

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>24</sup>

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## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-81599; File No. SR-BatsBZX-2017-30]

### Self-Regulatory Organizations; Bats BZX Exchange, Inc.; Order Instituting Proceedings To Determine Whether To Approve or Disapprove a Proposed Rule Change To Permit the Listing and Trading of Managed Portfolio Shares; and To List and Trade Shares of the Following Under Proposed Rule 14.11(k): ClearBridge Appreciation ETF; ClearBridge Large Cap ETF; ClearBridge MidCap Growth ETF; ClearBridge Select ETF; and ClearBridge All Cap Value ETF

September 13, 2017.

On June 1, 2017, Bats BZX Exchange, Inc. (“Exchange” or “BZX”) filed with the Securities and Exchange Commission (“Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change to: (1) Adopt Rule 14.11(k) (Managed Portfolio Shares); and (2) list and trade shares (“Shares”) of the ClearBridge Appreciation ETF; ClearBridge Large Cap ETF; ClearBridge MidCap Growth ETF; ClearBridge Select ETF; and ClearBridge All Cap Value ETF under proposed Rule 14.11(k). The proposed rule change was published for comment in the **Federal Register** on June 19, 2017.<sup>3</sup> On July 28, 2017, pursuant to Section 19(b)(2) of the Act,<sup>4</sup> the Commission designated a longer period within which to approve the proposed rule change, disapprove the proposed rule change, or institute proceedings to determine whether to disapprove the proposed rule change.<sup>5</sup> The Commission has received four comments on the proposed rule

change.<sup>6</sup> This order institutes proceedings under Section 19(b)(2)(B) of the Act<sup>7</sup> to determine whether to approve or disapprove the proposed rule change.

### I. Summary of the Exchange’s Description of the Proposed Rule Change<sup>8</sup>

The Exchange proposes to adopt new Rule 14.11(k), which would govern the listing and trading of “Managed Portfolio Shares.”<sup>9</sup> The Exchange also proposes to list and trade Shares of the ClearBridge Appreciation ETF; ClearBridge Large Cap ETF; ClearBridge MidCap Growth ETF; ClearBridge Select ETF; and ClearBridge All Cap Value ETF under proposed Rule 14.11(k) (each a “Fund,” and collectively the “Funds”).

#### A. Description of the Funds

The portfolio for each Fund will consist primarily of long and/or short positions in U.S.-exchange-listed securities and shares issued by other U.S. exchange-listed exchange-traded funds (“ETFs”).<sup>10</sup> All exchange-listed

<sup>6</sup> See Letter from Gary L. Gastineau, President, ETF Consultants.com, Inc., to Brent J. Fields, Secretary, Commission, dated July 7, 2017 (“Gastineau Letter”); Letter from Todd J. Broms, Chief Executive Officer, Broms & Company LLC, to Brent J. Fields, Secretary, Commission, dated July 10, 2017 (“Broms Letter”); Letter from James J. Angel, Associate Professor of Finance, Georgetown University, McDonough School of Business, to the Commission, dated July 10, 2017 (“Angel Letter”); and Letter from Terence W. Norman, Founder, Blue Tractor Group, LLC, to Brent J. Fields, Secretary, Commission, dated August 1, 2017 (“Norman Letter”). The comment letters are available on the Commission’s Web site at: <https://www.sec.gov/comments/sr-batsbzx-2017-30/batsbzx201730.htm>.

<sup>7</sup> 15 U.S.C. 78s(b)(2)(B).

<sup>8</sup> For a complete description of the Exchange’s proposal, including a description of the Precidian ETF Trust II (“Trust”), see the Notice, *supra* note 3.

<sup>9</sup> Proposed Rule 14.11(k)(3)(A) defines the term “Managed Portfolio Share” as a security that (a) is issued by a registered investment company (“Investment Company”) organized as an open-end management investment company or similar entity, that invests in a portfolio of securities selected by the Investment Company’s investment adviser consistent with the Investment Company’s investment objectives and policies; and (b) when aggregated in a number of shares equal to a Redemption Unit (as defined in proposed Rule 14.11(k)(3)(C)) or multiples thereof, may be redeemed at the request of an authorized participant (as defined in the Investment Company’s Form N-1A filed with the Commission), which authorized participant will be paid through a confidential account (“Confidential Account”) established for its benefit, a portfolio of securities and/or cash with a value equal to the next determined net asset value (“NAV”).

<sup>10</sup> The Exchange represents that, for purposes of describing the holdings of the Funds, ETFs include Portfolio Depository Receipts (as described in Rule 14.11(b)); Index Fund Shares (as described in Rule 14.11(c)); and Managed Fund Shares (as described in Rule 14.11(i)). The ETFs in which a Fund will invest all will be listed and traded on national

equity securities in which the Funds will invest will be listed and traded on U.S. national securities exchanges.

#### 1. ClearBridge Appreciation ETF

The ClearBridge Appreciation ETF will seek to provide long-term appreciation of shareholders’ capital. The Fund will seek to achieve its investment objective by investing primarily in U.S. exchange-listed equity securities. The Fund will typically invest in medium and large capitalization companies, but may also invest in small capitalization companies.

#### 2. ClearBridge Large Cap ETF

The ClearBridge Large Cap ETF will seek long-term capital appreciation. The Fund will seek to achieve its investment objective by taking long and possibly short positions in equity securities or groups of equities that the portfolio managers believe will provide long term capital appreciation. The Fund will normally invest at least 80% of its net assets (plus borrowings for investment purposes) in stocks included in the Russell 1000 Index and ETFs that primarily invest in stocks in the Russell 1000 Index. The Fund purchases securities that the Fund’s sub-adviser, ClearBridge Investments, LLC (“Sub-Adviser”), believes are undervalued, and sells short securities that it believes are overvalued.

#### 3. ClearBridge Mid Cap Growth ETF

The ClearBridge Mid Cap Growth ETF will seek long-term growth of capital. The Fund will seek to achieve its investment objective by investing primarily in U.S. exchange-listed, publicly traded equity and equity-related securities of U.S. companies or other instruments with similar economic characteristics. The Fund may invest in securities of issuers of any market capitalization.

#### 4. ClearBridge Select ETF

The ClearBridge Select ETF will seek to provide long-term growth of capital. The Fund will seek to achieve its investment objective by investing primarily in U.S. exchange-listed, publicly traded equity and equity-related securities of U.S. companies or other instruments with similar economic characteristics. The Fund may invest in securities of issuers of any market capitalization.

securities exchanges. While the Funds may invest in inverse ETFs, the Funds will not invest in leveraged (e.g., 2X, -2X, 3X or -3X) ETFs.

<sup>24</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> See Securities Exchange Act Release No. 80911 (June 13, 2017), 82 FR 27925 (“Notice”).

<sup>4</sup> 15 U.S.C. 78s(b)(2).

<sup>5</sup> See Securities Exchange Act Release No. 81247, 82 FR 36031 (August 2, 2017). The Commission designated September 17, 2017, as the date by which the Commission shall approve or disapprove, or institute proceedings to determine whether to disapprove, the proposed rule change.

### 5. ClearBridge All Cap Value ETF

The ClearBridge All Cap Value ETF will seek long-term capital growth with current income as a secondary consideration. The Fund will seek to achieve its investment objective by investing primarily in common stocks and common stock equivalents, such as preferred stocks and securities convertible into common stocks, of companies the Sub-Adviser believes are undervalued in the marketplace. The Fund may invest up to 25% of its net assets in equity securities of foreign issuers through U.S. exchange-listed depositary receipts.

### 6. Other Investments

According to the Exchange, while each Fund, under normal market conditions, will invest primarily in U.S. exchange-listed securities, as described above, each Fund may invest its remaining assets in other securities and financial instruments as follows: (i) Repurchase agreements;<sup>11</sup> (ii) warrants, rights, and options (limited to 5% of total assets); (iii) cash or cash equivalents;<sup>12</sup> and (iv) other investment companies (including money market funds).

### 7. Investment Restrictions

Each Fund may invest up to an aggregate amount of 15% of its net assets in illiquid assets (calculated at the time of investment),<sup>13</sup> consistent with Commission guidance. Each Fund

<sup>11</sup> The Exchange states that it will be the policy of the Trust to enter into repurchase agreements only with recognized securities dealers, banks, and the Fixed Income Clearing Corporation.

<sup>12</sup> The Exchange states that for purposes of the filing, cash equivalents include short-term instruments (instruments with maturities of less than 3 months) of the following types: (i) U.S. Government securities, including bills, notes and bonds differing as to maturity and rates of interest, which are either issued or guaranteed by the U.S. Treasury or by U.S. Government agencies or instrumentalities; (ii) certificates of deposit issued against funds deposited in a bank or savings and loan association; (iii) bankers' acceptances, which are short-term credit instruments used to finance commercial transactions; (iv) repurchase agreements and reverse repurchase agreements; (v) bank time deposits, which are monies kept on deposit with banks or savings and loan associations for a stated period of time at a fixed rate of interest; (vi) commercial paper, which are short-term unsecured promissory notes; and (vii) money market funds.

<sup>13</sup> In reaching liquidity decisions, the investment adviser to the Trust, Precidian Funds LLC ("Adviser"), may consider the following factors: The frequency of trades and quotes for the security; the number of dealers wishing to purchase or sell the security and the number of other potential purchasers; dealer undertakings to make a market in the security; and the nature of the security and the nature of the marketplace in which it trades (e.g., the time needed to dispose of the security, the method of soliciting offers and the mechanics of transfer).

will monitor its portfolio liquidity on an ongoing basis to determine whether, in light of current circumstances, an adequate level of liquidity is being maintained, and will consider taking appropriate steps in order to maintain adequate liquidity if, through a change in values, net assets, or other circumstances, more than 15% of a Fund's net assets are invested in illiquid assets. Illiquid assets include securities subject to contractual or other restrictions on resale and other instruments that lack readily available markets as determined in accordance with Commission staff guidance.

The Funds will not invest in securities listed on non-U.S. exchanges. The Funds also will not invest in futures, forwards, or swaps. Further, each Fund's investments will be consistent with its investment objective and will not be used to enhance leverage. While a Fund may invest in inverse ETFs, a Fund will not invest in leveraged (e.g., 2X, -2X, 3X or -3X) ETFs.

### B. Key Features of Managed Portfolio Shares

While Investment Companies issuing Managed Portfolio Shares would be actively-managed, and in that respect would be similar to those issuing Managed Fund Shares,<sup>14</sup> Managed Portfolio Shares would differ from Managed Fund Shares in the following respects.

- First, issues of Managed Fund Shares are required to disseminate their "Disclosed Portfolio" at least once daily.<sup>15</sup> By contrast, the portfolio for an issue of Managed Portfolio Shares would be disclosed only quarterly.<sup>16</sup>

- Second, in connection with the redemption of shares in "Redemption Unit" size, the delivery of any portfolio securities in kind would be effected through a Confidential Account for the benefit of the redeeming authorized participant without disclosing the identity of the securities to the authorized participant.

<sup>14</sup> Managed Fund Shares are shares of actively-managed Investment Companies listed and traded under Rule 14.11(i).

<sup>15</sup> Rule 14.11(i)(3)(B) defines the term "Disclosed Portfolio" as the identities and quantities of the securities and other assets held by the Investment Company that will form the basis for the Investment Company's calculation of NAV at the end of the business day. Rule 14.11(i)(4)(B)(ii)(a) requires that, for Managed Fund Shares, the Disclosed Portfolio will be disseminated at least once daily and will be made available to all market participants at the same time.

<sup>16</sup> The Exchange states that the portfolio for an issue of Managed Portfolio Shares would be disclosed quarterly in accordance with normal disclosure requirements otherwise applicable to open-end investment companies registered under the Investment Company Act of 1940 ("1940 Act").

- Third, for each series of Managed Portfolio Shares, a Verified Intraday Indicative Value ("VIIV") would be disseminated by one or more major market data vendors at least every second during the Exchange's Regular Trading Hours (normally, 9:30 a.m. to 4:00 p.m., Eastern Time ("E.T.")).<sup>17</sup> The Exchange states that dissemination of the VIIV will allow investors to determine the estimated intra-day value of the underlying portfolio of a series of Managed Portfolio Shares and will provide a close estimate of that value throughout the trading day.<sup>18</sup>

### C. Arbitrage of Managed Portfolio Shares

The Exchange asserts that market makers will be able to make efficient and liquid markets priced near the VIIV, as long as a VIIV is disseminated at least every second, market makers have knowledge of a Fund's means of achieving its investment objective, and market makers are permitted to engage in "bona fide arbitrage," as described below. According to the Exchange, market makers would employ bona fide arbitrage in addition to risk-management techniques such as "statistical arbitrage,"<sup>19</sup> which the Exchange states is currently used throughout the financial services industry, to make efficient markets in ETFs.

According to the Exchange, if an authorized participant believes that Shares of a Fund are trading at a price

<sup>17</sup> Proposed Rule 14.11(k)(3)(B) defines the VIIV as the estimated indicative value of a Managed Portfolio Share based on all of the issuer's holdings as of the close of business on the prior business day, priced and disseminated in at least one second intervals, and subject to validation by a pricing verification agent of the Investment Company that is responsible for comparing multiple independent pricing sources to establish the accuracy of the VIIV.

<sup>18</sup> According to the Exchange, the VIIV should not be viewed as a "real-time" update of the NAV per Share of each Fund, because the VIIV may not be calculated in the same manner as the NAV, which will be computed once a day, generally at the end of the business day.

<sup>19</sup> According to the Exchange, statistical arbitrage enables a trader to construct an accurate proxy for another instrument, allowing the trader to hedge the other instrument or buy or sell the instrument when it is cheap or expensive in relation to the proxy. Statistical analysis permits traders to discover correlations based purely on trading data without regard to other fundamental drivers. These correlations are a function of differentials, over time, between one instrument or group of instruments and one or more other instruments. Once the nature of these price deviations has been quantified, a universe of securities is searched in an effort to, in the case of a hedging strategy, minimize the differential. Once a suitable hedging proxy has been identified, a trader can minimize portfolio risk by executing the hedging basket. The trader then can monitor the performance of this hedge throughout the trade period making correction where warranted.

that is higher than the value of the underlying portfolio—for example, if the market price for the Shares is higher than the VIIV—then the authorized participant may sell Shares of the Fund short and instruct its “Trusted Agent”<sup>20</sup> to buy portfolio securities for its Confidential Account. When the market price of the Shares falls in line with the value of the portfolio, the authorized participant can then close out its positions in both the Shares and the portfolio securities. According to the Exchange, the authorized participant’s purchase of the portfolio securities into its Confidential Account, combined with the sale of Shares, may create downward pressure on the price of Shares and/or upward pressure on the price of the portfolio securities, bringing the market price of Shares and the value of a Fund’s portfolio securities closer together. Similarly, according to the Exchange, an authorized participant could buy Shares and instruct the Trusted Agent to sell the underlying portfolio securities from its Confidential Account in an attempt to profit when a Fund’s Shares are trading at a discount to its portfolio. According to the Exchange, the authorized participant’s purchase of a Fund’s Shares in the secondary market, combined with the sale of the portfolio securities from its Confidential Account, may create upward pressure on the price of Shares and/or downward pressure on the price of portfolio securities, driving the market price of Shares and the value of a Fund’s portfolio securities closer together. The Exchange states that, according to the Adviser, this process is identical to how many authorized participants currently arbitrage existing traditional ETFs, except for the use of the Confidential Account.

According to the Exchange, a market participant that is not an authorized participant would also be able to establish a Confidential Account and could engage in arbitrage activity without using the creation or redemption processes described above. The Exchange states that if such a market participant believes that a Fund is overvalued relative to its underlying assets, the market participant could sell Shares short and instruct its Trusted Agent to buy portfolio securities in its

<sup>20</sup> Proposed Rule 14.11(k)(2)(D) requires that authorized participants redeeming Managed Portfolio Shares sign an agreement with an agent (“Trusted Agent”) to establish a Confidential Account, for the benefit of such authorized participant, that will receive all consideration from the issuer in a redemption. A Trusted Agent may not disclose the consideration received in a redemption except as required by law or as provided in the Investment Company’s Form N-1A, as applicable.

Confidential Account, wait for the trading prices to move toward parity, and then close out the positions in both the Shares and the portfolio securities to realize a profit from the relative movement of their trading prices. Similarly, according to the Exchange, a market participant could buy Shares and instruct the Trusted Agent to sell the underlying portfolio securities in an attempt to profit when a Fund’s Shares are trading at a discount to a Fund’s underlying or reference assets.

#### D. The Creation and Redemption Procedures

The Exchange states that, generally, Shares will be purchased and redeemed on an in-kind basis. Accordingly, except where the purchase or redemption will include cash under the circumstances described in the applicable Fund’s registration statement, purchasers will be required to purchase “Creation Units” by making an in-kind deposit of specified instruments (“Deposit Instruments”), and shareholders redeeming their Shares will receive an in-kind transfer of specified instruments (“Redemption Instruments”). On any given business day, the names and quantities of the instruments that constitute the Deposit Instruments and the names and quantities of the instruments that constitute the Redemption Instruments will be identical, and these instruments may be referred to, in the case of either a purchase or a redemption, as the “Creation Basket.”

In the case of a redemption, a Fund’s custodian (“Custodian”) will typically deliver securities to the Confidential Account on a *pro rata* basis with a value approximately equal to the value of the Shares tendered for redemption at the redemption order cut-off time established by the Fund. The Custodian will make delivery of the securities by appropriate entries on its books and records transferring ownership of the securities to the authorized participant’s Confidential Account, subject to delivery of the Shares redeemed. The Trusted Agent of the Confidential Account will in turn liquidate, hedge, or otherwise manage the securities based on instructions from the authorized participant.<sup>21</sup>

If the Trusted Agent is instructed to sell all securities received at the close on the redemption date, the Trusted

<sup>21</sup> The Exchange represents that an authorized participant will issue execution instructions to the Trusted Agent and be responsible for all associated profit or losses. Like a traditional ETF, the authorized participant has the ability to sell the basket securities at any point during normal trading hours.

Agent will pay the liquidation proceeds net of expenses, plus or minus any cash balancing amount, to the authorized participant through DTC.<sup>22</sup> The redemption securities that the Confidential Account receives are expected to mirror the portfolio holdings of a Fund *pro rata*.

#### E. Availability of Information

Each Fund will be required to file with the Commission its complete portfolio schedules for the second and fourth fiscal quarters on Form N-CSR under the 1940 Act, and to file its complete portfolio schedules for the first and third fiscal quarters on Form N-Q under the 1940 Act, within 60 days of the end of the quarter. Form N-Q requires funds to file the same schedules of investments that are required in annual and semi-annual reports to shareholders. The Trust’s SAI and each Fund’s shareholder reports will be available free upon request from the Trust. These documents and forms may be viewed on-screen or downloaded from the Commission’s Web site at [www.sec.gov](http://www.sec.gov).

In addition, the VIIV will be widely disseminated by one or more major market data vendors at least every second during the Regular Trading Hours.<sup>23</sup> According to the Exchange, the VIIV will include all accrued income and expenses of a Fund and will assure that any extraordinary expenses, booked during the day, which would be taken into account in calculating a Fund’s NAV for that day, are also taken into account in calculating the VIIV.

For purposes of the VIIV, securities held by a Fund will generally be valued throughout the day based on the mid-point between the disseminated current national best bid and offer. According to the Exchange, by utilizing the mid-point pricing for purposes of VIIV calculation, stale prices are eliminated and more accurate representation of the real-time value of the underlying securities is provided to the market. Specifically,

<sup>22</sup> According to the Exchange, under applicable provisions of the Internal Revenue Code, the authorized participant is expected to be deemed a “substantial owner” of the Confidential Account because it receives distributions from the Confidential Account. As a result, the Exchange states, all income, gain, or loss realized by the Confidential Account will be directly attributed to the authorized participant. The Exchange also states that, in a redemption, the authorized participant will have a basis in the distributed securities equal to the fair market value at the time of the distribution, and any gain or loss realized on the sale of those Shares will be taxable income to the authorized participant.

<sup>23</sup> The Exchange states that it will disseminate the VIIV for each Fund in at least one-second intervals during Regular Trading Hours, through the facilities of the Consolidated Tape Association.

according to the Exchange, quotations based on the mid-point of bid/ask spreads more accurately reflect current market sentiment by providing real time information on where market participants are willing to buy or sell securities at that point in time. The Exchange also believes that the use of quotations will dampen the impact of any momentary spikes in the price of a portfolio security.

According to the Exchange, each Fund will utilize two independent pricing sources to provide two independent sources of pricing information. Each Fund will also utilize a "Pricing Verification Agent" and establish a computer-based protocol that will permit the Pricing Verification Agent to continuously compare the two data streams from the independent pricing sources on a real time basis.<sup>24</sup> A single VIIV will be disseminated publicly for each Fund; however, the Pricing Verification Agent will continuously compare the public VIIV against a non-public alternative intraday indicative value to which the Pricing Verification Agent has access. If it becomes apparent that there is a material discrepancy between the two data streams, the Exchange will be notified and have the ability to halt trading in a Fund until the discrepancy is resolved.<sup>25</sup> Each Fund's board of directors will review the procedures used to calculate the VIIV and maintain its accuracy as appropriate, but not less than annually. The specific methodology for calculating the VIIV will be disclosed on each Fund's Web site.

<sup>24</sup> A Fund's Custodian will provide, on a daily basis, the constituent basket file comprised of all securities plus any cash to the independent pricing agent(s) for purposes of pricing.

<sup>25</sup> Proposed Rule 14.11(k)(4)(B)(iii) provides that, upon notification to the Exchange by the Investment Company or its agent that (i) the prices from the multiple independent pricing sources to be validated by the Investment Company's Pricing Verification Agent differ by more than 25 basis points for 60 seconds in connection with pricing of the VIIV, or (ii) the VIIV of a series of Managed Portfolio Shares is not being priced and disseminated in at least one-second intervals, as required, the Exchange will halt trading in the Managed Portfolio Shares as soon as practicable. The halt in trading would continue until the Investment Company or its agent notifies the Exchange that the prices from the independent pricing sources no longer differ by more than 25 basis points for 60 seconds or that the VIIV is being priced and disseminated as required. The Investment Company or its agent would be responsible for monitoring that the VIIV is being priced and disseminated as required and whether the prices to be validated from multiple independent pricing sources differ by more than 25 basis points for 60 seconds.

#### F. Surveillance

The Exchange represents that trading of the Shares will be subject to its surveillance procedures for derivative products. The Exchange believes that its surveillance procedures are adequate to properly monitor the trading of the Shares on the Exchange during all trading sessions and to deter and detect violations of Exchange rules and the applicable federal securities laws.<sup>26</sup>

The Exchange represents that the Funds' Adviser will make available daily to FINRA and the Exchange the portfolio holdings of each Fund in order to facilitate the performance of the surveillances referred to above. In addition, the Exchange states that it has a general policy prohibiting the distribution of material, non-public information by its employees.

#### II. Summary of Comment Letters

The Commission has received four comment letters on the proposed rule change, each of which expresses opposition to the proposed rule change.<sup>27</sup> As of the date of this order instituting proceedings, the Exchange has not submitted a response to the comments.

A. *Gastineau Letter*.<sup>28</sup> The commenter opposes approval of the proposed rule change and recommends imposition of a number of requirements in the event the proposed rule change and exemptive application are approved. As an initial matter, the commenter believes that the proposed selective disclosure of Fund portfolio holdings information to Trusted Agents trading on behalf of Confidential Account holders would constitute insider trading and would violate federal securities laws.

In addition, the commenter asserts that market makers will face significant impediments to successfully arbitrage the Shares and predicts that this will lead to the Shares trading at wider bid-ask spreads and more variable premiums/discounts than actively-

<sup>26</sup> The Exchange represents that the Exchange or FINRA, on behalf of the Exchange, or both, will communicate as needed regarding trading in the Shares, underlying stocks, ETFs, and exchange-listed options with other markets and other entities that are members of the Intermarket Surveillance Group ("ISG"), and the Exchange or FINRA, on behalf of the Exchange, or both, may obtain trading information regarding such securities from such markets and other entities. In addition, the Exchange may obtain information regarding trading in the Shares, underlying stocks, ETFs and exchange-listed options from markets and other entities that are members of ISG or with which the Exchange has in place a comprehensive surveillance sharing agreement.

<sup>27</sup> See *supra* note 6.

<sup>28</sup> The *Gastineau Letter* is available at: <https://www.sec.gov/comments/sr-batsbzx-2017-30/batsbzx201730-1852499-155333.pdf>.

managed ETFs available today. First, the commenter questions the Exchange's assertion that the VIIV will provide an adequate basis for ensuring a Fund's ongoing price value alignment and secondary market trading efficiency. In evaluating the Exchange's statements regarding VIIVs, the commenter asserts that their utility should be compared not to the intraday indicative values ("IIVs") of existing ETFs but rather to the independently derived, real-time estimates of underlying fund value that ETF market makers use today to identify arbitrage opportunities and manage their risks ("MM IIVs"). The commenter asserts that, because existing actively-managed ETFs (and most index ETFs) provide full daily disclosure of their current portfolio, market makers of transparent funds have access to far better information about the current value of fund holdings than the proposed VIIVs would provide. Moreover, the commenter asserts that VIIVs will be significantly less precise than MM IIVs. The commenter also asserts that MM IIVs include significant information that would not be reflected in VIIVs, noting as follows:

- In calculating VIIVs, Fund securities would be valued based on the mid-point between the current national best bid and offer quotations. The commenter characterizes the bid-ask midpoint as a "fairly crude valuation metric" that does not capture important trading information incorporated into MM IIVs, such as the current bid-ask spread, the depth of the current order book on the bid and offer side of the market, and the predominance of current trading between bid-side and offer-side transactions.<sup>29</sup>

- VIIVs would be disseminated at least every second, while internal valuations used by market makers update continuously (often at frequencies higher than once per second) and may be reflected in MM IIVs with less time lag.

- The VIIV verification process would leave significant room for dissemination of erroneous values. In particular, 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. The commenter characterizes that disparity as "huge," asserting that it would be

<sup>29</sup> The commenter also states that the use of bid-ask midpoints can result in flawed intraday valuations for funds holding thinly-traded stocks, and that bid-ask midpoints may reflect prices at which no trading is permitted.

wider than the customary bid-ask spread of most domestic equity ETFs.<sup>30</sup>

- The VIIV process would not address all potential intraday valuation errors. The commenter notes that if the constituent basket file for a Fund includes material inaccuracies, the VIIVs would be erroneous. The commenter also describes that market makers would not be able to verify that corporate actions are appropriately reflected in a Fund's VIIVs because of the non-transparent portfolio.

- The 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 commenter states that, throughout this process, which may be protracted, the Fund would continue to disseminate VIIVs 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 commenter asserts that the internal valuation process of any existing ETF's market makers would almost certainly arrive at a fair estimate of a Fund's current underlying value far faster than the VIIV adjustment process.

The commenter asserts that reliance on faulty VIIVs may expose market makers to unrecoverable losses, noting that: (1) No liability for the timeliness and accuracy of the VIIVs appears to rest with the Exchange, its agents, or the Reporting Authority; and (2) the circumstances under which the independent pricing sources and the Pricing Verification Agent are legally liable for such issues are limited.

According to the commenter, market makers' forced reliance on VIIVs to determine intraday Fund valuations is a source of significant incremental risk for them versus making markets in existing ETFs. The commenter predicts that this will result in the Shares trading at wider bid-ask spreads and more variable premiums and discounts to NAV than similar existing ETFs.<sup>31</sup>

The commenter also criticizes the Confidential Accounts structure. The commenter asserts that, compared to the usual manner in which market makers in existing ETFs engage in arbitrage and buy and sell creation basket instruments, the Confidential Accounts arrangement exposes market makers to

significant additional costs, risks, and lost opportunities, including:

- Less control over trade execution and trade order management when implementing portfolio hedging and Creation Unit instrument transactions, which will result in more cost and risk, and less profit opportunity.

- No ability for market makers to use their market knowledge and their positions in other securities to enhance arbitrage profits and minimize costs.

- Reduced incentive for third-party service providers to trade expeditiously and with low market impact.

- Little or no ability for market makers to monitor trading in Confidential Accounts to ensure best execution or to evaluate trading performance.

- Forced *pro rata* hedging, which is very often not the best hedge. Sub-optimal hedging results in less efficient arbitrage.

- Given the more-involved routing of trade instructions and trade orders that the Confidential Account structure would necessitate, hedging and Creation Unit instrument transactions through Confidential Accounts will almost certainly take longer, on average, for a market maker to execute than similar transactions that the market maker executes internally. Slower executions may translate into less efficient arbitrage.

- Potentially significant explicit costs to establish and maintain Confidential Accounts.

Additionally, the commenter questions the Exchange's statements regarding the efficiency and utility of statistical arbitrage. The commenter states that while market makers may be able to gain some useful information about a Fund's current composition by knowing the Fund's investment objective and tracking performance correlations over time versus a known index, the amount of portfolio information that can be gleaned using this approach is limited. The commenter states that, as a result, any portfolio hedge constructed using this information would be subject to meaningful basis risk, especially during times of market stress or volatility.

The commenter expresses concerns regarding data security, and the misappropriation and misuse of a Fund's confidential portfolio information, in light of the dissemination of this information across a potentially broad network of Trusted Agents, affiliated broker-dealers, and other Confidential Account service providers. The commenter also raises concerns regarding the possibility that market participants could reverse-

engineer the Funds' portfolio holdings, subjecting the Funds to the dilutive effects of front-running. The commenter asserts that "it is far from a settled question that the Funds would not ever be susceptible to reverse engineering."

Moreover, the commenter raises concerns regarding the ability of the Funds, the authorized participants, and the non-authorized participant market makers, to comply with various laws, rules, and regulations. In addition, the commenter recommends certain limitations on the permitted investments of the Funds, and recommends the availability of certain information.

B. *Broms Letter*.<sup>32</sup> The commenter opposes the proposed rule change. The commenter asserts that the proposed selective disclosure of confidential Fund holdings information to Trusted Agents for trading on behalf of Confidential Account holders would violate federal securities laws. In addition, the commenter believes that the mechanism for ensuring secondary market trading efficiency in the Shares is "unreliable" and predicts that the Shares will likely trade at significantly wider bid-ask spreads and/or more variable premiums/discounts than existing ETFs. The commenter also expresses concerns regarding the following:

- The likelihood that the Shares' trading performance will be especially poor during periods of market stress and volatility.

- The ability to ensure the security of confidential Fund information disseminated to Trusted Agents, their affiliates, and service providers.

- Potentially significant added Fund costs and risks associated with calculating, verifying, and disseminating the VIIV and associated Fund warranties.

- The potential for frequent Share trading halts.

- The likely incidence of erroneous Share trades and the absence of an Exchange program to detect and remedy such trades.

- The potential for reverse engineering of a Fund's portfolio holdings.

- The tax risk due to the Funds' distinctive in-kind redemption program.

- The costs, risks, and uncertainties to broker-dealers serving as authorized participants and non-authorized participant market makers in meeting their compliance obligations with respect to securities traded on their behalf through Confidential Accounts.

<sup>30</sup>This commenter also expresses concern that if trading in a Fund's Shares is frequently interrupted by trading halts, there could be severe damage to the Fund's ongoing liquidity and trading efficiency. Moreover, the commenter states that the proposal does not address the treatment of erroneous Fund Share trades resulting from faulty VIIVs.

<sup>31</sup>The commenter also expresses concerns with respect to VIIV-related costs and liabilities for the Funds.

<sup>32</sup>The Broms Letter is available at: <https://www.sec.gov/comments/sr-batsbzx-2017-30/batsbzx201730-1842158-155104.pdf>.

*C. Angel Letter.*<sup>33</sup> The commenter opposes the proposal. The commenter believes that the opaque nature of the products and the inability of arbitrageurs to closely monitor execution quality will make arbitrage more difficult and the added costs and risks will lead to wider deviations of the market price from the underlying asset value. In addition, the commenter raises concerns that the Funds may fare worse than traditional ETFs during times of market disruption given their opacity and the complexity of the arbitrage relationship between the Funds and the underlying securities. The commenter also expresses concern that selective disclosure of portfolio information could raise issues under Regulation FD and that the use of Confidential Accounts could raise issues under Regulation SHO.

In addition, the commenter expresses the following concerns:

- It is unclear whether a firm's risk management would have access to the contents of Confidential Accounts. If a firm's risk management does not have access to such information, the firm would be subject to too much risk, but if the firm's risk management does have access, information barriers would create compliance complexities.
- Positions held in the Confidential Account not closed out by the end of the day would have to be settled, and the settlement information would be available to settlement personnel.
- The Trusted Agents would have serious compliance burdens, and these burdens could drive up the cost of being a Trusted Agent, which would drive up the cost of arbitrage. Higher costs and compliance risks would severely limit the number of firms willing to take on the burden of becoming Trusted Agents, and less competition could lead to higher fees and inferior service. In the event that there were many Trusted Agents, the likelihood of data breaches would increase.

In addition, the commenter believes that the VIIV calculations are dangerously flawed because they rely on sometimes flawed bid-ask quotes. The commenter believes that the VIIV should instead be based on the last trade, and if the underlying market is closed or the underlying asset has not traded recently, then a reasonable fair value methodology should be used.<sup>34</sup>

<sup>33</sup> The Angel Letter is available at: <https://www.sec.gov/comments/sr-batsbzx-2017-30/batsbzx201730-1843677-155109.pdf>.

<sup>34</sup> The commenter also states that VIIVs should be disseminated over the standard consolidated feeds, not specialized feeds, such that they are widely available to all investors.

Moreover, the commenter states that the proposed Funds are very different from ETFs and should not be labeled or approved as ETFs.

*D. Norman Letter.*<sup>35</sup> The commenter opposes the proposed rule change. The commenter refutes the Trust's statistical analysis that purports to demonstrate that the Funds' portfolio compositions could not be reverse engineered.<sup>36</sup> The commenter's analysis concludes that reverse engineering of a Fund's portfolio is in fact "achievable with a substantial degree of accuracy."<sup>37</sup> The commenter also asserts that, without knowledge of a Fund's underlying stocks, market makers may be unable to hedge their risks, which would result in wider and more persistent spreads or the market maker choosing not to make a market in the Shares. In addition, the commenter questions the sufficiency of disseminating the VIIV at one-second intervals, given that high frequency trading takes place in milliseconds, and raises concerns about potential systems failures that may disrupt the dissemination of VIIV. Finally, the commenter believes that selective disclosure of portfolio information to Trusted Agents would violate federal securities laws, and expresses concern regarding the security of confidential portfolio information.

### III. Proceedings To Determine Whether To Approve or Disapprove SR-BatsBZX-2017-30 and Grounds for Disapproval Under Consideration

The Commission is instituting proceedings pursuant to Section 19(b)(2)(B) of the Act<sup>38</sup> to determine whether the proposed rule change should be approved or disapproved. Institution of such proceedings is appropriate at this time in view of the legal and policy issues raised by the proposed rule change. Institution of proceedings does not indicate that the Commission has reached any conclusions with respect to any of the issues involved. Rather, as described below, the Commission seeks and encourages interested persons to

<sup>35</sup> The Norman Letter is available at: <https://www.sec.gov/comments/sr-batsbzx-2017-30/batsbzx201730-2161995-157800.pdf>.

<sup>36</sup> See Third Amended and Restated Application for an Order for exemptions from various provisions of the 1940 Act and rules thereunder (File No. 812-14405), dated May 2, 2017, at Exhibit E ("Additional Research on the Ability to Reverse Engineer the Proposed Precidian ETF," by Ricky Alyn Cooper, Ph.D., dated August 2015).

<sup>37</sup> See Norman Letter, Appendix One ("The Reverse Engineering of Portfolio Compositions," by Dr. Anthony Hayter, dated July 17, 2017).

<sup>38</sup> 15 U.S.C. 78s(b)(2)(B).

provide comments on the proposed rule change.

Pursuant to Section 19(b)(2)(B) of the Act,<sup>39</sup> the Commission is providing notice of the grounds for disapproval under consideration. The Commission is instituting proceedings to allow for additional analysis of the proposed rule change's consistency with Section 6(b)(5) of the Act, which requires, among other things, that the rules of a national securities exchange be "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 market and a national market system, and, in general, to protect investors and the public interest."<sup>40</sup>

### IV. Procedure: Request for Written Comments

The Commission requests that interested persons provide written submissions of their views, data, and arguments with respect to the issues identified above, as well as any other concerns they may have with the proposal. In particular, the Commission invites the written views of interested persons concerning whether the proposal is consistent with Section 6(b)(5) or any other provision of the Act, or the rules and regulations thereunder. Although there do not appear to be any issues relevant to approval or disapproval that would be facilitated by an oral presentation of views, data, and arguments, the Commission will consider, pursuant to Rule 19b-4, any request for an opportunity to make an oral presentation.<sup>41</sup>

Interested persons are invited to submit written data, views, and arguments regarding whether the proposal should be approved or disapproved by October 10, 2017. Any person who wishes to file a rebuttal to any other person's submission must file that rebuttal by October 23, 2017.

The Commission asks that commenters address the sufficiency of the Exchange's statements in support of the proposal, which are set forth in the Notice,<sup>42</sup> in addition to any other

<sup>39</sup> *Id.*

<sup>40</sup> 15 U.S.C. 78f(b)(5).

<sup>41</sup> Section 19(b)(2) of the Act, as amended by the Securities Acts Amendments of 1975, Public Law 94-29 (June 4, 1975), grants the Commission flexibility to determine what type of proceeding—either oral or notice and opportunity for written comments—is appropriate for consideration of a particular proposal by a self-regulatory organization. See Securities Acts Amendments of 1975, Senate Comm. on Banking, Housing & Urban Affairs, S. Rep. No. 75, 94th Cong., 1st Sess. 30 (1975).

<sup>42</sup> See *supra* note 3.

comments they may wish to submit about the proposed rule change. Specifically, the Commission seeks comment on the statements of the Exchange contained in the Notice, the issues raised by the commenters, and any other issues raised by the proposed rule change. In addition, the Commission seeks comment on whether the trading of the Shares would be consistent with the maintenance of fair and orderly markets. In this regard, the Commission specifically seeks comment regarding market makers' ability to make markets in the Shares and the sufficiency of the proposed VIIV as pricing information to market participants. Further, the Commission solicits comments on whether the selective disclosure of portfolio holdings to a Trusted Agent, as well as the non-transparent structure of the Funds, could result in any information asymmetry that would be inconsistent with the Act or other federal securities laws or rules and regulations thereunder.

Comments may be submitted by any of the following methods:

#### *Electronic Comments*

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an email to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-BatsBZX-2017-30 on the subject line.

#### *Paper Comments*

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street NE., Washington, DC 20549-1090.
- All submissions should refer to File Number SR-BatsBZX-2017-30. This file number should be included on the subject line if email is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for Web site viewing and printing in the Commission's Public Reference Room, 100 F Street NE., Washington, DC 20549, on official business days between the hours of

10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-BatsBZX-2017-30 and should be submitted on or before October 10, 2017. Rebuttal comments should be submitted by October 23, 2017.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>43</sup>

**Eduardo A. Aleman,**  
*Assistant Secretary.*

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**BILLING CODE 8011-01-P**

## **SECURITIES AND EXCHANGE COMMISSION**

**[Release No. 34-81602; File No. SR-IEX-2017-29]**

### **Self-Regulatory Organizations; Investors Exchange LLC; Notice of Filing and Immediate Effectiveness of Proposed Rule Change Related to Fees Pursuant to Rule 15.110**

September 13, 2017.

Pursuant to Section 19(b)(1)<sup>1</sup> of the Securities Exchange Act of 1934 (the "Act")<sup>2</sup> and Rule 19b-4 thereunder,<sup>3</sup> notice is hereby given that, on August 30, 2017, the Investors Exchange LLC ("IEX" or the "Exchange") filed with the Securities and Exchange Commission (the "Commission") the proposed rule change as described in Items I, II and III below, which Items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### **I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change**

Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 ("Act"),<sup>4</sup> and Rule 19b-4 thereunder,<sup>5</sup> Investors Exchange LLC ("IEX" or "Exchange") is filing with the Commission a proposed rule change to make a correction to the Exchange Fee Schedule related to fees for executions

that involve taking resting interest with non-displayed priority with a displayable order. The Exchange proposes to implement the change beginning on September 1, 2017. The text of the proposed rule change is available at the Exchange's Web site at [www.iextrading.com](http://www.iextrading.com), at the principal office of the Exchange, and at the Commission's Public Reference Room.

#### **II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change**

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

##### *A. Self-Regulatory Organization's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rule Change*

###### 1. Purpose

The Exchange proposes to amend its Fee Schedule, pursuant to IEX Rule 15.110 (a) and (c), to make a correction related to the fees for executions that involve taking non-displayed resting interest with a displayable order. Subject to certain exceptions, the Exchange charges \$0.0009 per share (or 0.30% of the total dollar value of the transaction for securities priced below \$1.00) to Members for executions on IEX that include resting non-displayed interest<sup>6</sup> for both the liquidity providing and liquidity removing order (the "Non-Displayed Match Fee").<sup>7</sup> One such exception relates to certain displayable orders that remove non-displayed liquidity upon entry. The Exchange Fee Schedule provides that the Non-Displayed Match Fee is not charged for displayable orders<sup>8</sup> that remove non-displayed liquidity upon entry if, on a monthly basis, at least 90% of the liquidity removing MPID's aggregate executed shares of displayable orders added liquidity during the month

<sup>6</sup> Non-displayed priority refers to an order or portion of a reserve order that is booked and ranked with non-display priority on the Order Book. See Rules 11.190(b)(3) and 11.190(b)(2).

<sup>7</sup> This pricing is referred to by the Exchange as the "Non-Displayed Match Fee" on the Fee Schedule with a Fee Code of 'I' which is provided by the Exchange on execution reports.

<sup>8</sup> See Rule 11.190(b)(3).

<sup>43</sup> 17 CFR 200.30-3(a)(57).

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 15 U.S.C. 78a.

<sup>3</sup> 17 CFR 240.19b-4.

<sup>4</sup> 15 U.S.C. 78s(b)(1).

<sup>5</sup> 17 CFR 240.19b-4.