

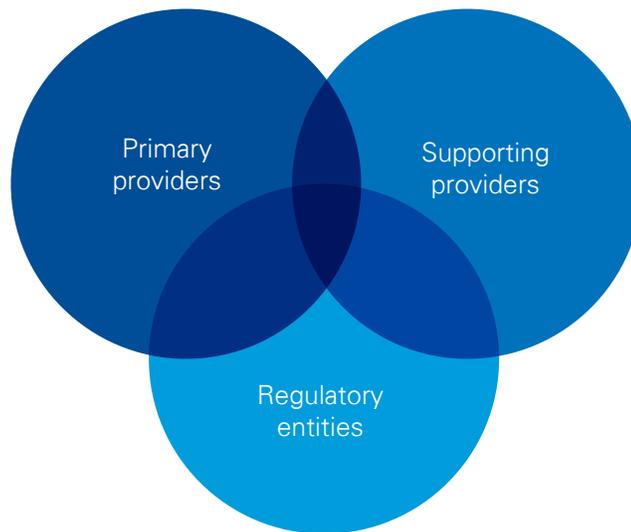
# ETF playbook glossary

## Glossary – Ecosystem of ETF industry roles

The roles in the ETF industry represent an ecosystem of different and specialized operational services and technology capabilities. Only a handful of the largest ETF sponsors have the infrastructure and resources to build and support a comprehensive ETF platform with all the required roles and functions.

Mid-sized and smaller ETF sponsors typically will utilize outsourcers to provide the vast majority of the technology and operations in the ETF ecosystem. Even among the different ETF roles, specialization is necessary to achieve economies of scale in order to keep fees low for investors.

For purposes of simplicity, we have grouped the ETF roles into three groups:



Each of the players in these groups has very specific and complex operational functions and technological capabilities. KPMG has the experience and ability to work with each of these different groups and assist with:

- Transforming platforms
- Improving levels of automation
- Implementing innovative data management and analytical capabilities.

**Index receipt agent** (aka ETF agent) – The index receipt agent has an essential and distinct role in that it provides the coordination and linkage of the various ETF roles. It maintains a platform that provides links and interfaces among the:

- Sponsor
- Index provider
- Authorized participants
- Exchanges
- Depository
- Regulatory entities.

On a daily basis, the index receipt agent:

- Gathers updated indexes
- Collects and publishes “create and redeem” baskets
- Assists with publishing the net asset value (NAV)
- Interfaces with the depository.

Index receipt agents typically offer bundling of other services, including the roles of administrator, distributor, custodian, record keeper, fund counsel, tax advisor, treasury/cash management, and/or transfer agent.

**Depository** – The depository is the central mechanism by which ETF information is registered and shared to the world. In the United States, the Depository Trust & Clearing Corporation (DTCC) provides this key role by:

- Gathering and publishing all ETF indexes
- Automating the ETF create/redeem process among ETF participants.<sup>1</sup>

DTCC provides a trade settlement function in its continuous net settlement (CNS) service for the create/redeem process. DTCC also provides surveillance reports to the industry about ETF activities.<sup>2</sup>

**Authorized participants** (aka market makers) – Authorized participants (APs) are often large banks or dedicated trading firms that provide market making and liquidity services for ETFs. APs initiate the:

- Create process to create new shares of ETFs
- Redeem process to eliminate ETF shares from the market

To create new shares of an ETF, APs exchange securities and cash with the depository in return for the corresponding amount of new ETF shares from the depository. In return for providing liquidity, APs are compensated by receiving the arbitrage value between the ETF and its underlying assets during the create/redeem process. In addition, ETF sponsors may act as an AP for their ETFs concurrently with other APs.

**Stock exchanges** – ETF sponsors must apply and receive permission to register a new ETF with a stock exchange. This normally occurs after the SEC has granted permission to start the new ETF. Exchanges have a number of rules to which the ETF must adhere in order to trade on it.

Exchanges may be able to calculate an ETF’s indicative intraday price or require that the ETF utilize a third-party service to do the calculation. Also, in the secondary market, exchanges support the trading of ETFs among investors.

**Custodian** – The custodian’s primary role is to hold and safeguard ETF assets. Custodians also provide trade processing, settlement, custody, and clearing for the create/redeem process. Some custodians provide securities lending, collateral management, and tax preparation services.

**Record keeper** – Record keepers provide fund accounting, valuation, and NAV calculations for an ETF. Note that index receipt agents frequently provide a bundling of record-keeping functions.

**Transfer agencies** – Transfer agencies keep track of which brokerage firms have custody of the various ETF shares, as well as the investors who own the shares. They work in close coordination with custodians.

<sup>1</sup> <http://www.dtcc.com/clearing-services/equities-trade-capture/etf.aspx>

<sup>2</sup> <https://www.dtcclearing.com/learning/clearance/topics/exchange-traded-funds-etf/about-etf/etfs-and-cns-processing.html>

## Secondary ETF roles

**Distributors** – Distributors have the role of conducting sales support for an ETF. For example, the distributor will reach out to brokerage firms, registered investment advisors (RIAs), retirement plan owners to:

- Introduce the ETF to them
- Support inclusion of the ETF into sell-side firms' ETF inventories.

In some cases, the ETF sponsor will act as the distributor, especially if it has existing fund wholesaler resources. Smaller ETFs, however, are more likely to utilize the services of a distributor since they typically lack a dedicated sales force.

**Independent auditor** – Each ETF must have an independent auditor who will audit the ETFs in adherence to accounting and regulatory requirements.

**Fund counsel** – As noted above, ETFs must register with an exchange and file an application with the SEC. ETF sponsors need to retain legal counsel—generally one that specializes in mutual funds and ETFs—to help navigate the registration and application processes.

**Advisors** – This term is used to refer to brokers and RIAs who provide investment advice about ETFs to investors.

## Regulatory roles

The regulators are the governing entities that oversee and enforce ETF regulations. Regulatory agencies are often supported by the monitoring and reporting that is conducted by exchanges and the depository.

**SEC:** The SEC is the primary regulatory body overseeing the ETF market in the United States. The SEC issues regulations and also has an examination and enforcement arm to administer fines and other disciplinary action for rule violations.

**CFTC:** The CFTC oversees ETFs that contain certain derivative securities and/or commodities funds. Similar to the SEC, the CFTC investigates and prosecutes alleged violations of the Commodity Exchange Act and Commission regulations.

## Primary providers

**ETF sponsors** (aka ETF owner, ETF advisor, ETF issuer, and ETF fund manager) – It all starts with the ETF sponsor, who is the owner, originator, and primary portfolio manager for an ETF. The sponsor:

- Establishes the ETF's investment strategy and prospectus
- Applies to regulators and stock exchanges (see above) for permission to issue a new ETF.

From a technology and operations perspective, the sponsor has very important decisions to make in terms of selecting all the service providers to fulfill all of the other needed roles in the ETF ecosystem.

**Index providers** – The primary portfolio construct for an ETF is represented as an index, such as the S&P 500 or Dow Jones Industry Average. The index provider selects the underlying investments and their weights within an ETF. The portfolio of the ETF's underlying investment components are packaged into an index and then sent to the index receipt agent, who plays another important role in the ETF ecosystem (see above).

The frequency of component changes within an ETF index ranges from daily to annually.

- For passive ETFs, index providers are often firms who specialize in publishing widely used indexes, such as Dow Jones, a McGraw Hill Financial company, who publishes the S&P 500 index.
- For active ETFs, it is common for the ETF sponsor or designated sub advisor to act as the portfolio manager and index provider.

**ETF administrators** – Day-to-day administration of ETF operational functions is provided by the administrator. The administrator coordinates:

- Technology services
- Operational services
- Financial administration
- Compliance oversight

Some large ETF sponsors function as their own administrator, but most ETFs outsource this role to a dedicated service provider with a highly scaled and efficient platform to service many ETFs. ETF administrators typically offer a bundle of other services and roles, including the index receipt and/or distributor (see above) role.

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