

# Concurrent Session C: ETFs

**Shelly Antoniewicz**

Moderator

Investment Company Institute

**Lawrence R. Maffia**

JPMorgan Exchange-Traded  
Funds

**W. John McGuire**

Morgan Lewis

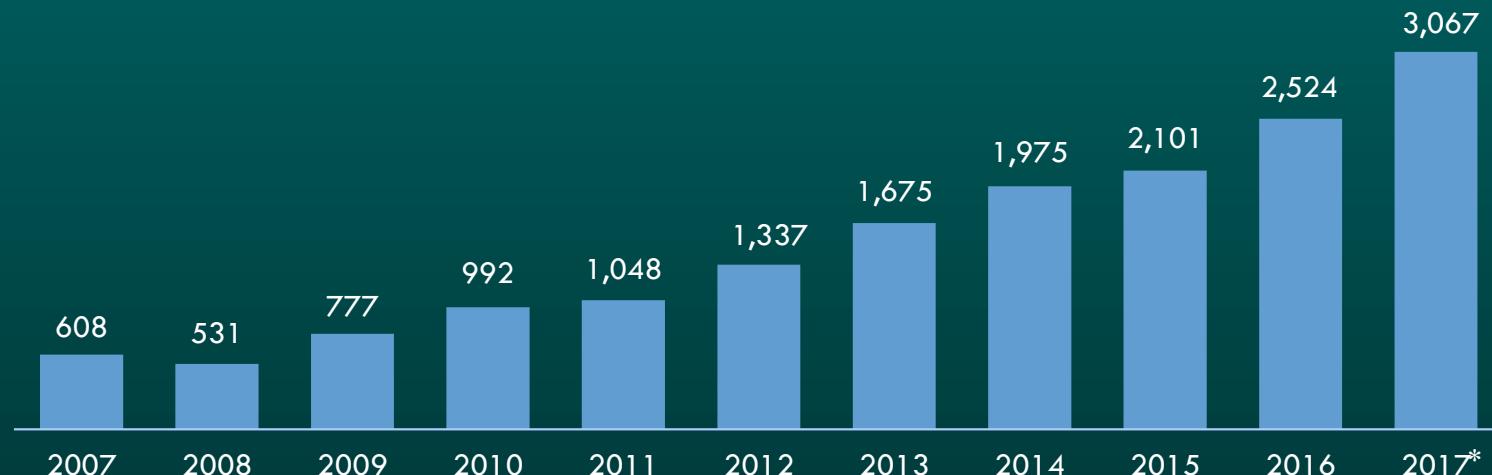
**Anthony Rochte**

Fidelity Investments

# ETF Industry Statistics and Trends

# ETFs Continue to Grow Rapidly

*Billions of dollars; year-end, 2007–2017\**



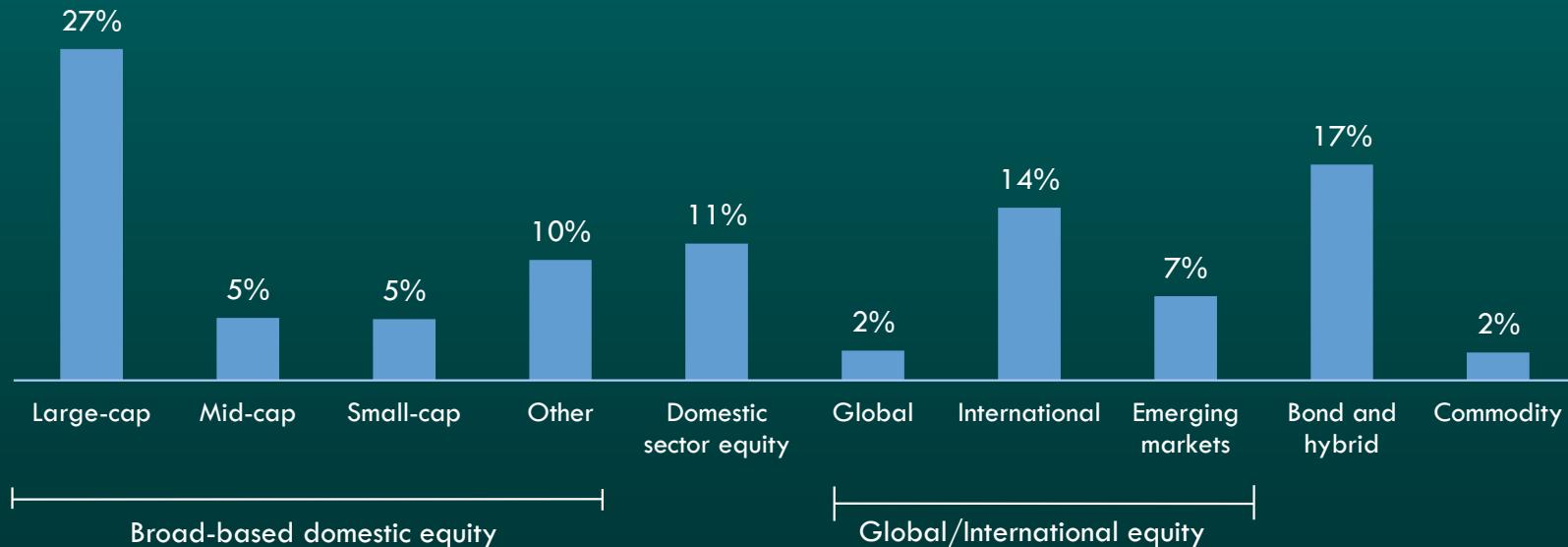
Number of ETFs	629	728	797	923	1,135	1,195	1,295	1,412	1,595	1,716	1,783
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\*Data as of August 2017

Source: Investment Company Institute

# Assets of ETFs Concentrated in Large-Cap Stocks

*Percent of total net assets; August 2017*



Source: Investment Company Institute

# Investor Demand for ETFs

*Net share issuance; billions of dollars; 2007-2017\**



\*Data as of October 11, 2017, not at an annual rate.

Source: Investment Company Institute

# What is an ETF?

# ETFs Similar in Concept to Mutual Funds, But There Are Key Differences

## Similarities to Mutual Funds

- Pool of stocks, bonds, and other assets
- Offer diversification and access to specific asset classes, markets, and strategies
- Strike net asset value (NAV) at 4pm
- Fund management fee charged via expense ratio
- Investor protections of the Investment Company Act of 1940 (vast majority of ETFs)

## Differences from Mutual Funds

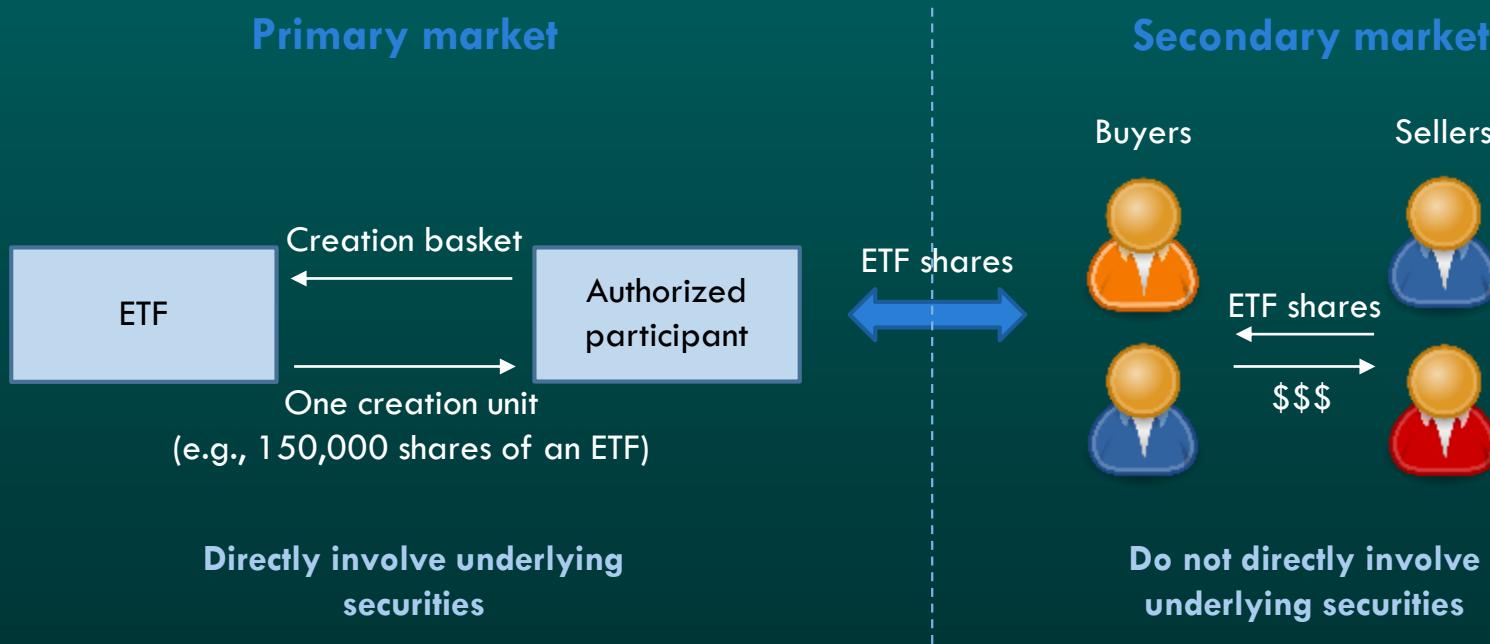
- Trade like a stock on an exchange
- Need a brokerage account to buy/sell ETFs
- ETF price continuously changing during trading day
- Purchases/sales of ETF can occur at prices greater than, less than, or equal to the ETF's NAV
- ETF investors responsible for trading decisions (e.g., order types and timing)

# Basic Structure of an ETF

- » Registered investment company with shares that trade on an exchange like shares of stock
- » ETF shares can only be created and redeemed directly with the fund by Authorized Participants, commonly referred to as “APs”
- » Most ETFs disclose information about portfolio holdings to the public daily
- » All ETFs disclose estimate of underlying market value of portfolio throughout the trading day (e.g., every 15 seconds)
- » ETF shares tend to trade at market prices close to the value of their underlying assets
  - » Facilitated by holdings transparency and the ability to create/redeem ETF shares

# Investors Never Interact Directly with an ETF

*Investors acquire ETF shares by buying them on an exchange or via APs as their clients*



# In Contrast, Investors Can Interact Directly with a Mutual Fund

*Investors acquire mutual fund shares by buying them directly from the fund or through an intermediary.*



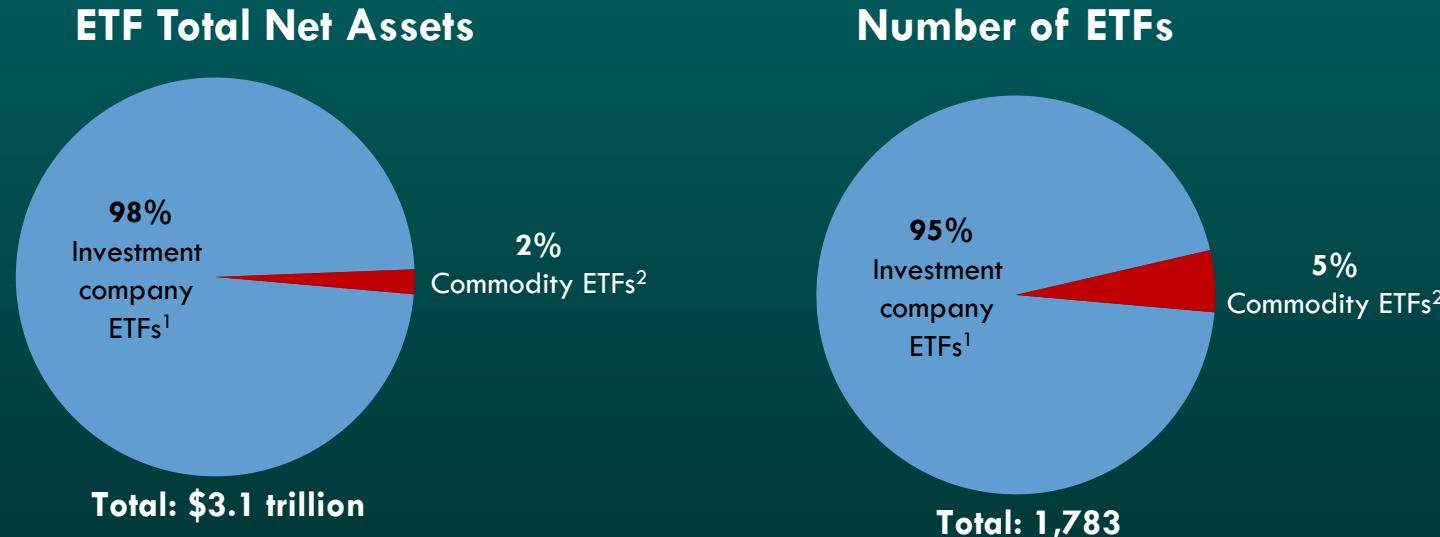
# Regulatory Framework for ETFs

# How Are ETFs Regulated?

- » Vast majority of ETFs are registered as investment companies under the Investment Company Act of 1940 (ICA)
  - » Regulated by the SEC Division of Investment Management
  - » Still subject to the same core regulatory requirements as mutual funds (e.g., custody of assets, limits on leverage, prohibitions on affiliated transactions)
- » Also subject to regulatory oversight by the SEC Division of Trading and Markets and exchange listing requirements

# Most ETFs Registered under the Investment Company Act of 1940

August 2017



<sup>1</sup>Registered under the Investment Company Act of 1940 and the Securities Act of 1933.

<sup>2</sup>Registered under the Securities Act of 1933 with some also regulated by the Commodity Futures Trading Commission under the Commodity Exchange Act of 1936.

Source: Investment Company Institute

# Independent Directors' Duties Between Mutual Funds and ETFs

# Independent Directors' Duties: Advisory Contracts

## Mutual Funds

- » Investment advisory and sub-advisory contracts and fees must be approved
- » Advisory fees typically are just for advisory services
- » Other than index funds, the investment goal is usually to beat the market

## Exchange Traded Funds

- » Investment advisory and sub-advisory contracts and fees must be approved
- » Advisory fees are usually a unitary fee covering most fund expenses
- » Most ETFs are index funds and investment goal is to track an index

# Independent Directors' Duties: Valuation

## Mutual Funds

- » Funds must value portfolio securities “for which market quotations are readily available” at current market value. When market quotations are not readily available, securities must be valued at “fair value as determined in good faith by the board of directors.”
- » In reality, most boards delegate daily valuation duties to the investment adviser

## Exchange Traded Funds

- » Funds must value portfolio securities “for which market quotations are readily available” at current market value. When market quotations are not readily available, securities must be valued at “fair value as determined in good faith by the board of directors.”
- » In reality, most boards delegate daily valuation duties to the investment adviser

# Independent Directors' Duties: Distribution

## Mutual Funds

- » Distribution (or principal underwriting) contracts and fees must be approved
- » Distributor sells fund shares directly or enters into dealer agreements with brokers
- » Mutual funds often have multiple classes with different distribution arrangements

## Exchange Traded Funds

- » Distribution (or principal underwriting) contracts and fees must be approved
- » Distributor enters into authorized participant agreements with brokers
- » ETFs only sell their shares to brokers, who then resell those shares on the market

# Independent Directors' Duties: Compliance Programs

## Mutual Funds

- » Funds must implement written compliance programs covering the funds and certain key service providers
  - » A key component is an anti-money laundering program
  - » Compliance program should also cover any exemptive orders the fund relies on

## Exchange Traded Funds

- » Funds must implement written compliance programs covering the funds and certain key service providers
  - » A key component is compliance with ETF exemptive relief conditions
  - » Even though of minimal concern, the fund must have an anti-money laundering program