



Exchange Traded Funds

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What is an Exchange Traded Fund?

Definition

An exchange traded fund (“ETF”) is a pooled investment vehicle that issues shares that trade intraday on stock exchanges at a market determined price.

- ◀ Investors may buy or sell ETF shares through a broker or in a brokerage account, just as they would the shares of any publicly traded company.
- ◀ ETFs can track an index or be actively managed.
- ◀ Similar to traditional mutual funds, but with significant differences.



What is an Exchange Traded Fund?

The Parties

◀ Sponsor

- Organizes the ETF
- Establishes the investment objective
- Establishes the creation basket

◀ Authorized Participant (**AP**)

- Creates and redeems ETF shares
- Lead AP stabilizes the price of EFT shares

◀ Stock Exchange

- Provides the market for individual investors to buy and sell shares



What is an Exchange Traded Fund?

Organization of an ETF

◀ Creation of ETF shares

- The sponsor or seed investor invests in a portfolio of securities and establishes the ETF's initial net asset value (**NAV**).
- The ETF sponsor daily publishes its **creation basket** of securities that may be exchanged for **creation units**.
- The creation basket is a list (known as a **portfolio composition file**) containing the names and quantities of the securities, cash or other assets that may be exchanged for creation units consisting of ETF shares. The creation basket generally mirrors the ETF portfolio.
- Creation units consist of 25,000 to 200,000 ETF shares.



What is an Exchange Traded Fund?

Organization of an ETF

◀ Creation of ETF shares

- ◀ An AP assembles a creation basket, which it delivers to the ETF in exchange for a creation unit of ETF shares.
- ◀ The AP then:
 - Holds the shares
 - Sells share to its clients
 - Sells the shares to others on a stock exchange



What is an Exchange Traded Fund?

Organization of an ETF

◀ Trading ETF Shares

- Investors buy and sell ETF shares on a stock exchange throughout the day at a price determined by supply and demand.
- The price of ETF shares approximates the ETF's underlying value due to:
 - ◀ Portfolio transparency provided by frequent release of ***intraday indicative values***.
 - Real time estimates of the ETF's underlying value based on prior day's holdings
 - ◀ The ability of the AP to arbitrage away differences between the ETF's share price and its NAV by creating and redeeming shares.



What is an Exchange Traded Fund?

Organization of an ETF

◀ Redeeming ETF Shares

- Only APs may redeem ETF shares.
 - ◀ The AP acquires the number of ETF shares in a creation unit and returns it to the ETF in exchange for the daily redemption basket of securities, cash or other assets.
 - ◀ The value of the creation unit is based on the ETF's NAV at the end of the day on which the redemption is initiated.



What is an Exchange Traded Fund?

Legal Structure

- ◀ ETFs are registered under the Investment Company Act of 1940.
 - Open-end investment company
 - Unit investment trust
- ◀ Shares are registered under the Securities Act of 1933.
- ◀ Trading in shares is regulated under the Securities Exchange Act of 1934
- ◀ Exemptive relief is required.
 - Role of the AP
 - Secondary market trading
 - In-kind redemptions
 - Delay in delivering redemption proceeds



Comparison to Mutual Funds

	Mutual Fund	Exchange Traded Fund
Regulation	1940 Act 1933 Act	1940 Act 1933 Act 1934 Act
Investments	Passive management (indexed) Actively managed	Passive management (indexed) Actively managed
Shares	Proportionate share in a pool of stocks, bond and other assets	Proportionate share in a pool of stocks, bond and other assets
Net Asset Value	Calculated at the end of the day	Calculated at the end of the day
Purchases and Sales	Bought and sold at the NAV calculated at the end of the day (forward pricing)	Bought and sold at market determined prices that may differ from the NAV
Sales Channels	Fund direct, broker-dealers, financial advisers, banks, other intermediaries	Broker-dealers
Portfolio Disclosure	Quarterly	Daily
Exemptive Relief	Not necessary	Required
Portfolio Liquidity	Must be able to satisfy redemption requests	Important because of spread between NAV and market price
Taxes	Daily redemptions make it difficult to manage shareholder tax liability	In-kind redemptions reduce shareholder tax liability

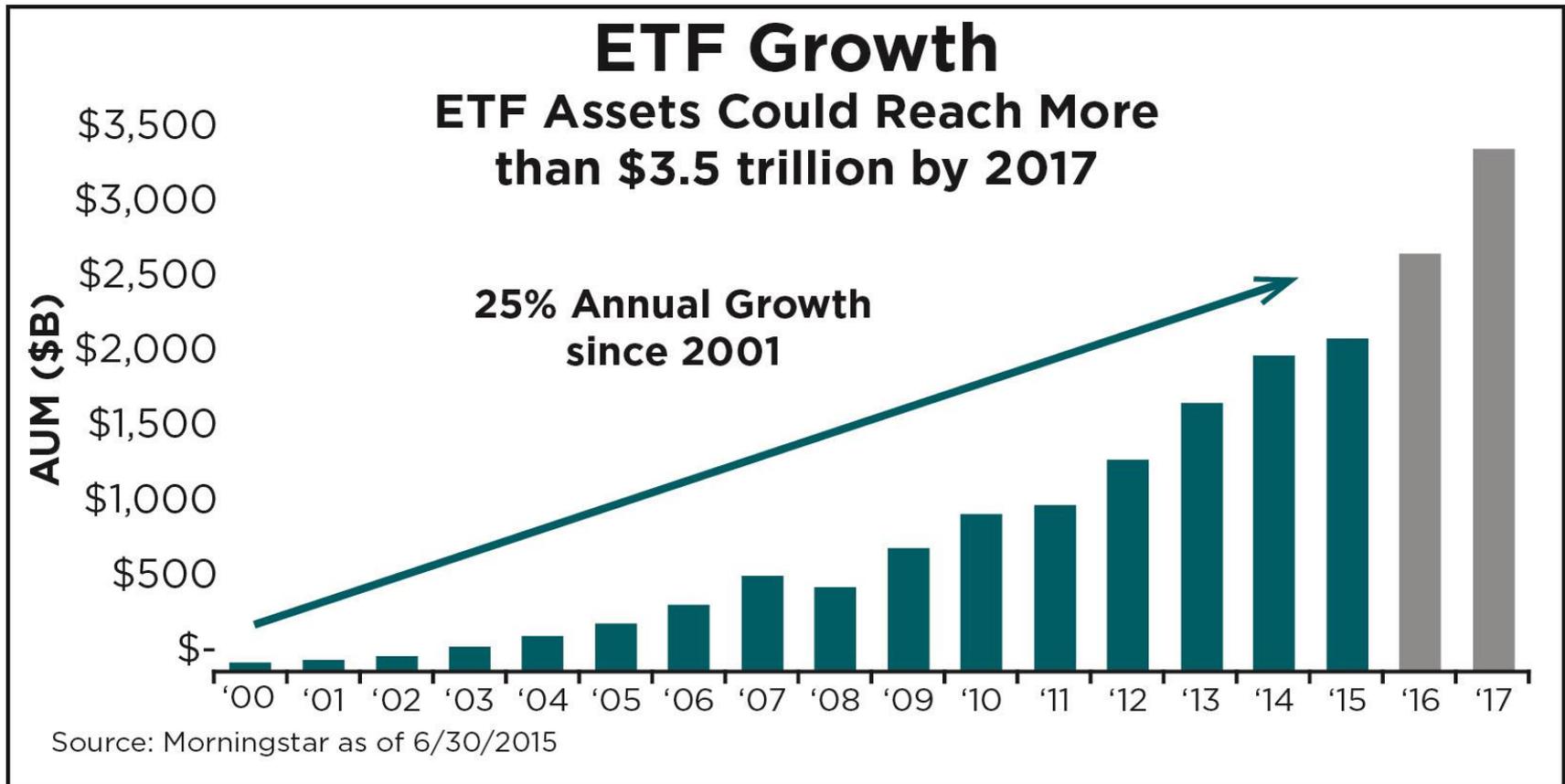


Why Are ETFs Popular?

- ◀ Intraday tradability
- ◀ Price and portfolio transparency
- ◀ Tax efficiency
- ◀ Access to specific markets or asset classes
- ◀ Rising popularity of passive investments
- ◀ Greater use of asset allocation models
- ◀ Externalization of distribution fees



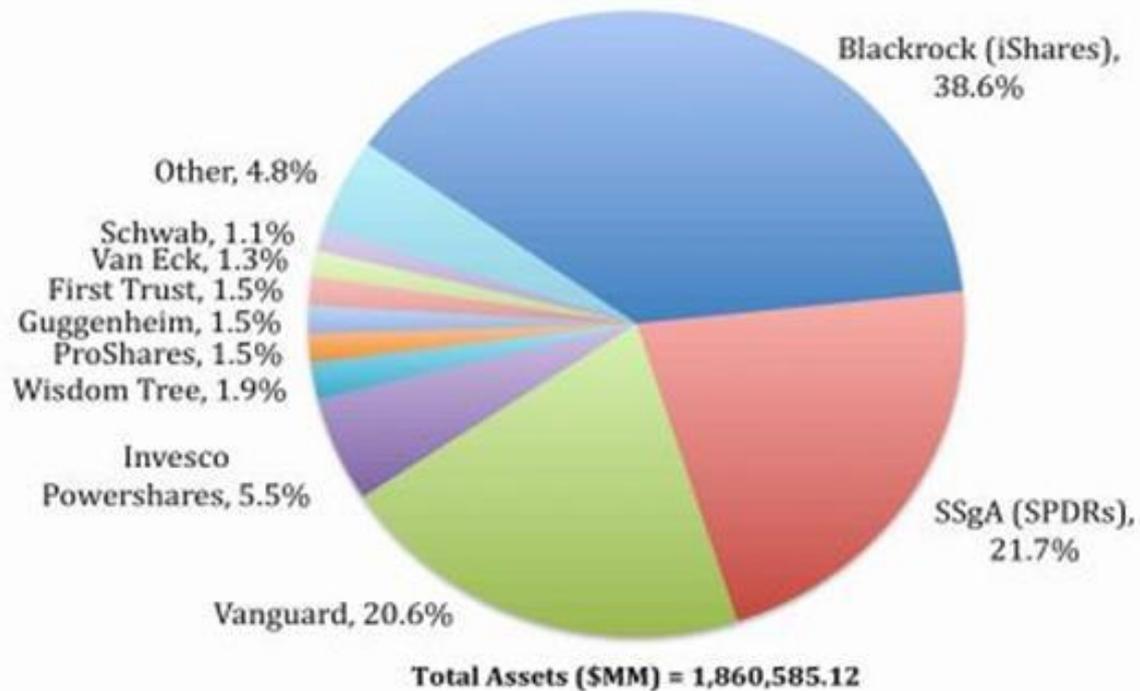
The Growth of ETFs





Participants in the ETF Industry

Sponsor Market Share - US ETFs



Source: First Bridge Data as of June 30, 2014