

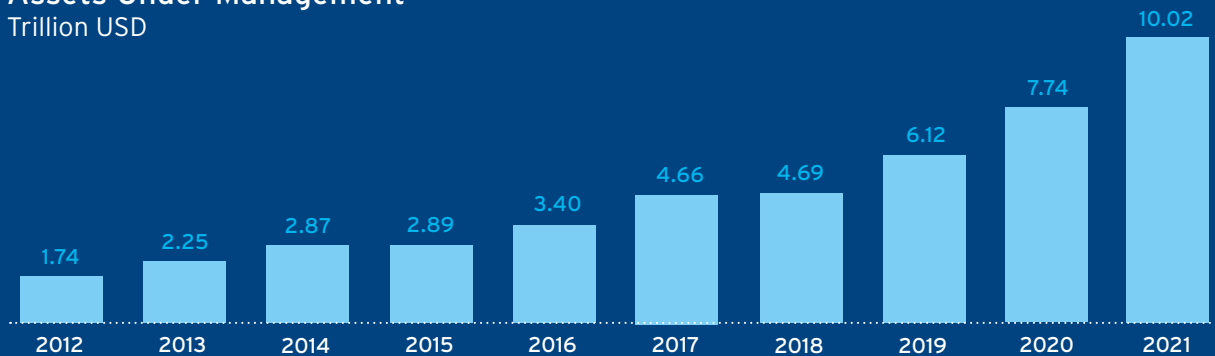
# Understanding ETFs

Securities Services



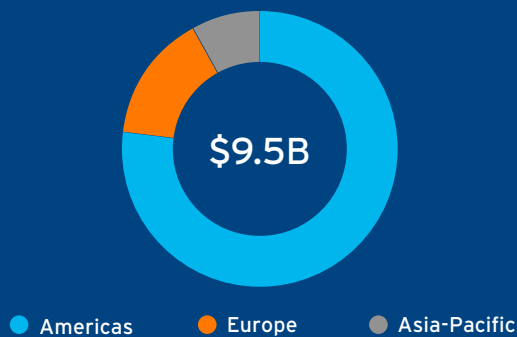
# Global ETF Market

## Assets Under Management Trillion USD



Source: ETFGI (31 December 2021)

## Net Sales



## Top Five Domiciles by Assets Trillion USD

	United States	7.2
	Ireland	1.0
	Japan	.54
	Luxembourg	.37
	Canada	.27

Source: EFAMA (as of 31 December 2021)

# So you're interested in ETFs?

The global Exchange-Traded Fund (ETF) market has grown dramatically over the last decade, with assets under management reaching \$10 trillion at the end of 2021. The growth of the market is expected to continue and more asset managers are considering adding ETFs to their product offering. While much of the ETF operating model will be familiar to traditional asset managers, there are ETF-specific nuances and considerations that must be taken into account.

This guide highlights some of the unique aspects of the ETF market, along with the changes you may need to make to your operations in order to support ETFs.

# How do ETFs work?

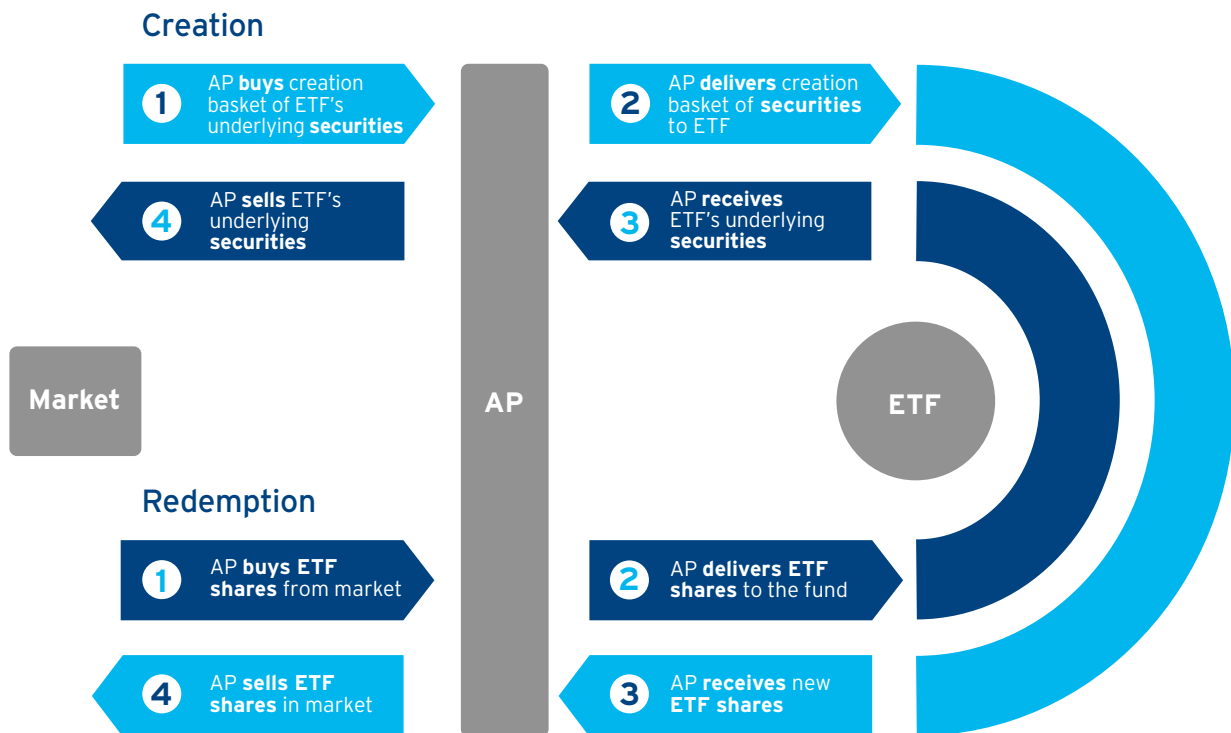
An ETF is a hybrid of a mutual fund and a security. Similar to a mutual fund, an ETF will typically hold a basket of securities in accordance with its investment objective. However, unlike a mutual fund that is priced and traded once a day, the price of the ETF changes throughout the day and investors buy and sell shares of the ETF like a security.

An ETF is constantly traded in the market, which gives investors intra-day liquidity. This is accomplished through the use of intermediaries, known as market makers, who trade ETFs on the secondary market and Authorized Participants (APs), who keep the ETF's market price in line with its Net Asset Value (NAV).

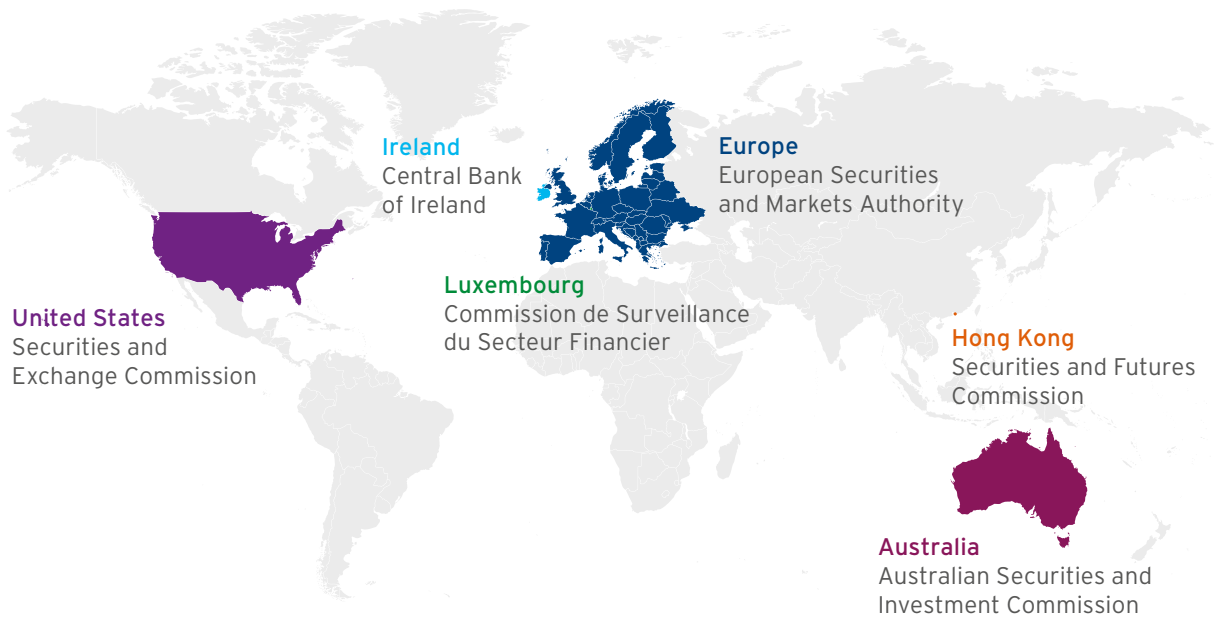
This is done through the arbitrage mechanism of the creation/redemption process, where the AP creates or redeems shares of the ETF. For example, if an ETF is trading lower than the NAV the AP can buy shares from the market at a discount and redeem them with the ETF for a profit. This should drive the market price to be in line with the underlying ETF.

At the end of the trading day, the AP nets its activity and buys or sells shares of the underlying ETF. This is done either in specie, through the exchange of securities, or with cash.

# Creation/Redemption Process



# Key Regulators



# Regulatory Frameworks

Globally, there is no specific ETF regulatory framework. Instead, ETFs are governed by existing fund and securities regulations, with some ETF-specific requirements. Here are some of the important regulations for some key ETF domiciles.

## United States

- The **Securities Act of 1933 (1933 Act)** is the framework for the offer and sale of securities in the US. The shares of ETFs are registered and governed under the 1933 Act. Additionally, some commodity and currency-based ETFs are solely registered under the 1933 Act.
- The **Investment Company Act of 1940** is the framework for regulated investment funds in the US. For ETFs it covers the establishment of ETFs, which types can be launched without exemptive relief from the Securities and Exchange Commission, and the use of custom baskets for the creation/redemption process.

## Europe

- The **Markets in Financial Instruments Directive (MiFID)** is the regulatory framework for investment intermediaries and the trading of financial instruments. Under MiFID, firms are required to report ETF transaction details such as, trade volume and price.
- **Undertakings for Collective Investment in Transferable Securities (UCITS)** is the regulatory framework for European investment funds. The use of the ETF label is restricted to UCITS funds.

## Hong Kong

- The **Code on Unit Trusts and Mutual Funds** regulates ETFs in Hong Kong. It covers the framework for the establishment of ETFs, fund structures allowed, and approval process for passive and active ETFs.

## Australia

- The **Corporations Act** provides the key regulations for mutual funds in Australia including ETFs, and is supplemented by regulatory guidance issued by the Australian Securities and Investment Commission.

# Legal Structure

The legal structure drives the governance and contractual arrangements of the ETF. Ultimately, the decision on the legal structure comes down to a combination of factors which may include distribution strategy, investor preference, and specific product requirements.



## United States

- **Open-End Investment Company** is an investment fund registered under the Investment Company Act of 1940.
- **Unit Investment Trust** is an investment fund established under a trust indenture between the fund sponsor and the trustee. The trustee acts as the legal owner of the fund's assets on behalf of the investors.



## Ireland

- **Variable Capital Company** is an open-ended investment company structured as a public-limited company and subject to Irish company law requirements.
- **Irish Collective Asset-management Vehicle (ICAV)** is a vehicle designed specifically for investment funds and has its own legislative regime that is exempt from certain requirements in European and Irish company law. The ICAV can elect to "check the box" for US tax purposes.
- **Unit Trust** is an investment fund established under a trust deed between the management company and the trustee. The trustee acts as the legal owner of the fund's assets on behalf of the investors.





### Luxembourg

- **Société d'Investissement à Capital Variable** is an open-ended investment company with variable capital and is generally organized as a public-limited company (S.A.) or a European Company (S.E.).
- **Société d'Investissement à Capital Fixe** is an investment company with fixed-share capital.
- **Fonds Commun de Placement** is a contractual arrangement with no legal identity that is managed by a management company.



### Hong Kong

- **Open-ended Fund Company** is a vehicle designed specifically for investment funds and has its own legislative regime and is exempt from certain requirements of the Companies Ordinance.
- **Unit Trust** is an investment fund established under a trust deed between the management company and the trustee. The trustee acts as the legal owner of the fund's assets on behalf of the investors.



### Australia

- **Unit Trust** is an investment fund established under a trust deed between the management company and the trustee. The trustee acts as the legal owner of the fund's assets on behalf of the investors.
- **A Registered Managed Investment Scheme** is an investment scheme registered with Australian Securities and Investment Commission. The responsible entity acts as the legal owner of the fund's assets on behalf of the investors. It is generally transparent for tax purposes, provided taxable income is attributed to investors.

# Operational and Organizational Considerations

Managers should be able to leverage most of their existing infrastructure to support ETFs. However, there are some elements that require specialized skills.

## Organization



### Capital Markets

A team of market specialists who interface with the broker-dealer and AP community to assist in the creation/redemption process and can assist the sales team in technical client questions about execution and liquidity.



### Product

Firms may want to develop a specialized ETF group responsible for the development, oversight, and ongoing management of the ETF product range.



### Sales

The distribution of ETFs differs from mutual funds and most managers supplement their existing sales team with specialists who know the ETF landscape to maximize distribution opportunities and partner with chosen banks.

## Operations



### **Portfolio Composition File (PCF)**

The daily list of securities that is used to calculate the indicative NAV (iNAV), as well as in the creation/redemption process. Typically these files are provided by a service provider but firms need to incorporate these files into their workflows and processes.



### **Creation / Redemption Baskets**

When ETFs create or redeem shares with the Authorized Participants a basket of securities usually changes hands. Typically, the basket is a mirror of the underlying ETF portfolio. When creating the baskets, the manager makes decisions about what is included in the basket and then sends that data to the Authorized Participants before the market opens.

# Service Providers

In order to launch an ETF, a number of service providers need to be appointed. Most are the same that are required for mutual funds, but a few ETF-specific providers are needed.

## Traditional Service Providers

### **Administrator**

Responsible for day-to-day operational support to the fund and provides NAV calculation, maintenance of books and records, PCF/AP order processing, and financial reporting services

### **Custodian**

Provides asset safekeeping, income collection, corporate-action processing, and oversight services

### **Transfer Agency**

Provides shareholder services to the fund, such as processing subscriptions and redemptions and shareholder account opening and correspondence

### **Others**

Includes legal advisors, auditors, tax advisors, corporate secretary, and listing agents

## ETF Service Providers

### **Authorized Participant(s)**

Liquidity provider(s) to the ETF that have exclusive rights to create or redeem ETF shares

### **iNAV Calculation Agent**

Responsible for calculating the intraday NAV of the ETF based on the underlying portfolio

### **Market Maker**

Broker-dealer or independent specialist that is contractually obligated to make two-way prices on the ETF throughout the trading day

### **Listing Agent**

Local market agent responsible for filing the application for the ETF to be listed on an exchange and responsible for all communications with the exchange

# How can we help?

Whether you're looking to establish an ETF or grow an existing platform, Citi can help. Across 13 domiciles, we offer a holistic enterprise-wide solution that can help coordinate through the entire ETF ecosystem, from issuance to fund servicing. Our consultative approach to ETF servicing, combined with ACES, our advanced workflow tool, provides a scalable platform with local expertise to support your ambitions.

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# Let's Talk

To find out more about how our ETF Services can help you, contact your Citi Representative or email us at [SecuritiesServices@citi.com](mailto:SecuritiesServices@citi.com)





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