ETF Regulatory and Operational Considerations

Transaction Services
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Distinctive features of exchange-traded funds require them to seek exemptive relief from certain provisions of the Investment Company Act, the Exchange Act, and the rules thereunder. The relief is conditioned on exchange listing, transparency and marketing requirements. ETF use of derivatives is a subject of an SEC concept release and a CFTC rulemaking, which has been challenged in court. The authors describe this regulatory landscape and then turn to key operational considerations involved in launching an ETF.

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Over the past few years, the financial industry has been impacted by changes to capital markets, a shift in investor risk tolerances, and an unprecedented overhaul of the financial regulatory system. As a result, investors and asset managers find themselves operating within an increasingly unfamiliar market and regulatory landscape. Investors are seeking better returns, more diversity, higher liquidity, further access to global markets and a broader range of products, all at a lesser cost. At the same time, asset managers are trying to attract assets by distinguishing themselves by offering a more diverse line of investment products from which investors can choose. One product that continues to attract investors, which, in turn, has led asset managers to launch or sponsor them, is the exchange-traded fund (“ETF”).

An ETF is an investment company that trades on an exchange and allows investors to purchase and sell shares at market determined prices.1 Although certain ETFs can be organized solely under the Securities Act of 1933, i.e., certain commodity or currency ETFs, most ETFs are organized as open-end investment companies, registered under the Investment Company Act of 1940 and the 1933 Act, similar to open-end mutual funds. While ETFs are similar to mutual funds in many aspects, due to their distinct features, they are prohibited from marketing themselves as mutual funds, and as such, are required to refer to themselves as ETFs. For purposes of this article, the focus will be mostly on those ETFs registered under both the 1940 Act and 1933 Act.

The ETF environment in 2012 generally consists of two distinct management structures: index-based and actively managed. Similar to an index-based mutual fund, an index-based ETF seeks to replicate the return of a major market index (e.g., the S&P 500 Index) by holding all of the securities of that index or a narrow-based index covering a particular market sector. Actively managed ETFs, which first came to market in 2008, are advised by an investment team that manages its investment activity based upon a fund’s predetermined investment style or strategy.

While initially developed to function in a manner similar to that of standard index funds, ETFs have since evolved. Today, ETFs offer a diverse array of strategies and objectives, including equity, bond, and leveraged ETFs. ETFs provide investors with exposure to various markets and classes of securities, as well as providing an
additional option for asset allocation purposes. These characteristics, along with their ability to offer a more liquid, transparent, tax-efficient and less costly product, have increasingly made ETFs more attractive than index-based mutual funds to certain investors. In the past few years, in a market with increased volatility, the demand for ETFs has increased as institutional investors have found ETFs to be a convenient tool for participating in, or hedging against, broad stock market movements.

Since the first ETF was launched in 1993, they have grown significantly in terms of assets, popularity and complexity. In fact, by 2006, just 13 years later, ETF assets had grown to over $400 billion. By comparison, it took the mutual fund industry about 60 years to reach those levels of assets. Furthermore, between 2009 and 2011, inflows to ETFs had surpassed inflows to mutual funds. As of the end of 2011, ETF assets had topped $1 trillion, with some experts, such as Moody’s Investor Services, predicting an ETF asset base of over $3 trillion by 2016. Actively managed ETFs have recently begun to grow in popularity. In fact, by some estimates, assets under management for actively managed ETFs could top $1 trillion by 2020.

Advisers who wish to enter this investment market and offer ETFs must first consider the many issues they will undoubtedly face. From registration to operational challenges, there is a lot of preparation in anticipation of an ETF launch. This article will focus on some of those challenges.

Overview – The Regulation of ETF

As noted above, ETFs are typically organized as open-end investment companies, which are regulated, in large part, by the 1940 Act and the 1933 Act.

Under the 1940 Act and 1933 Act, ETFs are treated like mutual funds. For example, they are required to file their initial registrations with the Securities and Exchange Commission on Form N-8A, and to amend their registration statements annually on Form N-1A.

As with all mutual funds, ETFs must provide their shareholders with annual and semi-annual reports, and must file those reports with the SEC. In short, the regulatory similarities between ETFs and mutual funds outweigh their differences.

However, certain unique characteristics of ETFs make it difficult to plug them into the standard mutual fund regulatory mold. Chief among those characteristics is the fact that ETF shares are sold on exchanges, like stocks, at market determined prices, whereas mutual fund shares are sold and redeemed by the fund itself, at net asset value (“NAV”). Another significant difference between ETFs and mutual funds is that ETF shares are purchased and redeemed in “creation units,” rather than individual shares.

Because of these and other differences between ETFs and mutual funds, shares of ETFs cannot be offered for sale to the public without first obtaining exemptive relief from various provisions of the 1940 Act and the Exchange Act of 1934.

Relief Under the 1940 Act

For an ETF to operate in compliance with the 1940 Act, it must first obtain SEC exemptive relief from various sections and rules pertaining to, among other things: (i) the purchase and redemption of “creation units”; (ii) the exchange-trading of ETF shares; (iii) the in-kind purchases and redemptions of fund interests by affiliated persons; (iv) the time frame for tendering redemption proceeds; and (v) the purchase of fund interests by other funds, above the 1940 Act’s fund-of-funds limitations. The exemptive relief required by ETFs is as follows:

- Sections 2(a)(32) and 5(a)(1): ETF allowed to sell and redeem fund ownership in “creation units,” rather than in individual shares;
- Section 22(d) and Rule 22c-1: purchase and sale of ETF shares allowed on an exchange, at prices other than NAV;
- Section 17(a)(1) and (a)(2): in-kind purchases and redemptions of creation units allowed by persons affiliated with the ETF;
- Section 22(e): redemption proceeds allowed to be tendered in excess of the seven-day requirement; and

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- Section 12(d)(1): sale of ETF shares to other investment companies in excess of the 1940 Act’s fund-of-funds limitations allowed.

**Relief Under the Exchange Act**

To lawfully operate as a mutual fund, an ETF must meet the listing requirements of the exchange on which it trades. In addition, it must apply for, and be granted, relief from various Exchange Act provisions and rules governing, among other things, certain activities of broker-dealers related to the distribution of ETF shares. The specific relief that must be sought is as follows:

- Section 11(d)(1): broker-dealers allowed to extend credit to customers for the purchase of ETF shares in certain circumstances;
- Rule 10b-10: customer confirmations allowed to exclude certain information;
- Rule 10b-17: requirement to deliver notice of certain specified actions (for example, dividend distributions, stock splits or rights offerings) waived;
- Rule 14e-5: purchase of redemption of fund shares by a dealer-manager of a tender offer for a component security of the fund allowed under certain circumstances; and
- Rules 15cl-5 and 15c-6: required disclosure of control by a broker or dealer with respect to certain transactions involving fund shares waived.

Relief is also required under Regulation M, as follows:

- Rule 101: persons who are participating in a distribution of ETF shares allowed to bid for or purchase the shares during their participation in the distribution and
- Rule 102: the ETF allowed to redeem its shares during the continuous offering of the shares.

**Standard Conditions for Exemptive Relief**

An important component to the viability of the ETF structure is its arbitrage mechanism. The ability for authorized participants (“APs”) to purchase and redeem creation units at NAV creates arbitrage opportunities because the market price of ETF shares may vary from their NAV on any given day. By engaging in such arbitrage activity, APs help keep the market price of an ETF at or near its actual NAV.9 Recognizing the importance of the arbitrage function, the SEC has included certain conditions in its standard ETF exemptive order, drafted to support the arbitrage function and to maintain the protection of investors. These conditions require, among other things, that:

- shares of an ETF must be listed on a national securities exchange;
- an ETF must publish daily on its website the securities that will be included in the purchase and redemption baskets, which represent the ETF’s portfolio, as well as the prior day’s NAV, closing price, and a calculation of the premium or discount of such price against the NAV;
- the exchange on which the ETF trades will disclose the current value of the ETF’s basket of securities on an interval basis (usually 15 seconds);
- marketing materials for an ETF must highlight the limited redeemability of the fund’s shares, and the fact that ETF shares are subject to the Section 12(d)(1) fund-of-fund limitations contained in the 1940 Act; and
- the ETF will not market itself as an open-end mutual fund.10

In March of 2008, the SEC proposed Rule 6c-11 and Rule 12d1-4 under the 1940 Act that would codify many of the exemptions typically granted to index-based ETFs.11 The rules would also codify certain exemptions that have recently been granted by the SEC to certain proposed “actively managed” ETFs that disclose, on a daily basis, the identities and weightings of the securities held by the ETF on its website.12 If adopted, the proposed rules would make launching an ETF much easier by eliminating the requirement that ETFs apply for exemptive relief, thereby saving advisers significant time and cost. While there is currently no timetable as to when proposed Rules 6c-11 and 12d1-4 may be adopted, one could surmise that such adoption is not a top priority for the SEC at this time, based on the SEC’s current agenda, which includes the implementation of the Dodd-Frank Act and the review of the use of derivatives by mutual funds and ETFs, as discussed further below.
Recent Regulatory and Compliance Challenges

Use of Derivatives by ETFs

Increased demand has caused advisers to launch ETFs with an increasingly broader array of investment objectives and strategies. Among those strategies is the use of derivatives. Because of the SEC’s recent focus on derivative-related issues, ETFs that employ derivatives as part of their investment strategies have become the subject of a great deal of regulatory scrutiny as of late. As a result, advisers who wish to seek exemptive relief for derivative-heavy ETFs must be prepared to address the additional regulatory scrutiny that is placed on such funds.

The use of derivatives by ETFs is not a new concept. Derivatives, which can be dangerous if not used properly, can also be very helpful for hedging, investment and tax planning by portfolio managers. For example, while an index ETF will need to closely track its index, it may also try to incorporate unique strategies that will set itself apart from other similar index ETFs and help attract additional assets; it may use derivatives to accomplish this, by gaining or adjusting exposure to a market, sector or security quickly, to implement alternative investment strategies, and to manage risk. In addition, most derivatives involve some sort of leverage, creating the potential for enhanced returns or losses. Despite their usefulness, derivatives also pose risks, including leverage and counterparty risks, and their use will increase the overall risk profile of a fund.

The regulatory framework governing the use of derivatives by investment companies has developed through a series of releases and no-action letters issued by the SEC. Investment companies that invest in derivatives must comply with several provisions of the 1940 Act, including the leverage limitations of Section 18, which also governs the issuance of senior securities, as well as provisions governing diversification requirements, concentration limitations, investments in certain other securities-related issuers and valuation, among others.

In August 2011, the SEC issued a concept release (“Concept Release”) seeking comment on issues regarding the use of derivatives by investment companies. The Concept Release, which was a continuation of the SEC’s March 2010 Release, requested public input on the issues that the SEC staff has been examining to gain insight into potential ways to improve the regulation of the use of derivatives by investment companies. In particular, the SEC asked for comments on several specific issues under the

agreements, firm commitment agreements and standby commitment agreements, in the context of Section 18. In Release 10666, the SEC determined that the use of such agreements was equivalent to an issuance of senior securities. The Commission concluded, however, that a mutual fund could still maintain compliance with Section 18 if it was able to cover the senior securities by maintaining segregated accounts. Guidance with respect to the use of derivatives continued to be provided over the years on a case-by-case basis, with over 20 SEC no-action letters that expanded upon Release 10666.

As discussed earlier, ETFs need to secure exemptive relief under the 1940 Act by filing an exemptive application with the Commission. On March 25, 2010, the SEC issued a release (“March 2010 Release”) stating that it was beginning to review and evaluate the use of derivatives by mutual funds and ETFs, to determine what additional protections would be necessary under the 1940 Act. In its release, the SEC indicated that it would defer the approval of 1940 Act exemptive requests by ETFs that make significant investments in derivatives until its review of the matter was complete. Specifically, the March 2010 Release was intended for actively managed and leveraged ETFs that rely on swaps or other derivative investments to meet their investment objectives, although the SEC had been informally deferring exemptive relief for any active ETF making any investments in derivatives since 2009. It is important to note that the March 2010 Release did not affect ETFs that had already been granted exemptive relief and was only applicable to new and pending applications.

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1940 Act regarding the use of derivatives by investment companies, such as (i) restrictions on leverage, (ii) fund portfolio diversification, (iii) fund investments in certain securities-related issuers, (iv) fund portfolio concentration and (v) valuation of fund assets. In addition, the SEC requested clarification regarding the various ways that ETFs currently utilize, or intend to utilize, derivatives. Specifically, the SEC sought to discover whether ETFs utilize derivatives for the same purpose as mutual funds, and whether an ETF’s use of derivatives raised different investor protection concerns under the 1940 Act. The SEC’s intent was to use the comments to help determine what, if any, additional guidance is needed to protect investors.

The deferral of exemptive relief for ETFs that use derivatives continued until December 6, 2012 when Norm Champ, Director of the Division of Investment Management of the SEC, announced in a speech that the Commission has lifted the moratorium on the consideration of exemptive applications for actively managed ETFs that use derivatives, provided that exemptive applicants make two specific representations in their request for relief. These are: (i) that the ETF’s board periodically will review and approve the ETF’s use of derivatives and how the ETF’s investment adviser assesses and manages risk with respect to the ETF’s use of derivatives; and (ii) that the ETF’s disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant Commission and staff guidance.

The Commission subsequently granted no-action relief to certain entities operating in reliance on exemptive relief conditioned upon representations that no actively managed ETF relying on the relief would invest in options contracts, futures contracts, or swap agreements. The no-action relief states that the Commission will not recommend enforcement action if these actively managed ETFs invest in such instruments provided that they comply with the representations above. It is important to note that the moratorium is still in effect for new and pending exemptive relief applications for leveraged ETFs.

It is ETFs’ rapid growth and their increasing complexity that have prompted regulatory concern. Regulators are concerned about the destabilizing effect that derivative-heavy ETFs may have on the overall markets and the potential for abuse of these instruments by investment professionals. In addition, regulators have expressed concern that investors may not comprehend the inherent risks associated with such instruments, which may make them an unsuitable investment given the investors’ risk tolerance. Regulators are also concerned with whether ETF advisers who use derivatives have appropriate risk management programs in place. As the ETF market continues to grow and competition increases, ETF advisers will be pressed and motivated to create additional strategies that may involve the use of derivatives and sophisticated financial instruments. Therefore, ETF advisers wishing to employ such strategies should continue to expect heightened regulatory scrutiny.

CFTC Exemptions

Advisers who have ETFs that invest in certain derivatives (i.e., commodity futures, commodity options, and swaps) as part of their investment strategy may also need to register with the CFTC as commodity pool operators (“CPOs”). Until recently, investment companies were excluded from the definition of a CPO under CFTC Rule 4.5 based on the fact that they were already regulated by the SEC under the 1940 Act. However, on February 9, 2012, the CFTC voted to amend Rule 4.5 to require advisers to investment companies that invest in certain derivatives to register as a CPO unless they are able to meet certain trading and marketing thresholds. Recognizing that funds would now face conflicting SEC and CFTC requirements, the CFTC also proposed rules that attempt to harmonize some of the SEC and CFTC rules for dually registered advisers and their funds, although many areas of conflict would still remain.

The CFTC amendments were not received well by the industry. For example, the ICI suggested that funds will now be subject to duplicative and inconsistent requirements, which would increase costs and ultimately hurt shareholders. In addition, the ICI argued that the CFTC has
no justification for its amendments to Rule 4.5, since investment companies are already heavily regulated by the SEC. On April 17, 2012, the ICI joined the U.S. Chamber of Commerce in filing a lawsuit against the CFTC in the U.S. District Court for the District of Columbia seeking injunctive relief to prevent the CFTC from implementing its amendments. On December 12, 2012, the court issued a ruling in favor of the CFTC upholding its Rule 4.5 amendments. Therefore, ETFs that invest in certain derivatives will most likely need to register as a commodity pool operator and commodity trading advisor unless they are able to meet the CFTC’s marketing and trading thresholds discussed below. The ICI and U.S. Chamber of Commerce is appealing the court’s decision. The deadline for complying with the CFTC’s Rule 4.5 amendments and registering as a CPO and CTA was December 31, 2012.

ETF advisers who invest in certain derivatives will now need to review their strategies and determine whether they can meet the trading and marketing thresholds under Rule 4.5. Under the CFTC trading threshold, ETFs will be able to use derivatives for *bona fide* hedging purposes, i.e., generally where transactions or positions in a contract for future delivery represent a substitute for transactions to be made or positions to be taken for the purpose of reducing price risks. To the extent derivatives are not used for *bona fide* hedging purposes, ETFs may use derivatives, provided that the initial margins and premium for nonhedging derivatives must not exceed 5% of the fund’s liquidation value or the aggregate net notional value of the derivatives must not exceed 100% of the liquidation value of the fund.

To meet the CFTC marketing threshold, an ETF will not be able to market itself as a commodity pool or as a vehicle for trading in commodity futures, commodity options or swaps. The CFTC will consider seven factors in determining whether the ETF meets the marketing threshold. Those seven factors, which will be reviewed on a case-by-case basis, are: (i) the name of the ETF; (ii) whether the ETF’s investment objective is tied to a commodity index; (iii) whether theETF makes use of a controlled foreign corporation for its derivatives trading; (iv) whether the ETF’s marketing materials refer to the benefits of the use of derivatives or make comparisons to a derivatives index; (v) whether the fund has a net short speculative exposure to any commodity through a direct or indirect investment in other derivatives; (vi) whether the futures/options/swaps transactions engaged in by the fund will directly or indirectly be its primary source of potential gains and losses; and (vii) whether the fund is explicitly offering a managed futures strategy.

If an ETF is unable to meet the trading or marketing thresholds, the adviser to the ETF will be required to register with the CFTC as a CPO. Registration as a CPO will also mean that the ETF adviser will most likely be required to register as a commodity trading adviser (“CTA”) as well, as the adviser would no longer meet the CTA registration exemption under Rule 4.14(a)(8). In addition to SEC regulations and oversight, ETF advisers who are required to register as a CPO and CTA will be burdened with having to comply with CFTC regulations and a host of CFTC related requirements. These requirements include becoming a member of the National Futures Association, additional recordkeeping, reporting and disclosure requirements, registration requirements with the NFA for principals and associated persons, fingerprinting, as well as proficiency requirements, among others. CPOs and CTAs would also be required to complete new Forms CPO-PQR and CTA-PR, respectively, to allow the CFTC to assess the risks posed by commodity pools in the derivatives markets and the financial markets in general.

**Potential Dodd-Frank Implications**

ETF advisers, especially those who use derivatives as part of their investment strategy, are also feeling the effects of Title VII of the Dodd-Frank Act. The Dodd-Frank Act has created a new regulatory landscape for over-the-counter derivatives with the intention of increasing transparency, protecting investors and reducing systemic risk within the financial system. The Dodd-Frank Act provides for, among other things: (i) the registration of swap dealers and major swap participants; (ii) business conduct standards, including reporting and
Because an adviser will need to seek exemptive relief prior to launching an ETF, it is important for an ETF adviser to understand the exemptive relief process. Depending upon the complexity of the strategy being used, the process can be timely and costly, and may require significant resources and analysis.

The reforms of Title VII of the Dodd-Frank Act will have a significant impact on ETF advisers who use derivatives. Their operations and technology infrastructures will need to be assessed and revamped to accommodate the new central clearing, exchange trading, oversight, reporting and recordkeeping requirements, among other things. Their compliance platforms will need to be upgraded to comply with this new regulatory landscape and heightened regulatory scrutiny. As a result of the foregoing, they should expect an increase in technology and compliance costs. Notwithstanding the adopted rulemakings that are already in effect, the general compliance date for Title VII of the Dodd-Frank Act is currently scheduled for December 31, 2012.

Title VI of the Dodd-Frank Act, known as the Volcker Rule, may also have an impact on ETFs. The Volcker Rule generally prohibits banking entities from engaging in short-term proprietary trading, and from owning, sponsoring or having certain relationships with a hedge fund or private equity fund, with limited exceptions. Banking entities typically serve as the APs to ETFs, who purchase and redeem creation units. The concern is that the activities of APs, as they relate to ETFs, would not fall within the limited exceptions of the proprietary trading provisions of the Volcker Rule, and thus, the rule would prohibit banking entities from serving as APs.

This could potentially have a negative impact on the ETF market, investors and capital markets. There is also concern that commodity pools may be lumped in with hedge and private equity funds, thus placing certain ETFs within the reach of the Volcker Rule. These concerns are all very real and the prohibitions of proprietary trading that could result would have a significant negative impact on ETFs should the regulations implementing the Volcker Rule be interpreted to impose them. While it is possible, if not likely, that these concerns will be addressed and alleviated prior to the final adoption of the regulations, ETF advisers need to be aware of them and be ready to make adjustments should the need arise.

**Operational Considerations for ETFs**

Operationally, there are many differences between an ETF and a mutual fund. As a result, there are many questions ETF advisers need to ask, such as: Are we equipped to navigate the exemptive relief process? Have we chosen service providers familiar with the ETF landscape? Do we have the requisite connectivity to allow for trading and communicating with third-party distributors and APs, and to be able to process redemption and creation orders? This section will discuss some of these questions and highlight additional items that ETF advisers may wish to consider.

**Exemptive Relief Process**

Because an adviser will need to seek exemptive relief prior to launching an ETF, it is important for an ETF adviser to understand the exemptive relief process. Depending upon the complexity of the strategy being used, the process can be timely and costly, and may require significant resources and analysis.

The process for obtaining SEC exemptive relief for an index-type ETF takes about six months, depending on the complexity of the strategy employed by the ETF. The process for obtaining relief for an actively managed ETF can take even longer, usually between 18 to 24 months, and possibly longer if the adviser does not wish to be fully transparent and publish a complete list of portfolio holdings in order to protect against front-running by others. The SEC deems full portfolio transparency necessary in maintaining the arbitrage mechanism of ETFs, although it has not ruled out approving an exemptive application for an actively managed ETF that is not fully transparent. The SEC is also looking for assurances that the adviser actually plans to launch an ETF based on the
exemptive relief being requested. In addition, the ETF adviser must draft and file a registration statement, which, depending on the complexity of the strategy, may require additional analysis and correspondence with the SEC addressing questions. Furthermore, to be listed on an exchange, the SEC will need to review and approve the exchange’s listing proposal under Rule 19b-4 of the Exchange Act, specifically for actively managed ETFs, for which exchanges do not have specific listing standards. While index ETFs, which mostly fall under standard listing rules already approved by the SEC, can be listed on an exchange rather quickly, it can take much longer for an active ETF — more than three months — due to the back and forth between the SEC and the exchange in drafting a formal proposal. Therefore, the approval process for actively managed ETFs can take longer and be more costly than that of standard index-based ETFs.

In addition, if an adviser wishes to register a leveraged ETF that uses derivatives as part of its investment strategy, such sponsor will need to take into consideration the SEC’s March 2010 Release and be ready to either have its exemptive relief application deferred until a later unknown date, or alter its strategy.

Selecting an Index
ETF managers launching an index ETF will need to choose an index and a method to track that index. While employing an index-based investment strategy seems simple, the reality is that many of the major market indices are already under exclusive license agreements with fund managers. The solution to this dilemma is for a fund manager to work with an index provider to develop an index that tracks the performance of a segment of the index. Because ETFs, for the most part, are tied to indices, it is important for an ETF adviser to work with an index provider that is reputable and well-known within the industry. The index provider should also have a sound understanding of the market, asset class or industry that the ETF adviser is targeting. The adviser should try to select a segment for which it can be the first ETF in that market. Due to the increased number of ETFs in the marketplace, an adviser will need to consider the ETF’s strengths, and its ability to differentiate its funds from existing ETFs on the market. An ETF adviser should also consider working with an index provider that can think outside the box and find a new manner in which to target a specific sector of the market.

Exchange
ETF advisers will also need to list the ETF on a primary exchange, such as the American Stock Exchange or New York Stock Exchange. When choosing a primary exchange, ETF advisers need to assess whether the exchange provides the necessary levels of product support. ETF advisers need to also consider the reputation, liquidity, trading volume and cross-listing arrangements of the exchange.

Service Provider Selection
Prior to launching an ETF, an adviser should have a thorough understanding of the role that service providers play in the day-to-day operation of an ETF. Similar to traditional mutual funds, service providers for ETFs include a custodian, administrator, transfer agent, fund counsel, independent auditor, and distributor. ETF advisers will also need to work closely with APs. It is important to realize that given the lower fees typically charged by an ETF, a cost-effective solution must be contemplated when selecting service providers. Also, taking into consideration the investment objectives and sophisticated strategies used by ETF advisers, i.e., those involving derivatives, commodities, currency and foreign currency, as well as the increased scrutiny by regulators, the importance of having experienced service providers cannot be overemphasized. For example, service providers need to be familiar with settlement and clearing requirements for both equities and commodities here in the U.S. and internationally. They also need to be familiar with international regulatory and tax issues. When selecting a service provider, it is important to consider the depth of its industry knowledge across the board, as well as its technological capabilities to meet the unique requirements of operating an ETF. Below are certain matters that should be considered when partnering with critical service providers:

As ETFs utilize increasingly complicated strategies, advisers may wish to create partnerships with administrators that offer solutions ranging from pre-to post-trade, including back and middle office, primary and secondary market trading, and liquidity solutions.
Administrator
ETFs frequently outsource their fund accounting, transfer agency, regulatory administration, compliance support and financial administration services to third-party service providers that have the capability to provide specific administrative and technological services. It is important when selecting a third party to provide ETF administrative services that the provider’s technological capabilities be scrutinized to assess current functionality and the prospective needs of the ETF adviser.

When considering a service provider’s administration services, attention should also be paid to the experience and ability of their regulatory administration department in drafting and filing exemptive relief applications, experience with both the annual and new product registration statement process, and corporate governance matters. An administrators’ abilities with respect to tax and treasury services should be evaluated to allow for the effective administration of day-to-day NAV calculations, market return calculations, discounts and premiums, and a tax-efficient product. With respect to transfer agency services, it is important that a service provider have connectivity with clearing houses and exchanges. A transfer agent must also be able to effectively process creation/redemption orders by APs, issue shares in creation units for settlement with purchasers, keep records of outstanding ETF shares and AP records, transmit purchase and redemption records to clients and exchanges, as well as process the payment of distributions.

As ETFs utilize increasingly complicated strategies, advisers may wish to create partnerships with administrators that offer solutions ranging from pre- to post-trade, including back and middle office, primary and secondary market trading, and liquidity solutions. It is also important for ETFs to partner with administrators that have connectivity with major global trading exchanges and clearing platforms. An administrator must also have the resources to keep up with the unique strategies flooding the ETF market. The relevant expertise of an administrator will be vital to the efficient operation of an ETF.

Custodian
A custodian’s primary responsibility is to keep the underlying securities of the ETF safe and to guard against fraudulent activity. The custodian maintains the electronic record of the securities held in the underlying investment portfolio while it may take into possession physical commodities when dealing with a commodity-based ETF. In addition, the custodian will work with the ETF adviser to create portfolio composition files, which are the creation baskets and cash components that may be necessary, and send them to the appropriate clearing agents. The custodian is also responsible for the trade processing, settlement and clearing of the creation units and underlying securities. A custodian may also provide securities lending and foreign exchange services to the ETF adviser.

It is important to choose a custodian with effective collateral management processes in place, especially with respect to swaps and derivatives. As more and more ETFs venture into new territories, it is vital to the success of the ETF to work with a custodian familiar with global settlement and clearance practices, as well as international tax issues.

Authorized Participant
APs are most commonly large institutions that enter into agreements with the ETF which allow them to participate in the creation/redemption process. The AP is essentially a market maker that will accumulate and deliver a basket of securities in kind, the creation basket, plus a cash component that will underlie the ETF’s portfolio to the adviser in return for a predetermined number of ETF shares, or creation unit. The AP then keeps the creation unit or offers a portion or all of it to the secondary market for sale. The AP can also redeem a creation unit in the same manner. The AP will buy or accumulate the appropriate number of ETF shares making up a creation unit and then offer the creation unit to the adviser in return for the equivalent value of the ETF’s portfolio securities, the redemption basket, and cash component. This is known as the creation/redemption process.
As mentioned earlier, APs play a significant role in the arbitrage mechanism of ETFs. Because market prices of ETF shares vary from the NAV based on supply and demand, the ability of an AP to increase or reduce the supply of shares contributes to the liquidity in the secondary market and helps keep the trading prices of ETF shares close their NAV. Therefore, because APs provide liquidity growth, it is important to choose APs who have a long-term interest in the ETF and an ability to participate in the creation/redeemption process.

Distributor
ETF advisers may also need to work closely with a distributor. The role of the distributor is to act as the liaison between an ETF and its APs throughout the creation/redeemption process. The distributor maintains records of, and approves, the orders placed by the AP, consolidates them and places those orders with the transfer agent, who in turn processes the creation or redemption units. The distributor will also work with the ETF adviser on securing and negotiating AP agreements. In addition, the distributor will submit marketing and advertising materials to the SEC and FINRA for approval. When securing a distributor, it is important to work with one that understands the ETF landscape and structure of AP agreements, and who can find APs that understand the market being targeted by the ETF. The distributor must also have the technological capabilities to electronically provide creation/redeemption orders to the transfer agent and to be able to post the creation basket with the custodian.

Conclusion
There is much to consider when entering the ETF market from both an operational and regulatory perspective. While a lot of these key issues are highlighted in this article, there are other issues ETF advisers may need to consider. For example, if new to the market, an ETF adviser may need to take into account the competitive landscape, which is mostly occupied by BlackRock with a 41% market share, and State Street Corporation and The Vanguard Group, both with an 18% market share.\(^5\) In fact, the strong competition has led to price wars, whereby firms lower expense ratios in hopes of gaining additional market share.\(^52\) For a greater chance of success, new ETF advisers may wish to assess the market and target niche sectors or investment styles, and be the first to market or launch such products. In addition, ETF advisers may wish to consider how to best market their product and the distribution channels they plan to use. When marketing their products, ETF advisers who also offer mutual funds as part of their product base may want to ensure that their marketing teams do not blur the lines separating mutual funds and ETFs. Doing so could violate a condition of an ETF’s exemptive relief, which prohibits an ETF from being marketed as a mutual fund.\(^53\)

In less than 20 years, ETFs have become a major player in the investment industry. ETFs, which generally have lower expense ratios and are more tax efficient than mutual funds, are appealing to investors who are looking for cheaper alternatives and ways to further diversify their portfolio. Despite the heightened regulatory scrutiny, strong competition and operational considerations, ETF assets are expected to go from just over $1 trillion to $3 trillion within the next few years. Suffice it to say, ETF advisers will seize an opportunity to expand their core competencies and penetrate investor wallets. To successfully penetrate and maintain a presence in the ETF market, one cannot overlook the importance of recognizing and understanding the various issues discussed within this article, including the need for a solid business plan and partnering with experienced third-party service providers.

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Currently, there is some uncertainty surrounding the definition of CFTC No-Action Letter 12-03 (July 13, 2012) (extending the compliance deadline from July 31, 2012 to December 31, 2012).


41 Conner, Fundamentals of Mutual Funds and Exchange-Traded Funds 2011, supra n. 2.


43 Exchange-Traded Funds, supra n. 9; see also, 17 C.F.R. Parts 239, 270 and 274.

44 Noblett, supra n. 42.

45 Jackie Noblett, “Active ETF wannabes have to wait passively” Ignites.com (Oct. 11, 2011), http://www.ft.com/intl/cms/s/0/c05006ca-f3fc-11e0-b221-00144feab49a.html; see also, Strench & Rourk, supra n. 42.

46 Id.

47 Kathleen H. Moriarty & Jeffrey McCarthy, “So You Want to Launch an ETF… ETF Development from the Drawing Board to the Trading Floor,” Journal of Indexes (July/August 2006).


50 Moriarty & McCarthy, supra n. 47.


