in order to stop insider-trading activity. Similarly, approval of the Proposal would represent the SEC's endorsement of the Funds' proposed daily selective disclosure of material, non-public information, in clear breach of current SEC guidance restricting tiered dissemination of material, non-public information by registered funds. How might that affect the SEC's ability to apply such restrictions in other situations? Approving the Proposal would essentially involve the chief regulator of securities markets and investment funds in the United States sanctioning activities that constitute per se violations of the very laws and regulations the SEC is supposed to be enforcing. In short, ignoring the securities law problems with the Proposal could have broader negative implications for the SEC and its mission.

Third, blessing an arrangement like this that stands in contrast to so much SEC law and policy could have even broader unanticipated consequences. They are outside the scope of this letter. But they too should be considered by the SEC and other commenters.

In sum, walling off the AP Representatives from the world, and restricting their trading and tipping by contract, falls well short of addressing my previously submitted concerns. This should be clear from the above illustrative discussion of just one of those

concerns. Each of the other legal issues (including other insider-trading issues) I raised in my Initial Letter was likewise left unaddressed in the new Proposal.

B. Focusing on the Intersection of the Primary Legal Concerns and the Broader Economic Ones

The Proposal and related Exemptive Application should not be allowed to proceed any further unless the primary legal concerns are sufficiently addressed. But to sufficiently address those legal issues, the larger economic ones they impact must also be considered. The main such economic issues are those relating to the liquidity with which Managed Portfolio Shares would trade. These issues are raised throughout the relevant record.

This point on the intersection between the legal issues and these larger economic ones can be made by discussing the best-execution problem I noted in my Initial Letter. Overall, the Proposal presents a recipe for something very different than broker best execution on behalf of their customers. The reason for this problem is not complicated. Per the terms of the Proposal, APs cannot see the content of the securities being bought and sold in their Confidential Accounts. Astute market observers will realize what this tells us about the ability of APs to police their AP Representative agents to ensure the latter provide them with best execution: there isn't any. I summarize this point glibly here, but provide a deeper and more nuanced explanation in my previous letter.[22]

Still, it is important to emphasize the extent to which the customer principals will be kept in the dark while the broker agents will have the full picture before them. To see this, just look at what the Proposal contemplates:

> In purchasing the necessary securities, the AP Representative would be required, by the terms of the Confidential Account Agreement, to *obfuscate* the purchase by use of tactics such as breaking the purchase into multiple purchases and transacting in multiple marketplaces.[23]

The same applies with respect to redemptions:

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[22] *See* Exhibit 1 (Initial Letter), at 19-22 (discussing my concerns relating to best execution).

[23] *See* Proposal, at 17 (emphasis added).

> As with the purchase of securities, the AP Representative would be required to *obfuscate* the sale of the portfolio securities it will receive as redemption proceeds using similar tactics.[24]

It follows that the AP Representatives are much less likely to uphold their best-execution obligations to their AP customers relative to brokers executing trades for more general customers. This statement should not be taken lightly, as the SEC and commentators have expressed much concern for best execution in recent years.[25] In fact, the leading scholarly legal discussion of best-execution problems in the contemporary stock market calls for the underlying problems to be solved with a large role to be played by customers armed with better disclosure from their brokers and trading centers.[26]

These conclusions and the associated market dynamics contemplated by the Proposal should be troubling to anyone who understands the basic mechanics and economics of the securities markets at issue. But this issue is especially disconcerting here for another reason—the one noted before this brief background description.

Any failure of best execution in the AP Representatives' transactions on behalf of APs will exacerbate the broader concern for the Proposal relating to the Share's liquidity and secondary-market trading performance. To see why this is so, think about redemption transactions. When APs (or their customers) redeem Shares, they will receive cash.[27] But that cash does not come directly in return for the redeemed Shares.[28] Instead, it comes from the proceeds received from the liquidation of the associated Creation Basket securities.[29] But AP Representatives will liquidate those securities at prices that are generally *below* the value they contribute to the VIIV. This is because the VIIV will be "based on the mid-point of the highest bid and lowest offer for the

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[24] *See id.* at 21-22 (emphasis added).

[25] *See generally* Merritt B. Fox, Lawrence R. Glosten, and Gabriel V. Rauterberg, *The New Stock Market: Sense and Nonsense*, 65 DUKE L. J. 191, 204-05, 253, 274 (2015) (reviewing the structure and regulation of the electronic stock market now present in the United States, and focusing extensively on best-execution problem relating to the same).

[26] *See id.* at 284 (touting fixes "focused on disclosure, designed to assist customers in determining whether their orders are being routed to venues offering best execution and whether order-routing directions are being ignored.")

[27] *See supra* Part I.

[28] *See id*.

[29] *See id.*

portfolio constituents of a series of Managed Portfolio Shares."[30] But when the AP Representatives sell off the underlying portfolio securities to meet the redemption request, most positions will likely be liquidated against bid prices. Accordingly, redeeming market makers and/or other arbitrageurs will not receive the market value of each of the underlying positions—and hence of the Shares themselves—reflected in the disclosed VIIVs.

Further, in these transactions, redeeming market participants may often receive less than even the current bid price. So-called "taker fees" are likely often to apply. AP Representatives will face time pressure to complete these trades. This is because the price of the traded securities will of course be subject to the volatility of the market. And the Proposal places all risk of loss squarely on the shoulders of the beneficial owners of the securities.[31] AP Representatives are therefore unlikely to take the risk of non-execution associated with transacting by providing liquidity to the market. Accordingly, the AP Representatives will likely seek quick execution, which will often involve taking liquidity against liquidity-provider bids in the market for each share of each security held in the portfolio. And taking liquidity in this fashion generally involves paying a taker fee in addition to receiving the inferior price associated with market bids.[32]

In this sense, the very structure of the creation/redemption-related trading in Creation Basket securities by AP Representatives on behalf of APs contemplated by the Proposal presents basic economic concerns. Indeed, to the extent it essentially relegates APs to liquidity-taking trading, it has a built-in lack of best execution for APs. But my point in looking closely at all of the above is broader. That broader point is that the best-execution concerns I have raised intersect with the Proposal's more general economic

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[30] Proposal, at 27-28; *id.* at 95 (setting forth Proposed Rule 8.900-E(c)(2)).

[31] The Proposal makes clear that such loss is solely the responsibility of the AP—meaning that it will fall on investors and market makers, and not on AP Representatives or the Funds. *See id.* at 23, n.28 ("An AP will issue execution instructions to the AP Representative and be responsible for all associated profit[s] or losses."); *id.* at 69, n.29.

[32] These points also show why the contemplated "obfuscat[ion of] the purchase [or sale] by use of tactics such as breaking the purchase [or sale] into multiple purchases [or sales] and transacting in multiple marketplaces" is problematic. *Id.* at 17; *see supra* notes 24 & 25 and accompanying text. Transacting piecemeal in this way will subject the APs to market-movement risk. Even if that risk involves more or less a 50% chance of favorable market movements and 50% chance of unfavorable ones, the risk itself is of course costly to those who bear it. Moreover, to the extent that the piecemeal trading itself causes price impact in the market, those percentages would change in a negative way for APs.

issues. To the extent that lack of best execution results in trades on behalf of APs being routed to trading platforms with inferior prices and/or higher taker fees, these concerns are exacerbated. If the best-execution problem is significant enough, redeeming APs could realize net redemption proceeds that could be materially below the market value of the Shares redeemed. These added costs would frustrate efficient market-making and arbitrage activity, leading to reduced Share liquidity in the market.

These facts are generally disconcerting. They also have more specific application of note, as they undermine the Proposal's contentions relating to the liquidity with which Managed Portfolio Shares will likely be traded in the market. For example, the Exemptive Application states the following: "Applicants believe that arbitrageurs will purchase or redeem Creation Units of a Fund in pursuit of arbitrage profit, and in so doing will enhance the liquidity of the secondary market as well as keep the market price of Shares close to their NAV."[33]

Lastly, it is important to note that, like with the insider-trading example provided in the previous section, I focus on only one example here. Most, if not all, of the issues I raised in my Initial Letter should be considered by focusing on the intersection between them and the broader economic concerns at play as well. In fact, the insider-trading example discussed earlier can be used to make this precise point.

If the proposed AP Representative trading is to be allowed, but only with walled-off traders who do absolutely nothing other than mechanical Creation Basket security accumulation and liquidation trades on behalf of APs, then it would likely be quite costly to supply AP Representative brokerage services. Broker-dealers would need to have professionals running this business. The business's service requirements might be relatively basic. But even if that is the case, the Wall Street hermits behind a wall at the far end of broker-dealer trading desks providing this service would have to be paid. Yet, restricted to mere mechanical Creation Basket security accumulation or liquidation, these brokers could sit idle behind their wall much of the time. Because the provision of this service will be more expensive due to the restrictions on the associated traders' labor, brokerage firms will have to charge APs more for their work. The Proposal contemplates that APs would have a range of options with respect to the provision of

[33] *See* Exemptive Application, at 23.

AP Representative services.[34] But there is much reason to believe that, under these constraints, a competitive market of broker-dealers providing AP Representative services is unlikely to develop. High costs for broker-dealers to provide AP Representative services and limited competition among providers would inevitably exacerbate the broader concerns for Managed Portfolio Share liquidity. Even if broker-dealers serving as AP Representatives could comply with insider-trading law, the extra costs of maintaining compliance would surely be significant. Ultimately, these costs would be borne by Fund investors, in the form of reduced liquidity and higher Share trading expenses.[35]

CONCLUSION

As I stated at the outset of my Initial Letter, "these significant [legal] problems should not be overlooked when evaluating the merits of the [p]roposal for which the requested rule change and exemptive relief are being sought."[36] Yet, the January 8, 2018 Proposal that replaced the one withdrawn on December 20, 2017 still calls for the use of selective disclosure of Portfolio Composition and Trading Information that runs afoul of longstanding securities law and policy. As made clear in this follow-up letter, the associated legal issues remain unresolved. Instead, the applicants have opted merely to repeat a "build a wall" refrain, along with what amounts to a general contractual bar on activity that is already prohibited under the law.

More generally, the unaddressed legal concerns belie the Proposal's contention that:

> [T]he proposed rule change is consistent with Section 6(b) of the Act, in general, and furthers the objectives of Section 6(b)(5) of the Act, in particular, in that it is designed to prevent *fraudulent* and manipulative acts and practices, to promote *just and equitable principles of trade*, to remove impediments to and perfect the mechanism of a free and open

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[34] *See* Proposal, at 67, n.27 ("The Authorized Participant will be free to choose an AP Representative for its Confidential Account from a list of banks and trust companies that have signed confidentiality agreements with the Fund.").

[35] One also has to wonder what such limitations on the scope of these broker-dealers would do to their incentives to comply with best-execution rules on behalf of their customer APs.

[36] Exhibit 1 (Initial Letter), at 2.

> market and a national market system, and, in general, *to protect investors and the public interest*.[37]

That the insider-trading and best-execution concerns addressed in this letter are rooted in, respectively, anti-fraud law and the desire to protect investors only furthers this conclusion.

Not to be lost from the relatively narrow focus of this letter, my conclusion here applies not just to the specific insider-trading and best-execution problems touched on above. Those were used as mere examples of my larger point that the serious legal issues I raised in my Initial Letter all remain unresolved.

In the end, I believe that Managed Portfolio Shares cannot be permitted without scrapping the selective disclosures at the Proposal's heart. My securities law concerns with the Proposal could be resolved by disclosing the Funds' portfolio information equally to all market participants. That's what mutual funds and other ETFs are generally required to do. But those behind the Proposal and relating filings understandably do not want that.[38] Given these irreconcilable differences between the Proposal and longstanding securities law and policy, the new Proposal should be dead on arrival.

Sincerely,

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[37] *See* Proposal, at 81 (emphases added).

[38] *See, e.g., id.* at 10.