

restitutions, additions and deletions).

However, additional portfolio flexibility would benefit the Aggregate Bond Fund, while at the same time permitting it to closely track the performance of its Underlying Index. The Aggregate Bond Fund will: (1) Seek to track the performance of that portion of its Underlying Index comprised of U.S. Treasury securities, U.S. agency securities, corporate bonds, non-corporate bonds (*e.g.*, bonds issued by supra-national entities such as the International Monetary Fund), asset-backed securities, and commercial mortgage-backed securities (approximately 65% of the Underlying Index as of December 3, 2003) by investing a corresponding percentage of its net assets (*i.e.*, approximately 65%) in the Component Securities of its Underlying Index;¹⁰ and (2) seek to track the performance of that portion of its Underlying Index invested in U.S. agency mortgage pass-through securities (approximately 35% of the Underlying Index as of December 3, 2003) by investing a corresponding percentage of its net assets (*i.e.*, approximately 35%)¹¹ through TBA transactions (as described below) on U.S. agency mortgage pass-through securities. Through the Aggregate Bond Fund's direct investments in Component Securities of its Underlying Index and its investment in mortgage pass-through securities through TBA transactions, the Aggregate Bond Fund will have at least 90% of its net assets invested (i) in Component Securities of its Underlying Index and (ii) and investments that have economic characteristics that are substantially identical to the economic characteristics of the Component Securities of its Underlying Index (*i.e.*, TBA transactions).

According to the Application, the Aggregate Bond Fund needs the investment flexibility to engage in TBA transactions as described above primarily because approximately 35% of the securities in the Aggregate Bond Fund's Underlying Index are expected to be pools of U.S. agency mortgage pass-through securities.¹² As discussed

below, it is easier to trade and obtain intra-day prices of TBAs than it is to trade and obtain intra-day prices of specific pools of mortgage pass-through securities. The readily available information about intra-day pricing of TBAs and the ease with which they can be traded should make it easier to create and redeem Creation Unit Aggregations and help maintain the efficiency of the Aggregate Bond Fund's arbitrage mechanism.

The Application states that, although the market or mortgage pass-through securities is extremely deep and liquid, it is impractical to trade mortgage pass-through securities on a pool-by-pool basis, particularly when large dollar amounts are involved. For this reason, the vast majority of mortgage pools are traded using "to-be-announced" or "TBA" transactions. A TBA transaction is essentially a purchase or sale of a pass-through security for future settlement at an agreed upon date.¹³ It has been estimated that 90% of mortgage pass-through securities (as

security" refers to a category of pass-through securities backed by pools of mortgages and issued by one of several U.S. Government-sponsored enterprises: the Government National Mortgage Association ("GNMA"), Federal National Mortgage Association ("FNMA") or Federal Home Loan Mortgage Corporation ("FHLMC"). In the basic pass-through structure, mortgages with similar issuer, term and coupon characteristics are collected and aggregated into a pool. The pool is assigned a CUSIP number and undivided interests in the pool are traded and sold as pass-through securities. The holder of the security is entitled to a pro rata share of principal and interest payments (including unscheduled prepayments) from the pool of mortgage loans. The portion of the Underlying Index representing the mortgage pass-through segment of the U.S. investment grade bond market is comprised of multiple pools of mortgage pass-through securities.

¹³ "TBA" refers to a mechanism for the forward settlement of agency mortgage pass-through securities, and not to a separate type of mortgage-backed security. TBA trades generally are conducted in accordance with widely-accepted "Good Delivery" guidelines published by The Bond Market Association ("TBMA"). The Good Delivery guidelines facilitate transactions in mortgage pass-through securities by establishing commonly observed terms and conditions for execution, settlement, and delivery. In a TBA trade, the buyer and seller decide on general trade parameters, such as agency, coupon, term to maturity, settlement date, par amount, and price. The actual pools delivered are determined two days prior to settlement date. TBA transactions promote efficient pricing because the Goog Delivery guidelines permit only a small variance between the face amount of the pools actually delivered and the nominal agreed upon amount. Intra-day and end-of-day pricing of TBAs is available from multiple pricing sources, such as Bloomberg L.P. ("Bloomberg") and Trade Web. TBMA publishes standard notification and settlement dates for TBA trades specifying uniform settlement dates for specific classes of securities. The most active trading market for TBA trades is usually for next-month settlement. See generally *TBAs: To-Be-Announced Mortgage Securities Transactions*, TBMA (1999).

measured by total dollar volume) are executed as TBA trades.¹⁴ TBA transactions increase the liquidity and pricing efficiency of transactions in mortgage pass-through securities since they permit similar mortgage pass-through securities to be traded interchangeably pursuant to commonly observed settlement and delivery requirements.

The Aggregate Bond Fund intends to use TBA transactions to acquire and maintain exposure to that portion of the Underlying Index comprised of pools of mortgage pass-through securities in either of two ways. First, and more commonly, the Aggregate Bond Fund will enter into TBA agreements and "roll over" such agreements prior to the settlement date stipulated in such agreements. This type of TBA transaction is commonly known as a "TBA roll." In a "TBA roll" the Aggregate Bond Fund generally will sell the obligation to purchase the pools stipulated in the TBA agreement prior to the stipulated settlement date and will enter into a new TBA agreement for future delivery of pools of mortgage pass-through securities. Second, and less frequently, the Aggregate Bond Fund will enter into TBA agreements and settle such transactions on the stipulated settlement date by actual receipt or delivery of the pools of mortgage pass-through securities stipulated in the TBA agreement. Since intra-day-prices of TBA agreements are more readily available than intra-day prices on specific mortgage pools and because mortgage pools tend to be less liquid than TBA agreements, the use of TBA agreements should help maintain the efficiency of the Aggregate Bond Fund's arbitrage mechanism. The Aggregate Bond Fund will accept actual delivery of mortgage pools only when the Advisor believes it is in the best interests of the Aggregate Bond Fund and its shareholders to do so. In determining whether to accept actual delivery of mortgage pools, the Advisor will consider, among other things, the potential impact of such acceptance on the efficiency of the Aggregate Bond Fund's arbitrage mechanism and the Aggregate Bond Fund's ability to track its Underlying Index. For these reasons, the Advisor believes that the ability to invest a significant portion of the Aggregate Bond Fund's assets through TBA transactions and to maintain such exposure through the use of TBA rolls would increase the liquidity and pricing efficiency of the Aggregate Bond Fund's portfolio. In addition, since holding a TBA position exposes the holder to

¹⁰ With respect to this portion of its portfolio, the Aggregate Bond Fund may invest up to 10% of its portfolio in bonds not included in its Underlying Index, but which the Advisor believes will help the Aggregate Bond Fund track its Underlying Index, as well as in certain futures, options and swap contracts, cash and cash equivalents.

¹¹ Telephone conversation between Janet Kissane, Milbank, Tweed, Hadley & McCloy LLP, Counsel for NYSE, and Florence Harmon, Senior Special Counsel, Division, Commission dated December 4, 2003.

¹² As used herein, the term "U.S. agency mortgage pass-through security" or "mortgage pass-through

¹⁴ *Id.* at 3.