What Advisors Need to Know About Trading ETFs

By Gary L. Gastineau

Advisors are using exchange-traded funds (ETFs) for a growing percentage of fund applications in clients’ accounts. This trend will accelerate as the advantages of ETFs over conventional mutual funds are more widely appreciated and as improved ETFs are introduced. The purpose of this article is to help advisors develop the basic trading skills they need to use ETFs effectively. The more ETFs you use and the more actively you trade them, the more important it is to trade them efficiently.

Three principal advantages of investment company ETFs over mutual funds are behind the increased use of ETFs:

Shareholder protection. Every shareholder of a conventional mutual fund pays part of the trading costs for other shareholders who enter or leave the fund. As figure 1 illustrates, mutual fund investors put in cash and take out cash. The transactions to buy and sell securities are paid for by all shareholders in the fund. Because of the way ETF shares are created, redeemed, and traded, ETF investors pay the cost of their own entries and exits from an ETF; they do not pay anyone else’s entry and exit costs. The allocation of ETF flow transaction costs is illustrated in figure 2, which shows that costs of acquiring and disposing of securities associated with changes in the size of the fund are borne by the investors entering and leaving the fund. Edelen et al. (2007) showed that the cost of investor flow transactions in the average mutual fund is about 75 basis points per year, so the fees some funds impose on entering or leaving investors rarely cover the cost of flow. Most such fees are levied only on redemptions made within a year (or less) of purchase. The cost of a flow transaction is a permanent performance penalty. It does not go away after a year. The opportunity to use ETFs to avoid the ongoing burden of this mutual fund cost is attractive to long-term fund investors. Because ETF performance is unburdened by the ongoing cost of flow, an ETF using the same investment process as a mutual fund is likely to outperform the mutual fund over any reasonable time span.

Tax efficiency. The ability to defer realization of capital gains indefinitely in many ETFs is widely discussed—if not widely understood. The tax deferral mechanism available in ’40 Act ETFs provides greater flexibility to portfolio managers responsible for funds that are used in both taxable and tax-exempt investor accounts (Gastineau 2010, 65–100).

Lower operating costs. ETF operating costs typically are lower than mutual fund operating costs. Savings on shareholder accounting, position management, and custody costs are reflected in generally lower expense ratios for ETFs.
Coming ETF Attractions

Today’s most popular ETFs are based on widely used benchmark indexes. One weakness of these funds is that the announcement of changes in a popular index attracts traders who attempt to front-run index fund transactions, typically buying shares of a stock to be added to the index before the fund trades. New nontransparent indexed and actively managed ETFs will eliminate front running and increase the range of choices available to investors.

For clients to benefit fully from ETFs, advisors need to protect clients from unnecessary trading costs. Advisors who buy and sell mutual funds have not needed trading skills. An advisor who buys and sells ETF shares needs to learn how to minimize ETF trading costs.

Buying and Selling ETFs is More Complicated than Trading Mutual Fund Shares

A mutual fund trade usually has little or no measurable market impact on net asset value (NAV). Consequently, advisors who use mutual funds for client investments have not developed a skill set that enables them to trade a wide range of securities. Even an experienced stock trader soon learns that the slogan “ETFs trade just like a stock” is an exaggeration. Table 1 compares some characteristics of stock trading and ETF trading.

Hence advisors need to understand how the ETF market itself works.

Actually, two very different ETF markets are operating today and a new ETF trading process is just over the horizon. The first existing ETF market is the market in high-volume benchmark index ETFs, and the second is the market for less actively traded ETFs. The market just over the horizon is a new market where ETFs will trade throughout the day at prices contingent on the NAV calculated for the fund’s portfolio at the end of the trading day.

Most benchmark index ETFs are very large funds that trade between 100,000 and 250 million shares per day. The typical bid/asked spread for these ETFs is a penny or two. Some of the most actively traded ETFs, such as the 500 SPDR (which has an almost permanent place on the “most active stocks” list), regularly trade at a $0.01 spread with frequent locked or crossed markets.

Major Benchmark Index ETF Trading Environment

This description of the major benchmark index ETF market applies to trading in the shares of less than 10 percent of existing ETFs. These ETFs, however, account for about two-thirds of ETF assets and more than 90 percent of ETF share trading volume. Most of the major benchmark index ETFs have been around for 8–10 years or longer. In spite of high volume and narrow posted spreads, some potential traps exist for unwary traders.

Trading in all of today’s ETFs is “supported” by a calculation called the indicative optimized portfolio value (IOPV). The IOPV is rarely used by any serious trader, for several reasons. First, the IOPV is based on the last sale of each portfolio position. Many of the positions in an ETF are much less actively traded than the ETF itself, so the IOPV calculation usually reflects stale prices. More importantly, you can’t trade with the IOPV. You only can trade with other investors’ bids and offers that are available in the market at the time you want to trade.

The large benchmark index ETFs are favorites with high-frequency traders who buy and sell them in huge quantities. However, the depth of the market may not be great throughout the trading day. A 500 SPDR position worth, say, $10 million–$100 million can be established or liquidated efficiently in a single day by a trader with modest skills. However, every trader should keep in mind that the volumes associated with high-frequency trading do not neces-

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<th>TABLE 1: COMPARISON OF STOCK TRADING AND ETF TRADING</th>
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<td><strong>Share price published</strong></td>
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<td><strong>Share bids/offers published</strong></td>
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<td><strong>Frequency of quote changes</strong></td>
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<td><strong>Capitalization</strong></td>
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<td><strong>Role of market maker</strong></td>
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<td><strong>Trading costs: market-on-close order impact</strong></td>
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<td><strong>Trading costs: NAV market</strong></td>
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sarily mean that huge bids and offers are exposed in the market at all times. In fact, anyone trying to trade in large size will look at the depth of the book. Your trading terminal or the brokerage firm that handles your trades will be able to provide information on the size of the best bids and offers and other bids and offers close to the current market. You want to look at the number of shares bid for or offered, not only at the best bid or offer (BBO), but also the size bid for at slightly lower prices and offered at slightly higher prices. Millions of shares may be trading every few minutes, but the book may be thin at prices within a few cents of the last trade.

One effect of high-frequency trading is that spreads in an active market are typically a penny or less. If you enter a limit order at a round penny, you risk being "subpennied." An aggressive trader may put a bid above your bid by a tiny fraction of a penny. That trader is using your limit order as a backstop: His order has priority over yours. If he buys some shares and the price moves up he can sell the shares he's purchased at a profit that is significant relative to the small risk he has taken and your order will not be filled. If, on the other hand, a large seller comes in and his subpenny bid is filled, the aggressive trader can turn around and hit your round penny bid at a very small loss. You may find yourself buying shares ahead of an avalanche of sell orders when you might prefer that your order not be filled.

Even if you see a resting bid or offer that is large enough to fill your order, it usually is better to use a marketable limit order rather than either 1) a market order or 2) a resting limit order. A marketable limit order is an order with a limit that appears to be readily executable given the bids or offers on the book, but the limit will keep you from paying more or receiving less than the limit. If the book is thin, a market order can cause the price to move more than a few pennies. In contrast, a marketable limit order will not permit an execution beyond the stated limit. You might enter the marketable limit order "immediate or cancel" so that it does not become a resting limit order subject to subpennying. The best time to trade an ETF is usually during the last hour of trading when bid/asked spreads tend to be tightest and volume is highest. Dick (2010) provides a very accessible discussion of some of the perils of using limit orders in a decimalized electronic market; Linnainmaa (2010) provides a more comprehensive discussion of problems with limit orders.

The best feature of these funds is that they can be traded at very low cost. Their weakness is that the transparency of their index composition changes reduces their returns and makes them relatively unattractive candidates for long-term holding—even with low expense ratios. Vanguard's introduction of a 6-basis-point expense ratio on an ETF share class of their S&P 500 fund looks like a bargain at first glance. The low expense ratio may draw more assets to that index and even boost performance of all S&P 500 index funds in the short term, but the impact of front-running every change in the index will soon dwarf the effect of the slightly lower expense ratio (Gastineau 2010, 101–129). The fact that the major benchmark index ETFs trade with tight spreads and in large size makes them ideal candidates for temporary positions when an advisor wants to make a significant change in a client's asset allocation quickly and establish the best long-term position in each asset class patiently (Gastineau 2010, 265–272).

Trading Less-Active ETFs

While the size of a mutual fund may be a factor in an investment decision, few advisors are concerned about their ability to get into or out of small mutual funds. Most advisors are willing to buy shares in a $10 million–$50 million mutual fund that has a good investment process and meets a client's objectives. If the advisor considers the cost impact of his client's flow transactions on the fund's performance, it is usually no more than a passing thought because the mutual fund trading process is so simple. The trading process in an inactively traded ETF is rarely simple, so advisors may avoid these funds, and this tends to put small, lightly traded ETFs at a competitive disadvantage relative to their larger, actively, and cheaply traded competitors. If you are considering an ETF with $50 million–$100 million in assets, its trading volume may be 10,000 or 20,000 shares a day and the displayed bid/asked spread for a position of the size contemplated by an advisor may be a significant fraction of 1 percent. Changes in trading economics over the past few years have reduced the profitability of ETF market makers. The natural position of a market maker who does not have a long-term stake is to have as little exposure as possible at the end of each trading day.

Advisors who understand the virtues of ETFs will want to get to know more about how ETF markets work and when they don't work particularly well. Inactively traded ETFs are traded on the same kind of electronic market as stocks and actively traded benchmark index ETFs, but that does not mean they trade much like a stock.

Any advisor who wants to use ETFs that routinely trade less than 100,000 shares per day needs to understand the ETF market structure and the roles various ETF participants play. You can accumulate or sell multimillion-dollar positions in an inactively traded ETF at reasonable trading costs, but you need to get to know the ETF market participants and work with them. Ask your principal broker for an introduction to an ETF market maker who trades the fund that interests you. A number of firms specialize in providing liquidity in less actively traded ETFs and you may want to have a conversation with one of them.

When you speak with these market participants, keep in mind that ETF
market making is very different than stock market making. In the market for a common stock, the supply of stock is limited to the number of shares issued by the company. Because of the limited supply, telling a market maker that you are interested in a stock may lead to a higher offer or a lower bid if the market maker sees you coming. In ETF markets, the price at which the fund shares trade is constrained by the fund’s NAV. The cost of trading an ETF is likely to decline if you want to trade in size. An ETF market maker enjoys economies of scale in most aspects of creating and redeeming ETF shares. Furthermore, no advisor or investor is willing to pay a large premium for the liquidity services the market maker provides because the fund can grow or shrink without a material market impact on the prices of the portfolio securities. Also, your dialogue will inform the market maker that a real investor has an interest in the fund and is not trying to outwit him. The market maker is interested in making money on the spread when you trade. He is going to be making a market in the ETF for a long time and will hope to see you again. Not every market maker will try to be helpful, but most of them will (Gastineau 2010, 208–210). Market makers know that a satisfied advisor can represent repeat business. If you open a dialogue with the people who trade a small, inactively traded ETF, you can get in or out without large transaction costs.

Understanding and Measuring Your Cost of Trading ETFs

The costs of ETF transactions in today’s market can be extremely difficult to measure. ETF issuers are required to arrange for publication of 1) an IOPV, and 2) a comparison of the fund’s end-of-day NAV with the closing quotes for the ETF shares. These data are supposed to help investors compare their ETF transaction prices with contemporary per-share portfolio values. These ETF values and quotes can obscure and even increase ETF transaction costs.

For the end-of-day quote to NAV comparison, ETF issuers collect information on ETF share bids and offers on the listing exchange market each day at 4 p.m. and compare the midpoint of the quote to that day’s NAV calculation for the ETF. Premium and discount tables or graphs summarizing these comparisons for various periods are published on ETF Web sites and in ETF prospectuses and annual reports. The comparisons usually show that the mid-point of the bid and offer at the close is very near the NAV on most days. Furthermore, the quote midpoint is slightly above the NAV about as often as it is slightly below the NAV. These tables and charts give investors and advisors inappropriate comfort that end-of-day ETF transactions occur very close to NAV. But the quote versus NAV comparisons do not indicate anything of the sort. Let’s look at how these data are collected and how market-on-close (MOC) orders work.

Market makers in even the most thinly traded ETFs understand that the midpoint of their daily 4 p.m. quote will be preserved in prospectuses and on ETF Web sites for years to come. These market makers have a stake in attracting traders to the ETFs they trade. Consequently, they monitor their real-time bid/offer NAV calculations closely as 4 p.m. approaches. Even if they have to widen or otherwise change their spread for a few seconds, they will work to get the midpoint of their bid and offer as close to the expected 4 p.m. NAV as possible. Their 4 p.m. quote is the most widely scrutinized and least useful bid/offer of the day.

Publication of this premium and discount information based on 4 p.m. ETF share quotes and NAV calculations has led to overuse of MOC orders, especially for ETFs that are thinly traded. Most investors do not realize that MOC orders often are used by individuals and defined contribution retirement plan investors who are accustomed to buying and selling no-load mutual fund shares at NAV. Publication of this premium and discount information accounts for the fact that MOC trades account for a disproportional share of ETF trading volume.

Market-On-Close Transactions in ETFs

It is important to understand what the information on premiums and discounts published in fund prospectuses and on fund Web sites means and how the mere fact that this information is published has increased the use and cost of MOC trades. Looking carefully at how MOC orders are executed will give you a better picture of how these ETF trades work, particularly if your experience with trading has been confined to buying and selling mutual fund shares. MOC orders in ETFs illustrate how unforgiving the securities markets can be at times. Cushing and Madhavan (2001) provide a close examination of the cost of market-on-close orders, and though they wrote before decimalization and high-frequency trading, the major issues have not changed.

<table>
<thead>
<tr>
<th>Share Price</th>
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<th>Offers</th>
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<tr>
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<td>25.25</td>
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<td>24.70</td>
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TABLE 2: HYPOTHETICAL ETF LIMIT-ORDER BOOK AT THE END OF THE TRADING DAY

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MOC orders in both stocks and ETFs are integrated with the limit-order books for the securities. A hypothetical schedule of bids and offers (resting limit orders) for an ETF near the end of the trading day is displayed in table 2. The schedule helps illustrate how integration of the limit-order book and MOC orders works. In this limit-order book, the best bid is for 2,000 shares at $24.90, and the best offer is at $25.10 for 2,000 shares. The estimated NAV at the close was $25, and $25 turned out to be the actual NAV. The MOC book will operate within and alongside this limit-order book with buyers and sellers entering market orders of various sizes for execution at the close. If the balance of the MOC orders is to buy 4,000 shares of the ETF at the market-on-close, and the limit-order book matches table 2, all the MOC orders will be filled at $25.30 unless a market maker or a last-minute customer order improves on the $25.30 transaction mechanism to assume that an MOC trade will be filled at or very close to NAV. Under this mistaken belief, too many ETF investors use MOC orders incautiously.

I can think of no reason an investor or advisor should ever enter an MOC order for an ETF. Opening a dialogue with the market maker is a far better approach and an even better solution should be available by early in 2011: NAV-based trading.

**NAV-Based Trading Has Been a Long Time Coming.**

ETFs were not introduced in Canada and the United States because they are better funds. They were introduced as merely something to trade on the Toronto and American Stock Exchanges. Serendipitously, they turned out to be a better choice than mutual funds for most investors. The fact that ETFs generally provide investors with results that are superior to the results of comparable mutual funds is largely due to interactions between the developers of the 500 SPDR and the Securities and Exchange Commission (SEC) staff.

The fact that ETFs generally provide investors with results that are superior to the results of comparable mutual funds is largely due to interactions between the developers of the 500 SPDR and the Securities and Exchange Commission (SEC) staff. The SEC required a series of elements in the 500 SPDR and the Securities and Exchange Commission (SEC) staff. The SEC required a series of elements in the 500 SPDR design that led to the shareholder protection that ETFs provide almost automatically. The combination of the investment company ETF structure, creation and redemption in-kind, exchange trading, and competitive market forces led to the lower cost structure of most ETFs. However, the intraday ETF trading process that requires funds to post a value of the fund share every 15 seconds has obscured trading costs and limited the scope of the ETFs that can be offered under the current trading system. The introduction of NAV-based trading of ETFs will facilitate trading in less actively traded ETFs at tighter spreads, expand the range of possible ETF portfolios and investment processes, and improve the transparency of ETF trading costs. NAV-based trading also will facilitate the introduction of nontransparent ETF portfolios because there will be no need to reveal the fund’s portfolio changes each day or to publish intraday values.

Entering an order to buy or sell ETF shares at or relative to the current day’s NAV is mechanically similar to entering an order to buy or sell shares in the traditional intraday ETF market. NAV-based buy and sell limit orders will be entered and executed relative to a proxy, probably 100.00, for the per share NAV based on the value of the ETF’s portfolio securities at 4 p.m. Eastern Time. A transaction at NAV plus one cent per share initially would be executed and reported at 100.01. If the fund’s NAV for the day turns out to be $20 per share, the 100.01 transaction will result in an execution price of $20.01 because each .01 translates into $0.01 (one cent) per share. (We deliberately omit $ signs on the proxies to avoid the implication that the transaction will occur near $100 per share; 100.00 is merely a reference point.)

Transactions will occur throughout the day at or around 100.00 and the dollar execution price for each trade will be determined when the NAV is published, sometime after 4 p.m. Unexecuted limit orders on the NAV book can be cancelled and new limit orders can be entered until the close of regular trading. After-hours trading relative to the NAV also will be available. Reflection on this trading mechanism suggests that resting limit orders will work far better than in the conventional ETF market. Most transactions will take place close
to NAV and exposure to predatory trading techniques should be limited. The ability to create or redeem ETF shares each day at NAV effectively limits the size and duration of premiums or discounts on ETF shares if trades are priced relative to NAV. Authorized participants, arbitrageurs, and ordinary traders all are reasonably attuned to the costs and opportunities of meeting demand for additional shares or redeeming existing shares of an ETF. NAV-based and traditional ETF transactions will be subject to similar fees and commissions. Investors will be able to compare differences in the spreads between conventional intraday ETF bids and offers and NAV-based bids and offers throughout the trading day. Even if an investor has ready access to intraday NAV proxy calculations based on contemporary bids and offers for an ETF’s portfolio securities, the portfolio value of many ETFs can change by much more than the typical bid/offer spread in just a few seconds. In conventional ETF trading, most investors cannot be confident that their executions will be as close to the contemporary share value as they intend. An investor receiving an execution at pennies over NAV will be able to calculate the trading cost precisely.

The conventional ETF market usually works well for investors who know how to use it to trade the largest and most actively traded ETFs, but it does not serve investors in less actively traded funds very well. NAV-based trading increases the opportunity for new ETFs to trade at a low-enough cost to compete with actively traded ETFs based on established benchmark indexes. NAV-based trading is also more consistent with the experience of advisors and defined contribution retirement plan participants who are accustomed to buying and redeeming mutual fund shares at the NAV. In an extension of NAV-based trading, executions based on dollar amounts and fractional shares will be facilitated by a financial intermediary to reduce ETF trading costs and simplify trading for small advisory accounts, defined contribution plans, and other accounts that are accustomed to the mutual fund NAV purchase and sale mechanism.

The NAV-based trading mechanism is essential to the introduction of new types of ETFs that will offer full-function active portfolio management or be based on nontransparent indexes that will not be plagued by high composition change costs caused by pre-announcement of an index fund’s trading plans.4

Algorithmic Trading and ETFs

Trading algorithms that interact with the bids and offers in the electronic market in an attempt to improve executions are as widely used in trading ETFs as in trading common stocks. Unfortunately, nearly all of the algorithms used to trade ETFs originally were developed to trade stocks and most of them do not accommodate the unique characteristics and economics of ETFs. There is no market value for a stock independent of the market where the stock is trading, so most algorithms look primarily at recent transactions and at bids and offers for the stock. In the ETF market the securities in an ETF’s portfolio have an independent value. The IOPV proxy value is based on the most recent sale of each security, not the current bid and offer, and a lot can change in less than 15 seconds. Market professionals use more sophisticated intraday ETF portfolio valuation calculations than the IOPV. Algorithms developed specifically for ETFs that use a dynamic intraday NAV calculation based on bids and offers for portfolio components as the basis for ETF trading are rare.5 This is the only kind of trading algorithm that should be used for intraday ETF trading.

Until NAV-based trading is available in the ETF you want to use, work with market makers, trade in the late afternoon (but not at the MOC), and use marketable limit orders. The three most important principles for ETF trading cost minimization are the following:

1. Monitor and attempt to measure your cost of trading. Trading cost in a major benchmark index ETF generally will equal half the spread between the bid and the offer plus the commission and any market impact if you are trading in a size larger than the number of shares in the best posted bid or offer on the other side of the market. If you are buying or selling an actively traded ETF, a reasonable trading cost measurement is possible only if a market maker creates or redeems to accommodate your trade close to NAV. With NAV-based trading, your transaction cost calculation will become quite simple: It is the difference between your net cost per share and the NAV. Clearly, if the bid/asked spread in an ETF is extremely wide and/or if the market impact is significant, trading costs in some ETFs can be unacceptably high.

2. Avoid market-on-close orders in an ETF. Data published by ETF issuers pursuant to an SEC requirement comparing the “market at the close” to the fund’s NAV suggests that buying ETFs with MOC orders is relatively safe. It is definitely not safe.

3. Use marketable limit orders, not resting limit orders and not market orders, when you trade ETFs. ETFs are a great improvement over mutual funds, but you can’t deliver their full value to your clients unless you trade them economically.

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Endnotes

1 Some elements of this article first appeared in Broms and Gastineau (2007), Gastineau (2010), and Gastineau (2009).

2 Investment company ETFs, like mutual funds, are regulated under the Investment Company Act of 1940, one of the major securities regulatory statutes in the United States.

3 ETFs typically account for between one-third and one-half of the names on the daily “most active stocks” listing in the Wall Street Journal.

4 A locked market is a market where the bid and offer are identical. A crossed market is a market where the bid is temporarily higher than the offer.

5 Among small ETFs, the relationships among fund assets, trading volume, and trading spreads vary widely.

6 Market makers will use their proprietary value calculations to estimate the NAV at the close, not the posted IOPV that is based on the last sale of each position. Advisors will do well to forget that the IOPV calculation exists.

7 Both the price of the daily closing trade and the net asset value for any ETF are easy enough to look up the next morning, but I am not aware of any source an investor or advisor can consult to find a series of day-by-day comparisons.

8 Trading shares in U.S. ETFs that hold foreign securities can be very frustrating if a major event occurs when foreign markets are closed. NAV-based trading eventually will be offered for the next trading day in the United States as well as for the current day if an ETF has substantial foreign holdings. Investors will be able to trade relative to a NAV calculated after a day of price discovery in the primary market(s) for the fund’s holdings and avoid paying a liquidity premium. In conventional markets, the liquidity peak for ETFs holding foreign securities is usually late afternoon, like ETFs with domestic portfolios. If the ETF’s holdings are concentrated in Western Europe, take a look at the market in mid-morning.

9 To my knowledge, the first such algorithm “for customer use” was announced in a Business Wire press release by Bank of America Merrill Lynch on July 26, 2010 (http://eon.businesswire.com/news/en/on/20100726005932/en). The description sounds like most of the customers for this service will be ETF market makers or advisors trading in creation unit size.

References


