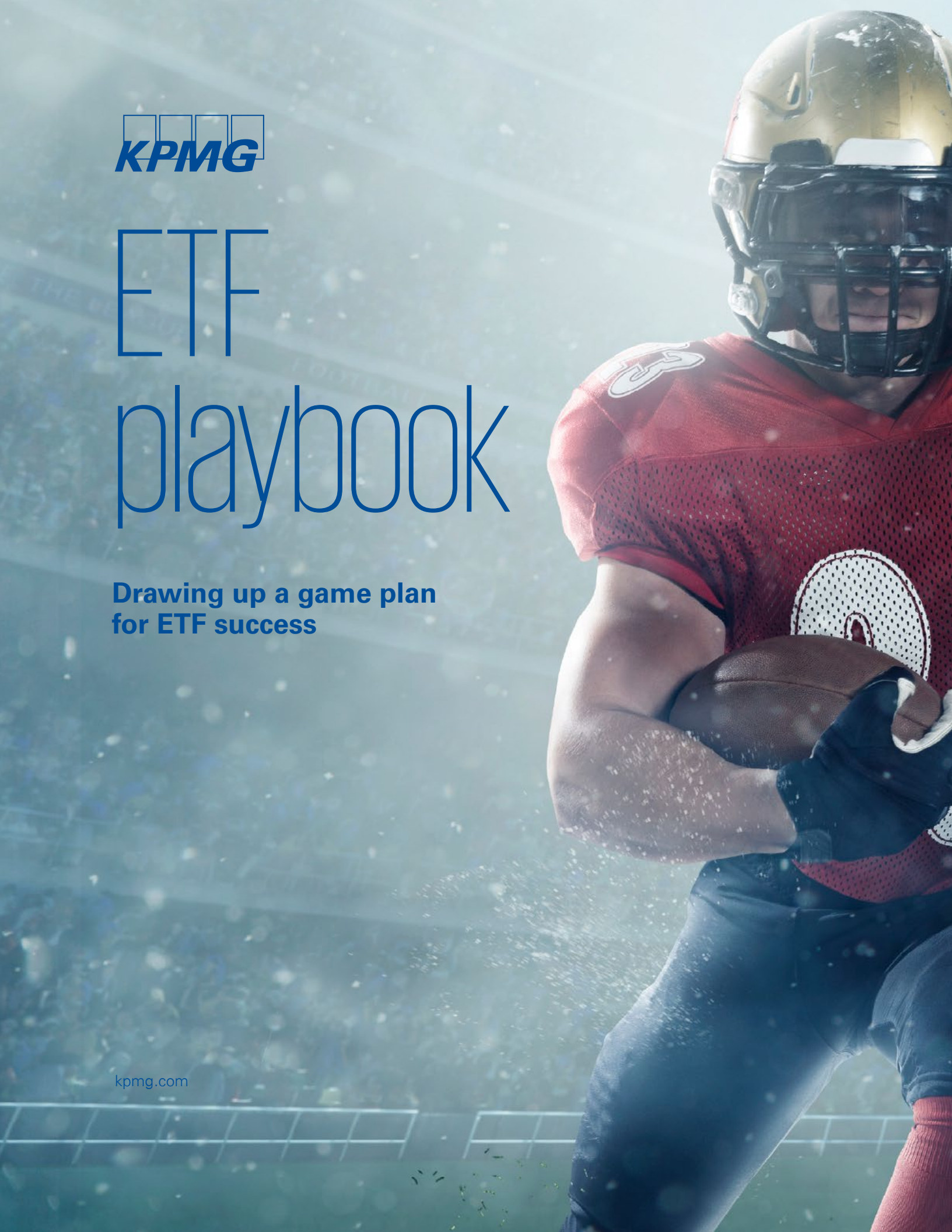
ETF playbook

Drawing up a game plan for ETF success



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Introduction

Are you thinking about taking the plunge and entering the exchange traded funds (ETF) game? Have you already begun drawing up some plays and taken initial steps towards forming a fund, or are you on the verge of launching one?

Or maybe you've launched your ETF, but haven't scored the touchdown you were expecting? What can you do to bolster your chances of being one of the few to score a game-winning touchdown and, more importantly, keep the winning streak going?

To help you reach these goals, we've created the ETF playbook. The playbook is designed to help you to enhance your game plan for success, and gain a thorough understanding of the ETF landscape.

— The first chapter explores the significant and growing "ETF opportunity" and addresses some essential elements needed to launch and operate a potentially successful ETF.

— Chapter 2 takes a deep dive into the potential tax implications of ETFs as compared to mutual funds and discusses the purported tax efficiency of ETFs.

— Chapter 3 explains some of the key technology and operations factors that can help improve the chances of a successful ETF.

— Chapter 4 examines the audit, financial, and regulatory requirements for ETFs versus mutual funds.

— Chapter 5 explores a recent SEC ruling (technically referred to as exemptive relief) that allows active ETF managers to keep their playbooks hidden in a "nontransparent" ETF.

The playbook also features case studies of ETFs that made it to the playoffs and those that were knocked out of contention early in the season, as well as practical, actionable lessons that can be gleaned from each.

Your ETF coaching staff

In this ETF playbook, you'll be seeing quotes and guidance from KPMG's ETF specialists. Each member of our coaching staff has more than 20 years' experience, and together they provide a full range of services needed by ETFs and Exchange Traded Products (ETPs), including regulatory, tax, accounting, audit, risk management, distribution, technology, operations, and other advisory services.

Here's a brief rundown of what they bring to the table:

Deanna Flores
Deanna is KPMG's national Tax leader for Public Investment Management and a principal in our National Tax Financial Institutions and Products group. She provides tax advice to investment management industry participants on matters related to investment alternatives and product structures, ETFs, cross-border financial products transactions, and investor opportunities.

Jay Freedman
Jay is a principal in the Financial Services Tax practice focusing on alternative investment and capital markets clients. He advises clients on a broad array of tax issues related to the alternative investment and banking industries, including financial products and derivatives, cross-border structuring and transactions, ETFs, partnership tax, and corporate tax.

Sean McKee
Sean is KPMG's national practice leader for Public Investment Management. He provides professional services across the investment management industry, including mutual funds, ETFs, hedge funds, commodity pools, investment managers, private equity funds, fund administrators, transfer agents, family offices, public pension funds, and institutional investors.

Jim Penman
Jim is an Advisory director with KPMG specializing in financial services product development, design, and architecture. His main focus is on innovation, systems implementation, technology enablement, and operational enhancement in connection with ETFs, mutual funds, trust companies, banks, broker-dealers, custody and record-keeping providers, and registered investment advisors. Jim has previously worked with ETF technology providers and DTCC on the launch of new ETFs.

Kim Zavislak
Kim is an Audit partner with KPMG providing financial reporting guidance and audit services to the complete spectrum of financial services clients, including investment advisors, banks, broker-dealers, ETFs, mutual funds, and private equity funds. She also assists clients with valuation issues, master-feeder fund structures, multiclass structures, derivatives, reorganizations, and common trust conversions.

Matt Giordano
Matt is KPMG's deputy practice leader for Public Investment Management. He provides professional services across the investment management industry including ETFs. Matt was formerly the chief accountant for the U.S. Securities and Exchange Commission's (SEC) Division of Investment Management. In this position, he oversaw accounting matters pertaining to ETFs.

Chapter 1: The ETF opportunity

The ETF space is expected to represent a significant growth opportunity in the coming years. That's why so many potential sponsors, entities, and investors are interested in them.

After starting out slowly in the late 1990s, assets under management (AUM) in ETFs and other (ETPs)[1] grew to more than $1 trillion in 2011 and jumped to more than $5 trillion in 2018.[2]

ETFs have become a favored investment both domestically and globally. Outside of the United States, there are 7,553 ETFs/ETPs offered by 386 providers listed on 69 exchanges in 57 countries, with assets expected to reach $1 trillion by 2020.[3]

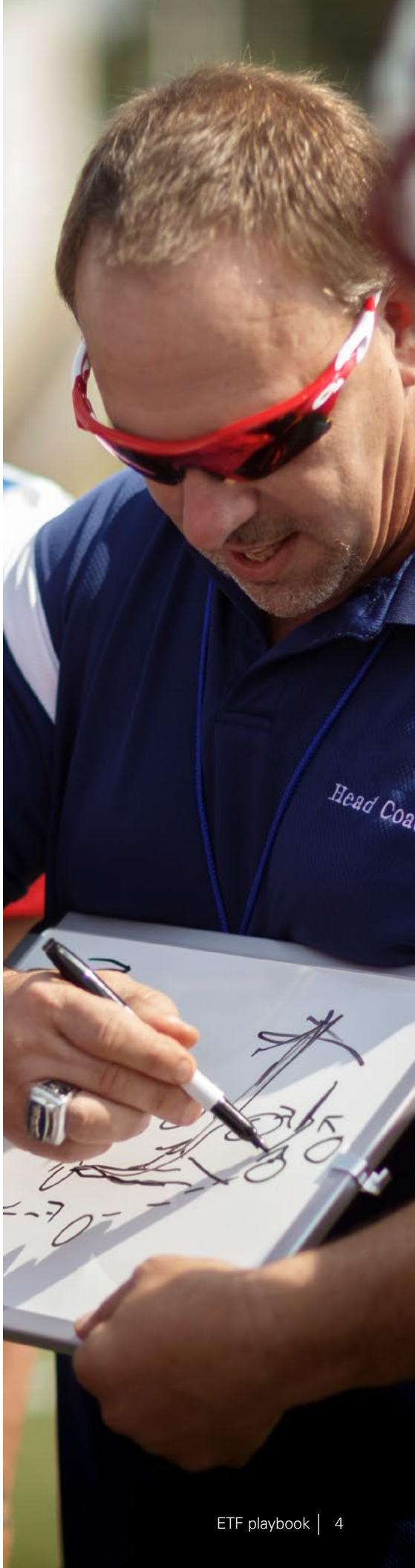
And that's just the tip of the iceberg. With ETFs increasingly becoming components of retirement plans, robo-advisors, advisory accounts, institutional investing, and self-directed investing, total ETF/ETP AUM is projected to hit $25 trillion globally by 2025.[4] It will likely be a key contender for marketplace supremacy alongside the reigning champ, mutual funds.

"ETFs are creating dynamic and innovative investment strategies," noted Sean McKee, KPMG's National Practice Leader for Public Investment Management. "And 'actively managed' ETFs represent the next generation of innovation."

Traditionally, ETFs were passively managed; that is, the manager assembled a portfolio of indexes on which to base the ETF, and made minimal, if any, adjustments to the portfolio. But with actively managed ETFs, the managers typically make frequent changes to the underlying index or portfolio allocations, like managers of mutual funds.

What's more, investors have a wide variety of choices; they can purchase ETFs holding currencies, commodities, frontier markets, sectors, countries, leveraged vehicles, bank notes, and more.

"In addition, the SEC's recent proposed 'exemptive relief application' rule, which would allow certain actively and passively managed ETFs to launch without going through the arduous exemptive order process, should further boost the growth of ETFs," noted Matt Giordano, KPMG Deputy Practice Leader, Public Investment Management, and former Chief Accountant, Division of Investment Management, SEC.



[1] ETPs, or exchange traded products, include ETFs, exchange traded vehicles (ETVs), and exchange traded notes (ETNs).

[2] Source: NASDAQ, Assets Invested In ETFs/ETPs Listed Globally Reached Record US$5.25 Trillion by September '18 (October 15, 2018)

[3] As of September 2018

[4] Source: ETF Strategy, A look ahead: The ETF industry's next 25 years (March 23, 2018)

Four paths to ETF success

ETF sponsors are finding many paths to achieve success. Below are some winning strategies that new ETF sponsors have used to enter the market.

#1—Finding an ETF niche: Finding and filling a niche has been a successful approach for offering new ETFs. We have seen several recent launches of ETFs for new subindustry groups, ETFs specific to new technologies (e.g., cryptocurrency ETFs), ETFs with new alpha or beta factors, socially conscious ETFs, and even cannabis-related ETFs.

#2—ETF sponsors nurturing distribution relationships: Having established distribution networks has been essential for many new ETFs. We have seen several ETF sponsors rapidly grow AUM by capitalizing on their strong relationships with the registered investment advisor (RIA) and/or family wealth communities, with institutional investors, or distributing through their own wealth businesses.

#3—Scale is important: Having an established family of funds and ETFs can provide capital and experience that helps bring new ETFs to market. Considering the trend of ultracompetition and fee compression, operational scale and efficiency are especially important when introducing new passive or indexed ETFs.

#4—Expanding globally: There is a trend of ETF sponsors expanding into international markets. For example, several non-U.S. ETF sponsors are looking to expand into U.S. markets, while many U.S. ETF firms are expanding into Europe, Indo-Asia, and South America. ETF sponsors with trading capabilities and experience in global markets, combined with strong local partners, may have an edge when it comes to expanding into G20, emerging, and frontier markets.

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More opportunity, more competition

But just because there will be more investable assets on the playing field doesn't mean there will be room for everyone to play.

The so-called "Big Three"—BlackRock, Vanguard, and State Street Global Advisors—currently control over 80 percent of the ETF landscape, and capture more than half of the American industry's fee revenue.[5]

So, the battle for the remaining portion of investable assets is likely to be difficult, albeit potentially lucrative.

"To be successful in this competitive market, it's going to come down to outthinking your competition, having a game plan in place, and staying two or three steps ahead of the rest of the pack," observed Jim Penman, KPMG Advisory director. "You'll have to be ready to seize an opportunity when it appears and be nimble enough to adapt quickly."

Let's take a look at some key factors that enhance the possibility of ETF success.

The right product

Regardless of the size of the fund or the sponsor, "you need to offer a product that provides a better or new solution for investors," noted Deanna Flores, KPMG National Tax Leader, Public Investment Management. "This fundamental principle was behind some of the recent ETF success stories."

To increase the possibility of creating an ETF product that connects with investors, you may want to identify where there are existing or emerging market gaps that may call for an ETF to fill those needs.

"One way to help determine if there's a market for your ETF is to hold focus groups with potential investors to see if they understand your product and its investment strategy," suggested Flores. "If you're considering marketing to retail investors, for example, you should be able to explain the product in a short elevator speech. If you can't, you may hit a roadblock entering that market."

Another key point is that the ETF should have a broad appeal, even if it's in a niche market. "Creating an ETF that's only appropriate for one or a few of your larger clients can lead to challenges down the road," cautioned Flores.

[5] Source: bloomberg.com, The Passive War, Rachel Evans, Dani Burger, and Sabrina Willmer (June 6, 2017)

The right distribution

Another potential key to a successful ETF is making sure your distribution game plan is in place well before launch.

"I can't emphasize enough how important your distribution strategy is," stated Penman. "No matter how good your product is and how compelling your investment theme, unless you can find a way to get it distributed, you could find yourself and your ETF falling short of the goal line."

The North American marketplace comprises four key sales segments:

— Direct-to-consumer

— Adviser sold

— RIA

— Institutional

What do investors like about ETFs?

Below are some potential advantages that retail and institutional investors can realize from ETFs:

Fees: ETFs generally have lower fees than comparable mutual funds. That's because the cost of shareholder servicing and recordkeeping is largely eliminated for ETF sponsors.

Investor objectives: ETFs are well suited to meet investor objectives related to portfolio diversification, liquidity needs, or hedging.

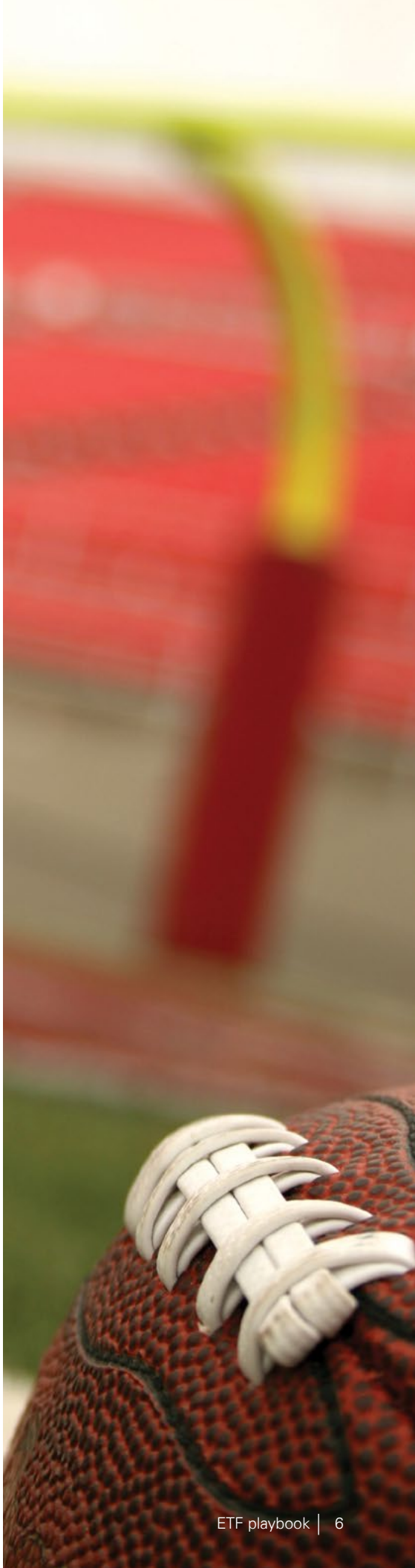
Intraday trading: ETFs are continuously valued throughout each trading day, and the price of an ETF share is market-derived.

Liquidity: ETFs can be bought and sold at any time during the trading day, just like a stock. This liquidity factor is particularly important to institutional investors (e.g., pensions), as they can use it to "equitize cash," or park money for short periods of time.

Taxes: Both ETFs and mutual funds distribute realized capital gains every year to minimize or eliminate entity-level taxes. "But in practice, ETFs often distribute fewer capital gains than comparable mutual funds due to ETFs' ongoing redemptions of investors in-kind," observed Flores. "That's why retail investors may prefer ETFs." (The potential tax implications of ETFs versus mutual funds is addressed in more detail in Chapter 2.)

Access: ETFs offer cost-effective access to an array of investment options for any investor with a brokerage account, as well as the ability to short-sell for investors looking for the inverse exposure of an ETF.

Transparency: ETFs generally must disclose their holdings on an intraday basis, while mutual funds generally have to do it quarterly. While this places an administrative burden on the ETF sponsors, it's a benefit for investors.



Repackaging an unsuccessful fund in an ETF wrapper?

You could be setting yourself up for failure if you're considering using an ETF as a way to repackage and sell another fund that wasn't successful previously.

Observed Jay Freedman, KPMG Tax principal, "We've seen managers who ran hedge funds that never really got off the ground, and then decided to repackage the product in an ETF wrapper so it would get more attention and market share."

"Invariably, this turned out to be a terrible idea," he continued. "If you didn't have the track record or the proper sales and distribution setup for the hedge fund, your chances of getting any more traction by repackaging it as an ETF are slim to none."

In addition, there are a number of subsegments that can serve as distribution channels, including robo-advisors,[6] platform providers, wirehouses[7], banks, trust companies, independent broker-dealers, and direct-to-consumer providers.

When it comes to developing a distribution strategy, the three typical ways to enter the ETF market are launching your ETF:

— Independently

— As a subadvisor with an existing ETF sponsor

— As a subadvisor to an ETF platform provider.

Here are some key points to keep in mind when developing your distribution strategy.

"Getting attention—and shelf space—at broker-dealers often depends on a product's size, liquidity, and track record," observed Penman. "Smaller ETF sponsors could have distribution challenges until they gain some credibility and market share through the performance of their funds."

On the other hand, fund providers that already have strong distribution channels in certain segments can often leverage those channels to market their ETFs.

"But just because you distribute a mutual fund through one channel doesn't necessarily mean that the same channel has the appropriate technology platform and expertise to distribute your ETF," noted Penman.

The right execution strategy

It's important to try and have all phases of your ETF game plan locked down tightly before launch—from investment strategy to operations to sales and distribution. According to Penman, "You generally have about 18 months after launch to get to the next level, where sales become self-sustaining."

If you don't hit that mark within that time frame, your chances of being successful dwindle markedly. "Generally speaking, you may as well shut it down," he observed. "Otherwise, you may be one of those stragglers who'll be out there for a long time stuck at the same level. And the cost and effort of keeping the ETF going is probably not worth the time and expense."

How do you gauge whether you're on the right track? Penman noted that "A good indicator of ETF success is reaching at least $50 million in assets within the first year and then continuing to build momentum from there. But only a small percentage of new fund launches get to that level."

Penman also noted that the bigger players in the ETF space have strong product portfolio management and a good feel for knowing when to go for it or punt. But smaller ETF sponsors who are determined to keep their fund alive may have to partner with someone, or hope that they get enough shelf space from some platform providers to drive sales.

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[6] A robo-advisor is an online wealth management service that provides automated, algorithm-based portfolio management advice without the use of human financial planners. It typically offers only portfolio management services and not tax, retirement, or estate planning.

[7] Wirehouses range from small regional brokerage firms to giant full-service brokerages. They typically have offices around the world that share financial information, research, and prices.

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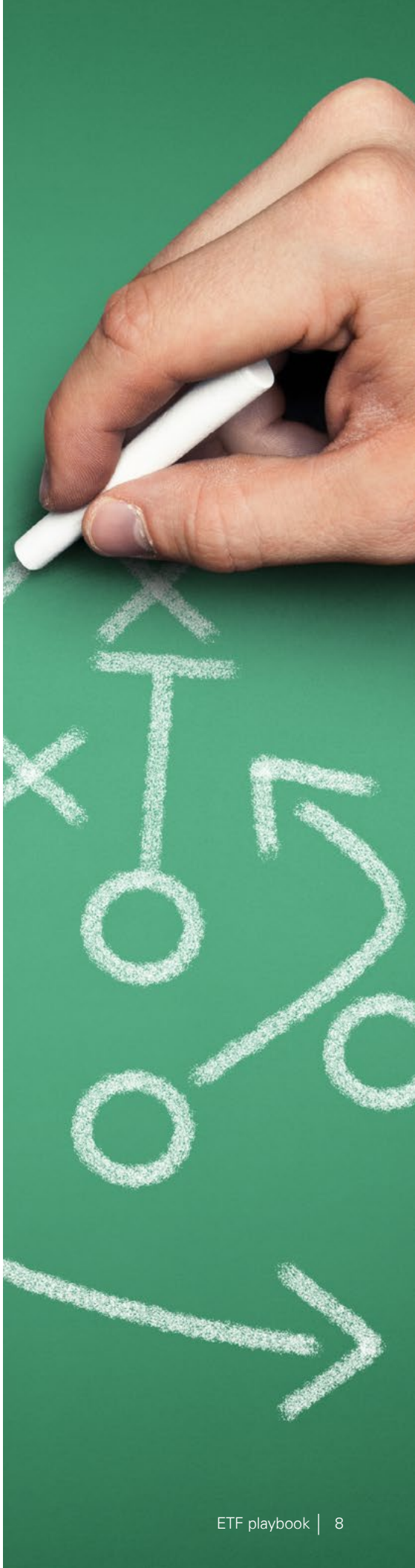
So, how do you make sure that you're prepared to execute quickly and effectively against your game plan? Our ETF coaching staff's blueprint to potentially increase your chances of success calls for:

- Understanding the ETF landscape thoroughly, including your competitors' strengths, weaknesses, and tactics
- Offering a product that connects with investors and developing a compelling "elevator speech" to explain the product to appropriate audiences
- Realistically assessing the fixed costs and run rate it will take to launch and maintain the ETF for at least 18 months (or until it gains traction). In addition, consider the amount and timing of seed capital to show activity in the fund, versus seeding the entire amount at launch
- Making sure that you have the right talent, experience, and track record to execute on the investment strategy you've selected
- Locking in your operations, technology, and sales platforms, and your custodian and distribution contracts
- Creating a competitive and predictable fee structure
- Building in options that allow you to be more nimble and agile than your competitors.

"If an ETF sponsor executes its game plan successfully, it can create a niche and potentially lock out the competition in that area," stated Flores. "A key component of successful execution is closely tracking the ETF's index, while also developing and evolving a plan to mitigate investor tax exposure."



Chapter 2: ETF tax efficiency

Fact or fiction?

ETFs are generally regarded as being more tax efficient than comparable mutual funds. This is one of the core selling points that ETF sponsors raise when discussing the "ETF advantage."[8] And it often is true.

But why is it true?

According to Flores, "It's essential to understand why ETFs are tax efficient before you include them in any investment strategy. Otherwise, you may end up holding an ETF whose tax advantages have been overstated."

"ETFs do hold great attraction and can offer significant benefits," she added. "But, from a strictly tax point of view, the tax efficiency of an ETF or a mutual fund is generally driven by four key factors:

— Operational infrastructure

— Portfolio management and investment mandate

— Overall market conditions

— Investor behavior.

Whether investors buy ETFs or mutual funds, they should keep their "eyes on the ball" and focus on the following:

— **What is their net return?** An ETF or mutual fund that permits investors to realize higher net returns over the long run may be the right choice, irrespective of tax efficiency in the short run.

— **Is the fund well-managed?** Smart choices by a fund sponsor may improve the tax efficiency of any fund, regardless of whether it is structured as an ETF or mutual fund.

Let's take a closer look at the drivers of tax efficiency.

Operational infrastructure

Both ETFs[9] and mutual funds must:

— Recognize gains, losses, and income at the fund level, but they're not taxed at the fund level on these items to the extent they are distributed to shareholders

— Distribute net realized gains and income to investors, which are then generally taxable to the investors as ordinary dividends, long-term capital gain dividends, exempt interest dividends, or returns of capital.

In addition, both ETFs and mutual funds may redeem shareholders on an in-kind basis.[10] Generally, this means that when an investor wants to redeem ETF or mutual fund shares, the fund could exchange the shares to be redeemed for a basket of securities held by the ETF or mutual fund.

In the case of ETFs, only certain institutional investors (called "authorized participants") may redeem shares directly from an ETF. Conversely, the institutional investors are also allowed to contribute securities to an ETF in exchange for newly issued ETF shares. Retail ETF investors, on the other hand, must purchase or sell ETF shares through a broker or another intermediary.

In the case of a mutual fund, there may be minimum size requirements for redemptions in kind (say 50,000 or more shares). What's more, retail investors typically want to be redeemed in cash, not securities. So, when mutual funds do use in-kind redemptions, it tends to be only for large redemptions by institutional investors.

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[8] Source: ETF.com, Why Are ETFs So Tax Efficient?

[9] Most ETFs are taxed as a regulated investment company (RIC). For the purposes of this article, we are comparing this type of ETF—a RIC ETF—to a mutual fund. However, it should be noted that an ETF may be structured for tax purposes as a RIC, C corporation, partnership, trust, or some combination of the foregoing. We are also assuming that the mutual fund or ETF shares are held in a taxable account, and not in a retirement or other tax-deferred investment.

[10] However, certain types of securities—for example, derivatives or thinly traded securities—can't be redeemed by an ETF on an in-kind basis. In this case, the ETF typically will include cash or other securities, as needed, to complete the redemption. Other types of ETPs, which are not discussed in this article, such as closed-end funds, do not permit in-kind redemptions.

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> Generally, there are more opportunities for ETFs with appreciated and liquid portfolio holdings to defer gain recognition.
>
> — Jay Freedman, Tax Principal, KPMG LLP

Redeeming shareholders on an in-kind basis means that ETFs and mutual funds don't have to liquidate securities to raise cash to pay the redeeming investor.[11] In addition, the ETF or mutual fund can use appreciated securities for the in-kind redemption.

In this case, provided certain requirements are met, neither the ETF nor the mutual fund recognizes gain on the transaction. Thus, there is no need for the funds to make a taxable distribution of gains to its other nonredeeming shareholders. (However, redemptions in kind are not permitted to trigger losses for an ETF or a mutual fund.)

The redeeming investor, on the other hand, must recognize gain or loss just as if the investor had been redeemed in cash. The amount recognized is equal to the difference between the tax cost or "basis" of the investor's ETF or mutual fund shares and the fair market value of the securities received.

KPMG observation: "While both ETFs and mutual funds are permitted to use in-kind redemptions, ETFs are structured so that in-kind redemptions are the primary redemption mechanism," observed Freedman. "As a result, there generally are more opportunities for ETFs with appreciated and liquid portfolio holdings to defer gain recognition by shareholders—and that's a touchdown any way you look at it."

Portfolio management and investment mandate

An ETF or mutual fund portfolio manager may make investment choices that are more or less tax efficient. For example, depending on the fund's investment mandate, market conditions, and other factors, the portfolio manager may:

- Decide to "harvest losses" by selling underlying securities or indexes that have underperformed in order to offset or minimize realized gains in the fund
- Only sell securities with a higher cost basis in order to minimize any resulting gains

[11] Where a mutual fund does not redeem shareholders on an in-kind basis, the fund typically would use cash on hand and/or cash received from new investors to meet redemptions, and liquidate portfolio holdings only as necessary. And, in any event, realized gains may be offset by other losses in a fund's portfolio.

Tax efficiency, not tax avoidance

The deferral of gains at the ETF or mutual fund level using in-kind redemptions for appreciated securities generally doesn't alter the **total amount** of taxable gains to be realized when the shareholder ultimately sells or redeems his or her ETF or mutual fund shares (although it may have the effect of converting short-term capital gains to long-term capital gains).

Bottom line: While the in-kind distribution strategy may foster tax efficiency by deferring tax on gains, it generally doesn't enable those gains to escape taxation.

— Minimize investments in securities (such as derivatives or illiquid securities) that can't be redeemed on an in-kind basis

— Use cash on hand, or cash received from new investors and reinvestments, to meet redemption requests

— Effectively manage selling of underlying securities by taking into consideration holding periods to maximize long-term capital gains.

"In some situations," noted Flores, "tax efficiency may be less dependent on the nature of the investment vehicle—ETF or mutual fund—than the choices of the portfolio manager. In other situations, the portfolio manager may not have as many opportunities to enhance tax efficiency."

"For example, relatively new types of ETFs, such as currency-hedged ETFs, may hold significant positions in derivatives, which can't be used for in-kind redemption requests," she continued. "And in the initial years, there may not be a sufficient reservoir of losses that can be used by the portfolio manager to offset any realized gains."

Another key factor impacting tax efficiency is portfolio turnover. Generally speaking, high portfolio turnover via the sale of the underlying securities creates more opportunity to trigger capital gains that must be distributed and potentially taxed to investors. This is particularly true in a rising market.

"Passive" funds that are designed to be more static and have less portfolio turnover, tend to be more tax efficient than those with actively managed portfolios and higher turnover. While this principle applies to both ETFs and mutual funds, since many (although certainly not all) ETFs employ fairly passive index strategies, they tend to have lower turnover than actively managed mutual funds.

That being said, if a passive mutual fund were required to sell appreciated securities to meet redemptions, it could trigger large taxable gains for nonredeeming shareholders. This could be the case where, for example, a passive mutual fund is shrinking due to net shareholder redemptions.

KPMG observation: "It should be noted that the perception of ETFs being a strictly passive product isn't set in stone," Freedman remarked. "Some ETFs with index strategies are mandated to rebalance frequently. And the increasing number of actively managed ETFs may change this equation."

He also pointed out that "some mutual funds are required to be managed in a tax-efficient way, which may cause the fund sponsor to adopt investment strategies to minimize capital gains distributions."

Overall market conditions

What's happening in the markets can also impact the ability of portfolio managers to achieve tax efficiency with ETFs and mutual funds. "For example, when markets are generally flat but there's significant volatility—that is, the markets may rise and fall hundreds of points on a daily basis, but basically wind up at the same level over the course of a year—there may be more opportunities for portfolio managers to realize losses and offset embedded gains in portfolio securities," Flores pointed out.

"They can do this even without utilizing the in-kind redemption mechanism," she added. "What's more, this type of market tends to help mutual fund managers achieve tax efficiency."

However, where markets are steadily rising, funds may hold mostly appreciated portfolio securities that generate taxable gains when sold to meet redemptions, for example. This means that a mutual fund may be more likely to trigger gains to meet shareholder redemptions than an ETF, if the ETF primarily redeems investors on an in-kind basis.

KPMG observation: "For the most part, markets have been on a consistently upward trajectory for more than 20 years," Flores observed. "This has made it more difficult for portfolio managers to manage funds on a tax-efficient basis without utilizing the in-kind redemption mechanism, which, as noted, is more frequently employed by ETFs, not mutual funds."

Investor behavior

When investors purchase ETF or mutual fund shares, they acquire a cost basis in those shares, which fundamentally reflects the amount paid by the investor, plus transaction costs. And when the investors ultimately sell or redeem the shares, they generally are taxed on the amount by which the sale or redemption price exceeds their cost basis.

Following an initial purchase, an investor's cost basis in the ETF or mutual fund shares is reduced to reflect returns of capital, adjusted, as appropriate, to reflect corporate actions (such as a fund merger or stock split), and increased when the investor reinvests distributions from the ETF or mutual fund to acquire additional shares.

However, an investor's cost basis doesn't increase as the ETF's market price or a mutual fund's net asset value (NAV) increases. It is also important to note that an investor's cost basis doesn't decrease as the ETF's market price or a mutual fund's NAV goes down. This also holds true for decreases in NAV due to distribution of dividends.

If, for example, an investor buys shares of a mutual fund or ETF whose market-derived price equals or is close to NAV before an ex-dividend date,[12] the investor will:

— Pay current tax on the dividend distribution

— Have an unrealized loss in its shares because the tax basis will be higher than the NAV after the NAV is reduced for the dividend payment.

[12] This is the date on which it is announced that a dividend payment will be made.

This is commonly referred to as "buying the dividend." It is generally something for investors to avoid, particularly near the end of the calendar year when ETFs or mutual funds may make their largest distributions.

KPMG observation: The frequency—and aggressiveness—with which investors tend to buy and sell funds can have an impact on the fund manager's ability to achieve tax efficiency.

"This is particularly the case with mutual funds that do not use redemptions in kind as their primary shareholder redemption mechanism," noted Flores. "For example, if a mutual fund has net cash inflows and growing assets under management, it may not be necessary for the portfolio manager to sell any underlying securities to meet redemptions by other shareholders."

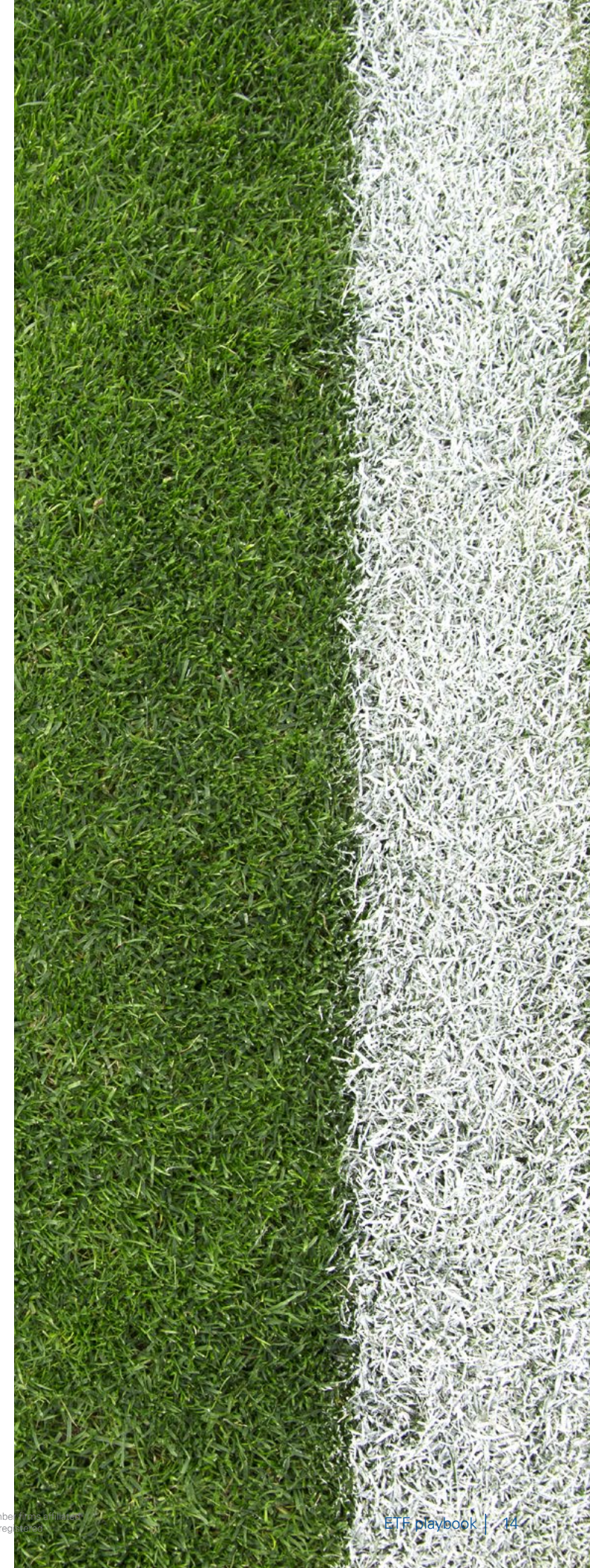
"However, where existing investors are exiting the fund and outflows aren't being replenished by new investors, or where an ETF is limited in its ability to use in-kind redemptions, such as where the ETF has significant holdings of derivatives, the portfolio manager's hands may be somewhat tied; they'll be forced to sell underlying securities without as much opportunity to achieve tax efficiency.[13]

A winning game plan

The winning football team generally is the one that focuses on both offense and defense and makes thoughtful decisions in designing a game plan. This is also a good approach when evaluating the tax efficiency of ETFs. It is true that ETFs may be more tax-efficient than mutual funds due to their routine use of in-kind redemptions. However, if the redemption feature is your primary focus, you may be overlooking some other important factors.

This includes determining whether a particular fund is well managed in terms of expense ratios, error tracking, investment mandates, and index methodologies, and what your net return will be.

To quote the legendary businessman and stock investor, Peter Lynch, "Know what you own and why you own it."



[13] Source: Morningstar.com, Which ETFs Are Making Capital Gains Distributions This Year? (December 2, 2015)

ETFs versus mutual funds: The tax match-up

Below is a quick summary comparing ETFs and mutual funds and their respective potential tax advantages and disadvantages.

Operational infrastructure

— Both ETFs and mutual funds are permitted to use in-kind redemptions.

— But ETFs are structured so that in-kind redemptions may be the primary redemption mechanism, so there may be more opportunities for ETFs to defer gain recognition by shareholders.

Overall advantage—ETFs

Portfolio management and investment mandate

— Investment choices: ETF or mutual fund portfolio managers may make investment choices that are more or less tax efficient, so tax efficiency may be less dependent on the nature of the investment vehicle—ETF or mutual fund—than the choices of the portfolio manager.

— Portfolio turnover: Generally, high portfolio turnover may create more opportunity to trigger potentially taxable capital gains for investors. ETFs typically—but certainly not always—employ fairly passive index strategies, so they tend to have lower turnover than actively managed mutual funds.

Slight advantage—ETFs

Overall market conditions

— Generally, rising markets during the past 20 years have made it more difficult for portfolio managers to manage funds on a tax-efficient basis without utilizing the in-kind redemption mechanism.

— In-kind redemptions are more frequently employed by ETFs, not mutual funds.

Advantage—ETFs

Investor behavior

The frequency—and aggressiveness—with which investors buy and sell funds can impact a fund manager's ability to achieve tax efficiency.

This is particularly the case with mutual funds that do not use in-kind redemptions as their primary shareholder redemption mechanism.

However, where an ETF is limited in its ability to use in-kind redemptions (e.g., the ETF has significant holdings of derivatives) the portfolio manager's hands may be somewhat tied.

Slight advantage—ETFs

Chapter 3: Five tech and ops factors to help improve ETF success

In football, one of the keys to success is the offensive line; it's the foundation of a great offense. You can have a hall of fame quarterback, an all-pro running back, and speedy receivers, but if you have an offensive line made of Swiss cheese, all that talent may not matter.

"The same holds true for ETFs," observed Penman. "You can have a brilliant product, but if your foundation—your technology and operations (tech and ops)—is substandard, your product may not break through the line and score touchdowns. You may end up just kicking a long field goal."

This section of the playbook takes a look at some of the unsung—but critical—"players" involved in ETF tech and ops roles, the potential impact they can have, and the questions you should consider asking before "drafting" them to be part of your team.

Background

The vast majority of ETF assets are considered passively managed ETFs.[14] However, the ETF industry is experiencing significant change in its offerings; for example, 2016 witnessed the first release of the Exchange Traded Managed Fund (ETMF), a hybrid product that trades like an ETF, but its portfolio is managed like an actively managed mutual fund (see sidebar on page 21).

However, as noted above, without an effective tech and ops strategy, your ETF may experience scalability, performance, and/or regulatory issues. "The best ETF investment strategy may not be enough if you don't have all of your technology and operational components in place," emphasized Penman. "Errors or failures in these areas can have significant financial and reputational repercussions."

The roster of players

From an investor's point of view, ETFs offer simplicity for investing in a veritable supermarket basket of investments. An investor can simply open and fund a brokerage account and immediately start trading ETFs.

But what happens behind the scenes to bring ETF shares to market is far from simple. The process of creating—or eliminating—an ETF requires a complex ecosystem with careful orchestration among several financial industry "players."

For many ETFs, tech and ops functions are outsourced to third parties. "Generally, only the largest 5 or 10 ETF providers have the scale and technology proficiency to invest in, develop, and manage their own comprehensive platforms," noted Penman. "In fact, those large ETF providers who maintain their own tech and ops platforms may also be service providers to other ETF providers." Because of the potential behind-the-scenes complexity of ETF operations, many new ETFs are brought to market through turnkey ETF outsourcers.

> "In light of the dynamic growth of ETFs and the prevailing regulatory scrutiny, it is critically important that investment managers ensure their infrastructure and operations are sustainable, effective, and aligned with their product and distribution strategies. Seasoned professionals that provide tailored and thoughtful insights to help you accomplish this are of immense value to the organization.
>
> In choosing a service provider that's right for you, we recommend carefully considering whether it offers the right blend of experience and professionals with informed judgment, and is also willing to invest the time and resources necessary to furnish you with valuable insights."
>
> —Sean McKee
> National Leader
> Public Investment Management, KPMG LLP

[14] Source: Investopedia.com, How Europe's ETF Market Will Reach $1 Trillion, Todd Shriber (June 8, 2017)

As a result, possibly the biggest tech and ops decision for many ETF sponsors is how to select their various service providers. Each service provider will have different levels of:

— Operational services and support

— Functional levels of technology automation

— Compliance and reporting capabilities.

Page 20 illustrates some of the tech and ops service providers in the United States who inhabit the ETF playing field and a brief explanation of their roles. For a more detailed explanation of what they do, please refer to the Glossary.

Selecting the right service providers

It is vital that you conduct vigorous due diligence with each service provider and ensure their tech and ops capabilities meet your current and future requirements.

Before you go about selecting your ETF service provider, you should consider, among other things, these five key business decisions that an ETF sponsor should make:

1. Who is going to administer, advise, and possibly subadvise your ETF? Will you be your own administrator or will you hire a third party? If hiring a third party, consider asking the following questions:

— What type of ETF indexes and trading strategies can you administer (e.g., passive or active)?

— What is the range of securities and investment components you can administer?

— What is your process for ensuring that you support and comply with applicable ETF regulations, including regulatory reporting and recordkeeping?

— What is your experience with administering global securities, derivatives, physical assets, real estate, leveraged or shorted positions, and other nontradable assets?

— What other similarly sized ETFs have you done administration work for?

— What is your level of technology automation, and what processes are done manually?

— How does your platform support custom ETF baskets, negotiated ETF baskets, or partial ETF baskets (if applicable to your ETF)?

— Can you please explain your fee structure (including reoccurring and nonreoccurring fees)?

2. Select your fund counsel (i.e., legal counsel) to help you navigate regulatory registration and exchange listings. Consider asking the following questions:

— What is your experience in advising ETFs? What funds have you provided counsel, or assisted in writing the prospectus?

— On which stock exchanges have you assisted with registration of ETFs?

— Have you facilitated exemptive relief with the U.S. Securities and Exchange Commission (SEC) and/or U.S. Commodity Futures Trading Commission (CFTC)? For example, have you taken advantage of the recent SEC rule reducing the time and cost needed for issuers to bring products to launch?

— Which types of ETPs and other funds have you offered legal counsel to(passive, active, ETMFs)?

— Do you have any conflicts of interest with any of the ETF's components?

3. Select the stock exchanges where your ETF will be primarily listed. Factors to consider:

— What is the listing application process, and what are the agreement terms and fees?

— What services and software programs are offered to calculate an intraday indicative net asset value NAV?

— What assistance does the exchange provide with regulatory filings?

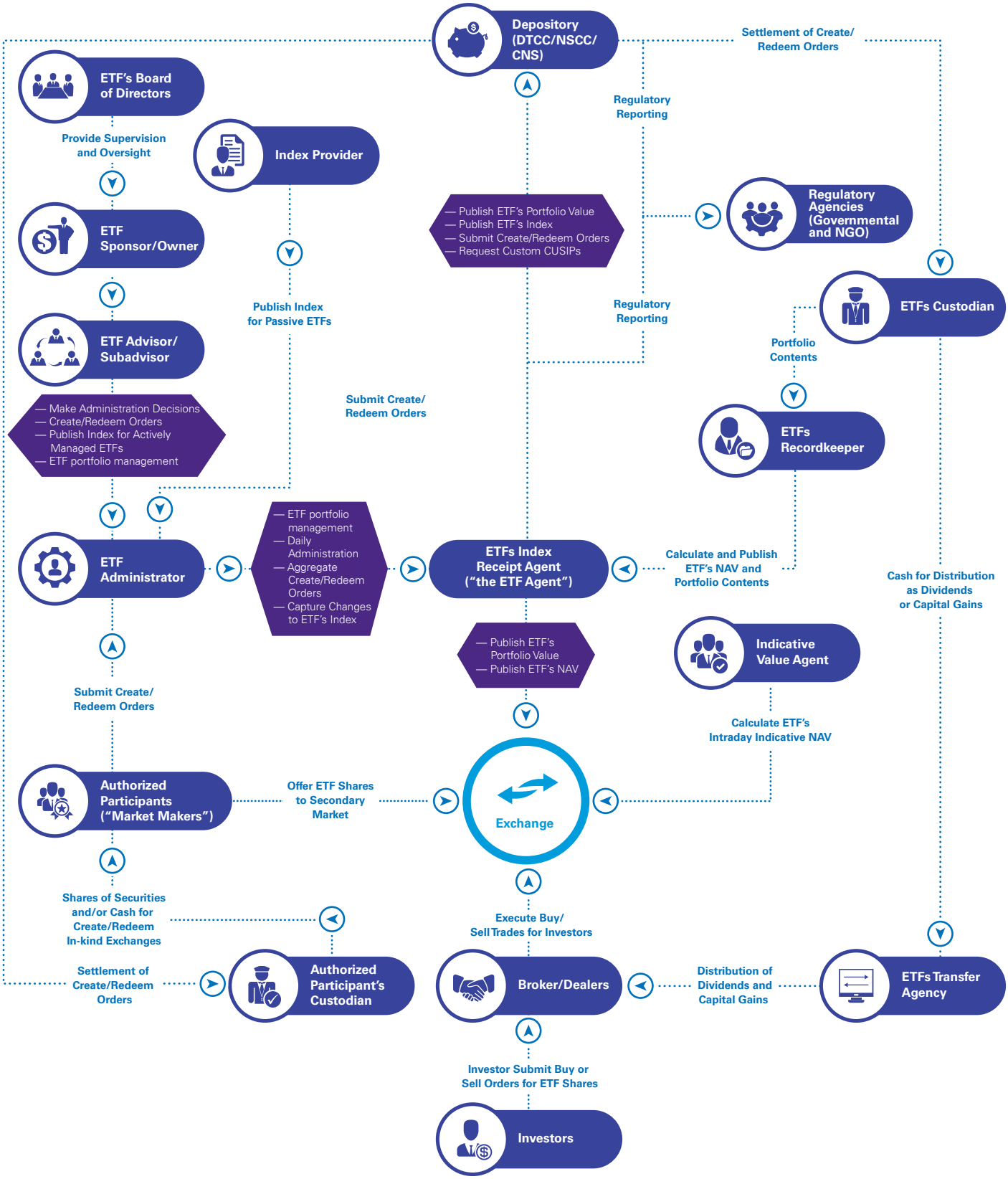
— What are the exchange's public reporting and disclosure requirements?

— Select authorized participants to help make the market and provide liquidity for your ETF. Consider asking the following questions:

- Are you able to take a lead role in market making?
- What coverage do you provide with any of the ETF's components?
- What is the level of liquidity that you can provide?
- Do you have any conflicts of interest with any of the ETF's components?

ETF industry ecosystem

Below is an illustration setting out the various tech and ops "players" in the ETF ecosystem.



Potential and promise: Passive ETFs, active ETFs, ETMFs, ETNs, and Commodity ETPs

There are five major types of ETFs/ETPs currently being sponsored and sold:

1. **Passive ETFs:** They make up the bulk of ETFs being sold today. The ETF is composed of securities that match the contents of a published index (e.g., the S&P 500).
2. **Actively managed ETFs:** Traction for actively managed ETFs has increased and continues to accelerate. With this type of ETF, the ETF index is customized, typically by the ETF sponsor. The ETF sponsor may change the ETF's index on a daily basis; thus, it is actively managed.

   However, active ETF managers are required to publish their index and portfolio contents every day; this has discouraged many active managers from sponsoring an ETF.
3. **Commodity ETPs:** Commodity ETPs trade like ETFs, but may be structured as grantor trusts for federal income tax purposes. This means that investors are treated as if they directly own a pro rata share of the underlying assets held in the trust. Examples of commodity ETPs are the iShares gold and silver trusts. Other commodity ETPs may be structured as partnerships or corporations for tax purposes.
4. **ETMFs:** ETMFs are a special type of actively managed ETF structure. With an ETMF, the investment manager has the discretion to withhold disclosure of index contents from the public; thus, they are commonly referred to as "nontransparent ETFs."

   ETMFs provide active managers with the ability to make investments privately, without the marketplace being able to trade ahead of the manager.
5. **ETNs:** ETNs trade like ETFs, but may be structured as debt instruments offered by, and subject to, the solvency of the issuer. Investors do not have ownership rights to underlying ETN assets, but are eligible to receive investment income generated by those assets.

Uncertain future for ETMFs: Only a limited number of brokers have been willing to devote resources to develop the custom trading interfaces needed to support this type of ETF. So while they may hold huge potential, ETMFs may not get traction until regulatory and structural changes occur.

4. Select an index receipt agent, custodian, recordkeeper, and transfer agency. Consider asking the following questions:

— Can you explain how your roles and responsibilities will be different from mine (as ETF sponsor)?

— How do I monitor the day-to-day operational fulfillment activities that you will be providing?

— What operational key performance indicators will you measure and report?

— What investments are you making to modernize your technology systems, and what is your plan for continuous IT improvement?

— What processing steps are conducted manually?

— How do you ensure that your platform complies with applicable ETF regulations, including regulatory reporting?

— What range of securities and investment components does your platform support? What does it not support?

— What are the quality control and testing processes for your system enhancements?

— What are your disaster recovery and business continuity capabilities, and how often are they fully tested?

— Can you explain how your platform will support the scale and volume of expected trades we will be making?

— What other similarly situated ETF clients are you currently serving?

5. Decide whether to act as your own ETF distributor or hire a distributor service. Or are you planning on going without a distributor entirely and solely relying on marketing efforts? If contracting a distributor service, consider asking the following questions:

— What kind of experience do you have in distributing and promoting our style of ETF?

— Will you have any conflicts of interest in promoting our ETF versus your other clients? If so, can you explain what they are and how you will resolve it?

— What is the range and abilities of your sales force?

— On what basis are you compensated?

— How do you manage and track campaigns and other marketing efforts?

— Can you explain your fee structure (including reoccurring and nonreoccurring fees)?

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Establish your strategy

The ETF market is poised to continue to grow rapidly, perhaps doubling in size within the next eight years and rivaling mutual funds. Additionally, the ETF market could experience significant innovation for years to come, with new asset classes, new investment styles, and new international investment opportunities.

But whether you are considering entering the ETF market for the first time or expanding your existing ETF offerings, it is important that you have an effective tech and ops strategy. Your platforms and your service providers' platforms should be in place and ready to service whatever types of ETFs you are planning on offering in order to increase your chances of success.

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Chapter 4: Your accounting and reporting game plan

Accounting, financial reporting, and internal control game plans may be similar to mutual funds

Are you a mutual fund sponsor looking to expand into the ETF arena? An ETF sponsor wanting to launch another fund? Or are you new to the ETF game?

In all three cases, among the many considerations you'll have to deal with is the need to comply with the complex accounting, financial reporting, and internal control requirements for ETFs. Mutual fund sponsors, in particular, may be concerned that these rules are very different from what they're used to.

However, according to Sean McKee, "It may come as a surprise that many of the accounting, internal control, and financial reporting processes of ETFs and mutual funds are quite similar; like two football teams that favor an aggressive passing offense and a bend-but-don't-break defense, the plays may have different names, but the execution is similar. So launching or transitioning to an ETF may be less daunting than you think."

Regardless of whether you are sponsoring an ETF, mutual fund, or both, it's very likely you'll need the assistance of service providers to help establish and implement these systems. (For an overview of the various service providers that inhabit the ETF playing field, and an explanation of what they do, click here.) The good news is that because of the similarities between mutual funds and ETFs in this respect, service providers deeply experienced in mutual funds may also be able to provide assistance with respect to ETFs.

Former SEC regulators weigh in

Three KPMG audit partners who formerly served at the SEC providing guidance on ETF and mutual fund accounting, auditing, and regulatory matters, echoed McKee's assessment.

"One of the things we recognized as we reviewed hundreds of ETF registrants' accounting, financial reporting, and internal controls systems was that they were essentially the same as the setups for mutual funds," noted John Russo.

Added Chad Gazzillo, "The regulatory principles impacting both ETFs and mutual funds were very similar. We found that advisors with extensive experience working with traditional mutual funds were generally able to transition into the ETF space."

Because of the many different and specialized operational services and technologies needed to build and support an effective ETF platform, it can be difficult to sort through the large ecosystem and select the most suitable players for your ETF," observed Matt Giordano. "It can help to engage an outside party that has the experience and ability to guide you in both selecting and working with these various firms, as well as assist you in taking advantage of the ETF exemptive relief application process, if applicable."

ETFs and mutual funds: The comparison

Although ETFs are not mutual funds, they have some similarities, but also some significant differences. For example, both must register as an investment company and are, therefore, subject to similar regulatory requirements.[15]

In this section of the ETF Playbook, we take a look at the many similarities—and some differences—between ETFs and mutual funds with respect to accounting, financial reporting, internal controls, and some other general characteristics.

[15] Most ETFs must register with the SEC as an open-end investment company or unit investment trust. Exceptions include certain exchange traded notes and commodity-based ETFs, which are exempt from regulation under the '40 Act but are regulated under the Securities Act of 1933 ('33 Act) and may also be regulated by the Commodity Futures Trading Commission.

> It may come as a surprise that many accounting, internal control, and financial reporting processes of ETFs and mutual funds are quite similar. So launching or transitioning to an ETF may be less daunting than you think.
>
> — Sean McKee
> National Leader
> Public Investment Management,
> KPMG LLP

Accounting and financial reporting

Similarities:

ETFs and mutual funds are subject to the same types of:

— Regulatory requirements under federal securities laws[16]

— Limitations on their use of leverage and transactions with affiliates

— Reporting and disclosure requirements relating to investment objectives, risks, expenses, and other information in their registration statements[17] and periodic reports

— Oversight by boards of directors.

Accounting and financial reporting similarities include the following:

— The use of investment company accounting[18]

— The calculation of NAV, which must be done every business day

— The valuation of investments and related disclosures[19]

— The use of "trade date accounting" for security purchases and sales;[20] in other words, security transactions must be recorded on the date that the trade is made

— Recognition of investment income, such as interest and dividends

— The recognition, measurement, and disclosure of derivative transactions[21]

— The recognition, measurement, and disclosure of liabilities, including debt and corresponding expenses

— Many operational expenses (however, ETFs may incur some types of expenses that mutual funds do not, including listing and index-licensing fees)

— Both ETFs and mutual funds must disclose gains or losses from in-kind redemptions.[22]

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[16] The majority of ETFs are registered as open-end management investment companies (or less frequently, as unit investment trusts) under the '40 Act. They are regulated by the U.S. SEC, although they must first receive exemptive relief from certain provisions of the Investment Company Act of 1940 ('40 Act) before they can begin operations.

[17] Both ETFs and mutual funds must file periodic financial reports with the SEC using Form N-CSR within 60 days of a period's close. However, commodity ETFs under the '33 Act file Form 10-Q for interim periods and 10-K for annual periods.

[18] See FASB ASC 946, *Financial Services—Investment Companies*

[19] See FASB ASC 820, *Fair Value Measurements*

[20] See FASB ASC 946-320-25-1

[21] See FASB ASC 815, *Derivatives and Hedging*

[22] The permanent difference for realized gains or losses will result in adjustments within the equity components of net assets listed on financial statements.

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Differences:

- ETFs do not sell individual shares directly to, or redeem them directly from, retail investors like mutual funds do. APs, typically financial institutions, are the only investors allowed to interact directly with the ETF.
- APs transact in shares of the ETF by creating shares that a distributor can sell (called "creation units") and then redeeming the shares. These transactions are accomplished in bulk transactions, commonly referred to as "baskets."
- ETFs trade on stock exchanges throughout the entire trading day, and their market prices fluctuate based on supply and demand. On the other hand, mutual funds are priced once daily after the market closes at the fund's NAV.
- Certain ETFs opt to disclose their total return based on the market value of their shares; that is in addition to the required total return calculation based on the NAV.
- Many ETFs disclose their holdings daily to the public in addition to the quarterly disclosure required for all mutual funds.
- ETFs generally are redeemable "in-kind." That means the ETF may deliver specified portfolio securities to the redeeming APs instead of selling securities to raise cash to accommodate redemptions.
  - Selling securities could trigger taxable gains to the ETF, which could be passed through to the retail investor. Therefore, selling shares of ETFs can be more tax-efficient compared with mutual funds for a retail investor.
  - Nonetheless, the accounting and financial reporting of in-kind redemptions and sales of securities to meet redemption requests are the same.

ETFs versus mutual funds
Key accounting and financial reporting standards

Similarities	Differences
— Treatment of investment balances, activities, and related income — Treatment of derivative balances, transactions, and related income — Accounting for liabilities, including debt and corresponding expenses — NAV calculations (although ETFs can be purchased and sold on stock exchanges) — Preparation of financial statements, highlights, and schedules in an annual report — Filing of financial statements	— ETFs only allow direct transactions by APs — The use of creation units by APs allows ETFs to more readily make in-kind transfers of investment securities to satisfy redemptions — ETFs allow investor transactions in the secondary market (stock exchanges)

Building and managing ETFs

There are generally four major methods for building and/or managing ETFs:

- Most ETFs are **index-based** and seek to track a securities index. These so-called passive ETFs generally invest in securities that make up the index. Some ETFs track indexes that reflect a particular market sector.
- **Leveraged or inverse** ETFs seek to deliver daily returns that are multiples (or inverse multiples) of the performance of an index or other benchmark.
- **Actively managed** ETFs pursue active-management strategies and publish portfolio holdings daily.
- **Commodity ETFs** are focused on investments in commodities, such as gold, silver, oil, and so on.

Internal control over financial reporting

All investment companies, including ETFs, are responsible for establishing and maintaining adequate internal controls over financial reporting (ICOFR) under the Sarbanes-Oxley Act (SOX).

The SEC requires management of ETFs and mutual funds to evaluate the effectiveness of the issuer's ICOFR as of the end of each fiscal year. The principal executive and financial officers must disclose to their audit committee and independent auditors all significant deficiencies and material weaknesses found in the design or operation of ICOFR.

SOX generally exempts ETFs and mutual funds from provisions that require a management report and an attestation report of a registered public accounting firm regarding ICOFR.[23]

When it comes to ICOFR, there are few differences between ETFs and mutual funds. Still, your management may need to tailor its internal controls of ETFs to ascertain that:

- Equity transactions with an AP who creates and redeems equity units are recorded on a timely basis.
- In-kind transactions are recorded and fairly disclosed.
- With respect to ETFs with physical possession of commodities, the inventory is recorded and protected from misappropriation.
  - This also includes taking into account the internal control of custodians and subcustodians, and their use of physical inventory counts. (It's typical to hire a third-party service provider to assist in this effort.)

Similarities outweigh differences

Many investment companies that manage mutual funds are introducing ETF products. Some are doing it as a defensive maneuver, trying to protect their position against competition that is, or will soon be, offering their own ETFs. Others are using it as an offensive strategy, seeking to capture new ETF business before the field becomes too crowded.

Whether you are new to the ETF game or merely expanding your options, it is essential to have appropriate accounting, financial reporting, and internal control systems in place to compete effectively.

As this section illustrates, there are many similarities between ETFs and mutual funds. So if you are looking for a professional services firm to assist you in the launch of your ETF, one with deep 1940 Act experience like KPMG should fit the bill nicely. KPMG can help you tackle the challenge of launching your ETF, avoid dropping the ball, and put you in position for a winning drive.

Final thoughts

Due to their overall efficiency, which growth and competition will continue to drive, ETFs may command increasing market share in the investment community among both institutional players as well as the consumer market. The first four chapters of this playbook highlights ETFs' significant expansion and growth potential, explores many of the reasons why this has occurred, and also offers suggestions on how fund managers and ETF sponsors can bolster their likelihood of success.

The ETF landscape is not without some potential storm clouds on the horizon, however. The so-called "flash crash" that occurred in August 2015 raised the eyebrows of regulators at the SEC.[24] The crash saw the market price of many ETFs fall below their underlying value, in some cases substantially. This resulted in significant losses for investors who sold their ETF shares at the market price.

So, while ETFs offer great opportunities, fund managers and ETF sponsors need to stay alert to regulatory, market, and other changes that could tilt the playing field.

[23] Section 405 of SOX generally exempts ETFs subject to the '40 Act and mutual funds from provisions of Section 404 that require a report of management and an attestation report of a registered public accounting firm on ICOFR, but commodity ETFs subject to the '33 Act are not exempt.

[24] Source: MarketWatch, Should you fear the ETF? (December 27, 2015)

Chapter 5: Nontransparent active ETFs can finally take flight

Imagine being the head coach of a football team. You draw up a playbook with innovative schemes and strategies. You even set the order in which the first 20 plays will be called. And then you have to hand the playbook over to your opponent a day before the game! Now that doesn't seem fair, does it?

> **From an operational standpoint, if you're already managing ETFs, it shouldn't be too difficult to add a nontransparent ETF to your fund family. But if you currently don't have an ETF infrastructure in place, the operational burdens of creating one from scratch can be extensive.**
>
> —Matt Giordano
> Deputy Practice Leader, Public Investment Management, KPMG LLP, and former Chief Accountant, Division of Investment Management, SEC

Well that essentially was the predicament that active exchange traded fund (ETFs) managers were in since these investment vehicles began to skyrocket in popularity. It may also explain why there are so few actively managed ETFs (less than 300 out of 2,300 total ETFs),[25] and only 2 percent of U.S. ETF assets are held there.

But that may be about to change dramatically thanks to a recent U.S. Securities and Exchange Commission (SEC) ruling (technically referred to as exemptive relief).[26] Active ETF managers no longer have to tip their hands and reveal the various components that make up their ETF baskets; they can keep their playbook hidden from the public—and the competition—in a "nontransparent" ETF.

"However, there are a number of regulatory and operational considerations that need to be thoroughly vetted prior to launching a nontransparent ETF," noted Matt Giordano, Deputy Practice Leader, Public Investment Management, KPMG, and former Chief Accountant, Division of Investment Management, SEC. "For example, from a regulatory standpoint, the SEC application process can be costly and time-consuming depending on the type of exemptive relief you're looking for."

Giordano added, "From an operational standpoint, if you're already managing ETFs, it shouldn't be too difficult to add a nontransparent ETF to your fund family. But if you currently don't have an ETF infrastructure in place, the operational burdens of creating one from scratch can be extensive."

Before exploring the details of the SEC's exemptive relief and what you need to do to establish a nontransparent ETF, let's take a quick look at the market landscape for ETFs.

[25] Source: InvestmentNews.com: Who benefits the most from non-transparent ETFs?, (April 12, 2019)

[26] Source: Investment Company Act Release No. 33440; 812-14405: Precidian ETFs Trust, et al., (April 8, 2019)

ETFs' skyrocketing popularity

An ETF is an investment fund that is generally made up of a diversified basket of stocks, commodities, bonds, and many other asset types. As ETFs have evolved, creative managers have built new asset classes, such as space, timber, artificial intelligence, water, and social media, and new innovations seem to be coming to market every week.

ETFs have skyrocketed in popularity with investors for a variety of reasons, with relatively low costs, ease of access, diversification, and potential tax benefits topping the list (see sidebar). What's more, ETFs have had an annualized average growth of 15.66 percent over the past five years versus only 3.53 percent for mutual funds.[27]

Prior to the SEC exemptive order relief, fund managers generally had to disclose all ETF holdings daily, whether they wanted to or not.[28] This made it virtually impossible for active managers to keep their investment strategies a secret if they wanted to use their current ETF structure.

Active managers were particularly concerned that other traders could figure out the strategy given the daily transparency. This would potentially allow "front-running" against them, which could dilute positive returns for investors. In other words, competitors would be able to buy or sell the equities or other assets that the nontransparent ETF manager intended to acquire or sell, thus preventing the manager from getting the desired price for the shares or assets.

This front-running issue discouraged active managers from entering the ETF space. Going back to our football analogy, if your opponents know the plays in your playbook, they can get into formations that would negate your strategy.

But thanks to the exemptive order relief, certain managers of nontransparent ETFs can now actively manage their ETFs like mutual fund managers do, without having to disclose their underlying investments each day. Fund providers and active managers have been anxiously awaiting this development for some time.

According to the *Wall Street Journal*, American Century, BlackRock, Capital Group, Gabelli, JPMorgan, and Nuveen are expected to launch their own version of nontransparent ETFs.[29] What's more, a Cerulli survey report found that within a year, 55 percent of respondents would launch a nontransparent ETF equity strategy and 30 percent expected to launch a similar nontransparent fixed income ETF strategy.[30]

What do investors like about ETFs?

Below are some advantages that retail and institutional investors can get from ETFs as compared to corresponding mutual funds:

— **Fees:** ETFs typically have lower fees than comparable mutual funds.

— **Investor objectives:** ETFs are well suited to meet investor objectives related to portfolio diversification, liquidity needs, or hedging.

— **Intraday trading:** ETFs are continuously valued throughout each trading day, and the price of an ETF share is market derived.

— **Liquidity:** ETFs can be bought and sold at any time during the trading day, just like a stock. This liquidity factor is particularly important to institutional investors (e.g., pensions).

— **Taxes:** Both ETFs and mutual funds distribute realized capital gains every year to minimize or eliminate entity-level taxes. But in practice, ETFs often distribute fewer capital gains than comparable mutual funds. However, ETFs using the Precidian model are more likely than other types of ETFs to distribute taxable gains to shareholders. That's because the current order limited the nontransparent ETF's ability to realize tax benefits by cherry-picking appreciated securities for redemption.

— **Access:** ETFs offer cost-effective access to an array of investment options for any investor with a brokerage account, as well as the ability to short-sell for investors looking for the inverse exposure of an ETF.

— **Transparency:** Transparency in passive ETFs allows investors to see how closely the passive ETF follows its benchmark. But nontransparency in active ETFs allows managers to buy and sell securities at the best price, which can result in improved performance for investors.

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[27] KPMG analysis of Investment Company Institute (ICI) data (2019)

[28] By comparison, mutual funds typically disclose their holdings monthly and are only required to do so quarterly.

[29] Source: *Wall Street Journal*: What to know about 'nontransparent ETFs.' (May 5, 2019)

[30] Source: Cerulli Associates: U.S. active managers evaluating launching nontransparent ETF products. April 2019

Structuring a nontransparent ETF

The SEC approved the nontransparent ETF model because it was structured in a way that satisfied two key principles:

1. Investors would benefit from it.
2. The ETF shares could be accurately priced by a third party.

The nontransparent ETF method that the SEC approved, referred to as the Precidian model, called for the ETF to appoint a "trusted agent" who has access to all of the ETF portfolio holdings. This allows the trusted agent to accurately price the ETF shares and support market liquidity.

Because the portfolio makeup is kept confidential, other trading firms are prevented from "front-running" and bidding up the price of the underlying securities or other assets before the nontransparent ETF can buy them. And just like a mutual fund, the public is made aware of ETF holdings on a quarterly basis.

Other methods of nontransparency are being reviewed by the SEC. "While the Precidian model sets precedent, it's likely that other methods will be accepted in the future," stated Sean McKee, KPMG's National Practice Leader for Public Investment Management. "Several other fund companies have already filed nontransparent ETF applications with the SEC that use methods differing from Precidian's. It will be interesting to see how the SEC rules. But it seems unlikely that it will only allow one method for operating a nontransparent ETF. "

> **"While the Precidian model sets precedent, it's likely that other methods will be accepted in the future [by the SEC]."**
>
> —Sean McKee
> National Practice Leader
> for Public Investment
> Management, KPMG LLP

Top four things fund managers should anticipate

Regardless of whether you're currently managing a passive ETF, mutual fund, alternative investment, or hedge fund, or are just breaking into the ETF space, here are some things to consider before forming and operating a nontransparent ETF:

More responsibility
It takes more work and entails greater responsibility to coordinate trading activities with an actively managed ETF than it does with traditional, passive ETFs.

Less management revenue
Actively managed ETFs generate comparatively less fee revenue than actively managed mutual funds with the same amount of assets under management. So it's critical to optimize your operating model and keep a close eye on expenses.

Potentially less support
Your current service providers (e.g., custodian, fund accounting, transfer agent) may not yet be prepared to support nontransparent ETFs. This is something you'll need to confirm before forming a nontransparent ETF.

A longer application process
The length of the application process for ETFs often varies by the complexity and types of asset anticipated to be held in the ETF. So, for example, a strategy to hold derivatives, leverage, hedging, and nonpublic securities assets in an ETF will likely result in a longer time period to gain SEC approval (or may fail to gain approval altogether).

Despite these potential obstacles, nontransparent ETFs can give you access to a larger investor base or propel your current investment strategy to greater success by putting active management strategies into an ETF wrapper. "However, simply putting an underperforming investment strategy into an ETF wrapper is certainly no guarantee of success," cautioned Jim Penman, Director, Advisory, KPMG. "You need to do a thorough analysis of all factors to make sure it's an appropriate move." (See "Keys to scoring with an ETF.")

Keys to scoring with an ETF

While there are no guarantees for ETF success, there are steps to take that may increase the likelihood of scoring a touchdown:

Understand the ETF landscape thoroughly, including your competitors' strengths, weaknesses, and tactics.

Offer a unique, differentiated product that connects with investors, and develop a compelling "elevator speech" to explain the product to appropriate audiences.

—Make sure your ETF has broad appeal, even if it's in a niche market. An ETF that's only appropriate for a few large clients can lead to problems down the road.

Realistically assess the fixed costs and run rate it will take to launch and maintain the ETF for at least 18 months (or until it gains traction). In addition, consider the amount and timing of seed capital to show activity in the fund, versus seeding the entire amount at launch.

Make sure that you have the right talent, experience, and track record to execute on the investment strategy you've selected.

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Lock in your operations, technology, sales platforms, and custodian/ distribution contracts.

—**No matter how good your product is, your ETF is likely to fall short of the goal line unless you can find a way to get it distributed.**

Create a competitive and predictable fee structure.

Build in options that allow you to be more nimble and agile than your competitors.

Executing an effective two-minute drill

It's anticipated that nearly all active fund managers will at least consider offering their active investment strategies as ETFs, and many have already started the process. So if you're thinking about entering the nontransparent ETF market, you'll want to move quickly and put your plan in place before the space becomes too crowded.

"Time is of the essence. Waiting even 18 months may to too late," cautioned Penman. "The specific ETF market you're targeting may be saturated by then."

So it's time for you to go into the two-minute drill. This means determining how to best structure your nontransparent ETF so it's well positioned to gain SEC approval, line up your service providers and distribution channels, determine who your potential investors are, and formulate your marketing plan.

Being the first to market with a new ETF asset class or industry subsector can work to your advantage and help you potentially take a leading position in that investment strategy.

> **"Time is of the essence. Waiting even 18 months may be too late. The specific ETF market you're targeting may be saturated by then."**
>
> —Jim Penman
> Director, Advisory, KPMG LLP

Serving the ETF and mutual fund marketplace

KPMG's reputation in the ETF industry is well recognized, and we have provided long-standing support to mutual funds and ETF providers alike with tax, audit, risk management, regulatory, and accounting services. Our highly experienced, cross-functional ETF team:

— Is currently engaged in in-depth discussions with several active fund managers about the steps needed to enter the nontransparent ETF market

— Assists both passive and active ETF managers in establishing, marketing, and distributing ETF products and growing ETF assets

— Works with funds and fund managers with respect to ETF and mutual fund product development, operating model efficiencies, project management, service provider selection, technology and operational enablement, and fee structuring.

About KPMG

KPMG is a leading provider to the financial services industry, serving more than **25 percent** of Fortune 1000 companies in the United States. Through the KPMG global network of member firms, we serve clients worldwide with more than **2,700** partners and almost **39,000** professionals.

KPMG:

Audits	Provides professional services to	Provides professional services to
20%	76%	64%
of the top mutual funds	of the top 25 wealth management firms	of the top 25 U.S. money managers

Source: KPMG Analytics 2019

KPMG

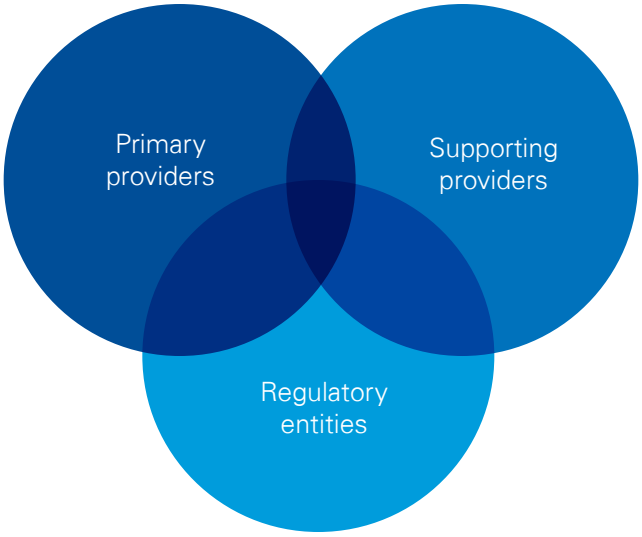
ETF playbook glossary

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.

Midsize 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 help 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 enhanced 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 NAV

— Interfaces with the depository.

Index receipt agents typically offer bundling of other services, including the roles of administrator, distributor, custodian, recordkeeper, 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 with 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.

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.[31]

[31] Source: dtcc.com, Exchange Traded Fund (ETF) Processing

Authorized participants (aka market makers)—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 perform 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.

Recordkeeper—Recordkeepers provide fund accounting, valuation, and NAV calculations for an ETF. Note that index receipt agents frequently provide a bundling of recordkeeping 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.

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 that specialize in publishing widely used indexes, such as Dow Jones, a McGraw Hill Financial company, which publishes the S&P 500 index.

— For active ETFs, it is common for the ETF sponsor or designated subadvisor 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 many 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.

ETF advisor: Primary responsibility for directing the investment decisions and providing various regulatory reporting, such as the 13F and 13H reports, falls within the ETF advisor's responsibilities. This role is often retained by the ETF's sponsor (owner) or performed by the ETF administrator. And, in some cases, the role of the ETF advisor falls to an unaffiliated investment manager.

ETF subadvisor—The ETF advisor may subcontract the portfolio implementation and trading functions to a subadvisor. The subadvisor may have responsibility for monitoring dispersion between the ETF index and actual portfolio contents. The subadvisor may rebalance the ETF to more closely align the portfolio contents to the index. And when there is a change to the ETF index, the subadvisor will implement the change through a portfolio rebalance. However, the subadvisor does not make investment decisions for the ETF; that role is retained by the ETF advisor.

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), and 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. Similar to the SEC, the CFTC investigates and prosecutes alleged violations of the Commodity Exchange Act and Commission regulations.

How KPMG can help

KPMG is a leading provider to the financial services industry, serving more than 70 percent of Fortune 1000 companies in the United States.

Our U.S. asset management services are delivered through more than **3,500** professionals, including **386** partners. KPMG is part of a global network of member firms whose financial services presence of more than **35,000** professionals spans **115** jurisdictions covering the world's most prominent financial centers.

In addition, KPMG provides professional services to:

— 74 percent of the top 50 mutual fund families

— 50 percent of the top 160 alternative assets managers in the United States

— 78 percent of the top 50 U.S. money managers

— More than 25 percent of all U.S. mutual funds, ETFs, and closed-end funds, whose combined AUM exceeds $6 trillion.[32]

We also deliver audit, tax, and advisory services to a broad range of industry players—from start-ups to Fortune 50 diversified financial service firms—enhancing financial and operational structures and helping our clients proactively take advantage of change rather than merely reacting to it.

We offer:

— Global strength and capabilities: Professionals located in all of the world's major commercial hubs, working through a global network of member firms, serve clients wherever they do business.

— Outstanding team leadership by senior professionals: Our engagement teams, led by senior partners and professionals, work closely and collaboratively with you to offer practical, customized, and appropriate insight and guidance and deliver tangible results.

— Leading technology and innovation: We supplement our hands-on approach with industry-leading technology and tailored approaches that allow you to operate and leverage your resources—people, vendors, legacy platforms, and equipment—more efficiently.

[32] KPMG Analytics

Connect with us

For more information about KPMG's ETF-related services, please contact any of the ETF team members:

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