Exchange-Traded Products –

EMERGING AS AN INCREASINGLY IMPORTANT GLOBAL ASSET CLASS

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The exchange-traded product (ETP) industry — including exchange-traded funds and related exchange-traded vehicles — has recently reached two remarkable milestones: more than one thousand funds with over $1 trillion AUM. Since the introduction of the S&P 500 Depositary Receipt (SPDR) ETF in 1993, the marketplace has seen steadily increasing popularity, with an accelerating growth rate in recent years.

According to the National Stock Exchange, there were 672 ETFs in 2006, 875 in 2008, 924 in 2009 and 1,099 last year. Over the same period, assets under management have likewise grown: from $433 billion in 2006 to $1.01 trillion at year-end 2010. As another measure of their increasing attractiveness to investors, net cash flow into ETFs was $119 billion in 2010, the fourth year in a row when annual inflows totaled more than $100 billion.

This growth of AUM has been sparked both by cash inflows into existing ETFs and by a steady stream of innovative products. In 2010, 223 new ETFs were launched — compared to 100 in 2009 — enabling investors to access a wide variety of regions, asset classes and investment strategies.

At this growth trajectory, many industry watchers foresee a future when ETFs overtake the traditional fund as the preeminent investment choice for average investors.

Definition

An ETF is an investment vehicle that typically tracks a stock market index and trades on an exchange, just like a regular stock. The key term in that sentence is "typically." ETFs were first developed in the U.S. to make stock program trading available to retail investors, so that, like institutional investors, they could trade a basket of securities in a single transaction.

The method of creating an ETF starts when an institutional investor provides a basket of specified securities for deposit into the ETF's portfolio. This basket generally includes most or all of the securities underlying the ETF's index. In exchange, the institutional investor receives the equivalent value of the ETF's shares in large lot sizes called "creation units." Thereafter, the institutional investor (known as the "authorized participant," or AP) may hold the shares in creation units, or sell some or all of the individual shares into the secondary market, where they are bought, sold and priced throughout the day on a stock exchange.

Technically, an ETF is an investment company (IC) registered with the U.S. Securities and Exchange Commission (SEC) — or with the appropriate regulatory agency within its home domicile — because it holds a portfolio of securities and continuously issues and redeems its shares at daily NAV, just like an open-end fund. However, many institutional and all retail investors do not acquire or redeem their shares directly at the NAV from the ETF provider, but instead buy and sell them at their market prices on the secondary market, similar to the way in which shares of closed-end funds are bought and sold.

This hybrid structure, consisting of mutual fund and closed-end fund elements, does not fit into the existing regulatory regime governing investment companies. Therefore, in the U.S. ETFs must often receive formal exemptive, interpretive, no-action and other relief from certain provisions of applicable federal securities laws before they can be brought to market. (Please note, regulatory approval, processes and timelines can be different depending on structure and domicile of incorporation; as always with any highly regulated financial product, advice from experienced legal and accounting firms is invaluable.)

ETF/ETV — History of Innovation

In this article, in addition to the term ETFs, we will also use "exchange-trade vehicles," or "ETVs," to identify those exchange-traded products that: (1) are not investment companies, (2) usually hold nontraditional portfolio assets, but (3) nevertheless use many essential features of the original ETFs.

ETFs and ETVs can take many forms. With the significant increase in the number of funds and their total net assets over the years, we have seen a corresponding emergence of innovation and diversification both in terms of the investment areas targeted by these funds and the structures of products on the market. There are now exchange-traded products that track virtually every recognizable stock market index, many bond market indexes and, as mentioned, even commodities and currencies.

The tradition of product pioneering continued last year. Among the notable innovative ETFs launched in 2010 were Van Eck Global's "Market Vectors Rate Earth/Strategic Metals," which invests exclusively in producers of strategic metals including so-called rare earths; the ETPS Physical Precious Metals Basket Shares, which holds a blend of gold, silver, platinum and palladium (the first precious-metals basket to be launched in the U.S.); and the first-ever "end-date" or "bullet" bond ETFs from BlackRock's iShares and Guggenheim Partners that hold a portfolio of bonds all maturing in the same year.

Last year also saw an increased number of registrations, which are currently pending SEC approval, filed for innovations on the actively managed front by asset managers such as Alliance Berstein, John Hancock and Huntington. An increase in registrations filed with the SEC demonstrates continued support and interest for firms to add ETFs as a product suite.

General Considerations for Launch

Since the first product was introduced in 1993, the astonishing evolution and growth of the ETF/ETP industry has consisted of countless hours of product development. All of this effort, however, has served a remarkable purpose: It has brought products to market that not only fill the needs of institutional investors, but bring retail investors into an institutional space in terms of ETFs' competitive pricing and efficiencies as investment vehicles. For asset managers considering issuing new ETFs, there are a series of stages to keep in mind. (These considerations relate primarily to launching an ETF in the U.S. As noted above, experienced legal and accounting advice is required; this article provides a general list of issues but is not a substitute for such advice.)

- **Stage 1: Landscape**

  Before you even get to the drawing board in terms of your product's design, it is important for an asset manager to gauge the investment interest landscape. Are there interested investors? What is the level of product demand? Who are the current competitors? What are the barriers to entry? Most importantly, will you create a product that meets the needs of your current investors?

- **Stage 2: Product Structure**

  ETFs and ETPs are not uniformly structured; they have used a variety of forms. For example, there are ETFs in the form of unit investment trusts, such as SPDRs, as well as open-end funds, such as iShares. Currently, there are ETPs structured as grantor trusts, such as streetTracks Gold Trust, and those that use a limited partnership structure, such as United States Oil Fund (ticker: USO). There is not one preferred choice. The structure of the fund depends on a number of factors, such as the fund's investment portfolio, and is a decision of the fund sponsor.

- **Stage 3: Investment Strategy**

  Since ETFs are currently offered in both passive and active forms, not all products aim to replicate an index. For more traditional passive products, index selection can be important to a product's success. Many well-known indexes have already entered into a restrictive or exclusive licensing agreement with fund managers, and therefore are not available.

  Absent available well-known indices, some ETF sponsors have sought to create an index that is unique – utilizing a specific alpha or quantitative model with proven market performance. Market niche indexes have been steadily growing in popularity.

  If products are planned to be constructed as active, relevant considerations can be a manager's reputation and track record – thinking through the interconnectivity between the ability to provide daily transparency into the ETF's holdings relating to a fund's ability to be fairly priced and traded on the secondary market. Since active ETFs remain in an immature state of innovation, it is important to seek the advice of industry experts including legal counsel, market makers and primary market liquidity agents. Although the number of actively managed ETFs have been increasing, it is important to state that currently regulators have only approved products that offer investors full daily transparency into fund holdings. Any deviation is subject to regulatory approval.

- **Stage 4: Exchange**

  Shares of ETFs and ETPs trade intraday, thus requiring the product to be listed with a primary exchange, such as the NYSE, NASDAQ, the LSE, Euronext or the Hong Kong Stock Exchange. It is important to choose a primary exchange that best suits your needs. Key considerations for asset managers include product support, reputation, liquidity, trading volume and cross-listing arrangements.

- **Stage 5: Service Providers**

  The role of service providers has grown in importance in recent years; for example, portfolio valuation and NAV accuracy have undergone increased scrutiny to ensure investor protection. Settlement, back-office and clearing procedures may also be looked at closely by regulators. As ETFs continue to demonstrate increased innovation, an asset manager can benefit by establishing a partnership with a firm that can offer solutions spanning pre-to-post trade, including back and middle office, primary and secondary market trading, and liquidity solutions, and that has connectivity with major global trading exchanges.

- **Stage 6: Distributor**

  One primary role of the distributor is to take the orders from the APs and, often, to act as the liaison between the ETF's transfer agent and the APs. The distributor passes the order information to the transfer agent, who either creates or redeems the shares in creation units with the local depository.

- **Stage 7: Authorized Participants (APs)**

  ETFs and ETPs operate both in a primary and a secondary market environment. Apart from the fact that the portfolio assets of an ETF or ETP can appreciate or depreciate due to market events, creation/redemption orders for shares entered by APs have a direct impact on the assets underlying an ETF or ETP. APs are the large institutional counterparties who enter into an agreement with the ETF or ETP, which permits them to participate in the creation/redemption process.

- **Stage 8: Registration Process**

  Asset Managers will need to retain an attorney to help prepare and file the registration statement (including the prospectus and exhibits) with the SEC (or appropriate home-domicile regulatory agency) for review and comment. Counsel will also negotiate with the SEC and file amendments to the statement, as well as finalize the prospectus and other materials.

2011 and Beyond

In our view, the ETF/ETP space will continue to expand on its long-standing trends — asset growth, product innovation, global expansion — in 2011 and thereafter. In particular, we see:

- **Growing Institutional Interest**

  Although exchange-traded funds are most commonly thought of as a retail product, institutional investors are finding that they can be helpful tools in such critical portfolio management tasks as cash equitization, transition management, rebalancing and obtaining hard-to-achieve exposures. ETF use among U.S. pension funds, endowments and foundations has grown to about 14%, according to Greenwich Associates. Despite that relatively modest share, institutions actually represent roughly half the assets invested in ETFs in the United States.

  The future looks very bright for ETFs in the institutional market. Almost 55% of institutions currently employing ETFs expect their usage to increase in the next three years, including nearly 20% that expect the amount of assets dedicated to ETFs to grow by 5% – 10% in that period. Money managers are slightly more likely to predict an increase in use: 65% expect to be devoting more assets to ETFs in the next 12 months, compared with half of plan sponsors.

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- **Changes in Distribution**

  To gain share from traditional mutual funds, several fund complexes have introduced zero-commission trades on ETFs. Schwab offers free trades for 11 of its proprietary ETFs, Fidelity on 25 iShares ETFs, Vanguard on more than 60 and TD Ameritrade on more than 100 commission-free ETFs.

  In the UK, the impact of changing distribution practices can be seen through the retail distribution review (RDR). A major component of the RDR initiative is putting more constraints on how shareholder servicing fees are disclosed to make them more transparent to investors.

- **Increased Popularity Among Fee-Based Advisers**

  Some believe that ETFs will continue to be embraced by fee-based financial advisers, something that may help support their popularity. If regulators tighten up on potential conflicts of interest in the brokerage and advisory industry, more advisers are expected to move toward business models based on fees from clients rather than sales commissions on products. Fee-based advisers tend to have their own investment strategies and disciplines, and the use of easily traded, relatively low-cost ETFs may be popular among such advisors because they provide excellent liquidity and are an efficient tool to dictate asset allocation.

- **Products Launched Outside North America**

  Several factors could contribute to the growth of ETF/ETPs outside North America. As leading issuers look to extend their footprint outside their home domicile, prospects for growth are especially strong in the Europe, Asia and Latin American markets. At the same time, products domiciled in Hong Kong are flourishing and are being offered throughout Asia. And regulators in local jurisdictions around the world may adjust their policies to promote ETF creation, trading and domiciliation. Promoting global access, the industry is increasingly looking at ways to assist in streamlining liquidity in fragmented markets and promoting and creating global access products tied to ETFs.

Now and in the Future

In 2011 and beyond, we expect that ETFs and their related products will continue to evolve into very important, increasingly mainstream vehicles within the investment community's allocation tools. Broadening investment demand and product innovation on a global scale could open up new avenues for growth for the asset class for years to come. ■

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