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Who's Who in the ETF Ecosystem

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Understanding the functions of all participants in a trade is a vital part of exchange-traded fund (ETF) investing. Two roles that are often confused, even by experienced investors, are Market Maker and Authorised Participant. Jason Xavier, head of EMEA ETF Capital Markets at Franklin Templeton Investments, offers a simple explanation of what each role plays in ETF trading.

A motto that has served me well in my career is "keep it simple". Too often in the investment world, we can find ourselves resorting to jargon. That can alienate even experienced investors, especially when describing unfamiliar concepts.

So, in this article, I intend to go back to basics and introduce the main participants in the exchange-traded fund (ETF) ecosystem with whom my colleagues and I deal with on a daily basis: authorised participants and market makers. I'll explain their roles, responsibilities and why they matter.

But first, let's remind ourselves of what an ETF is. You can learn more about this by checking out some of my previous articles here.

ETF Basics

ETFs are open-ended investment funds which trade around the globe on regulated stock exchanges. In many instances, ETFs track indices which are developed according to either a market-capitalisation weighted approach or a fundamentally weighted approach.

Proponents of ETFs tout liquidity and the flexibility of intraday trading as benefits.

The table below highlights the main differences between ETFs and mutual funds.

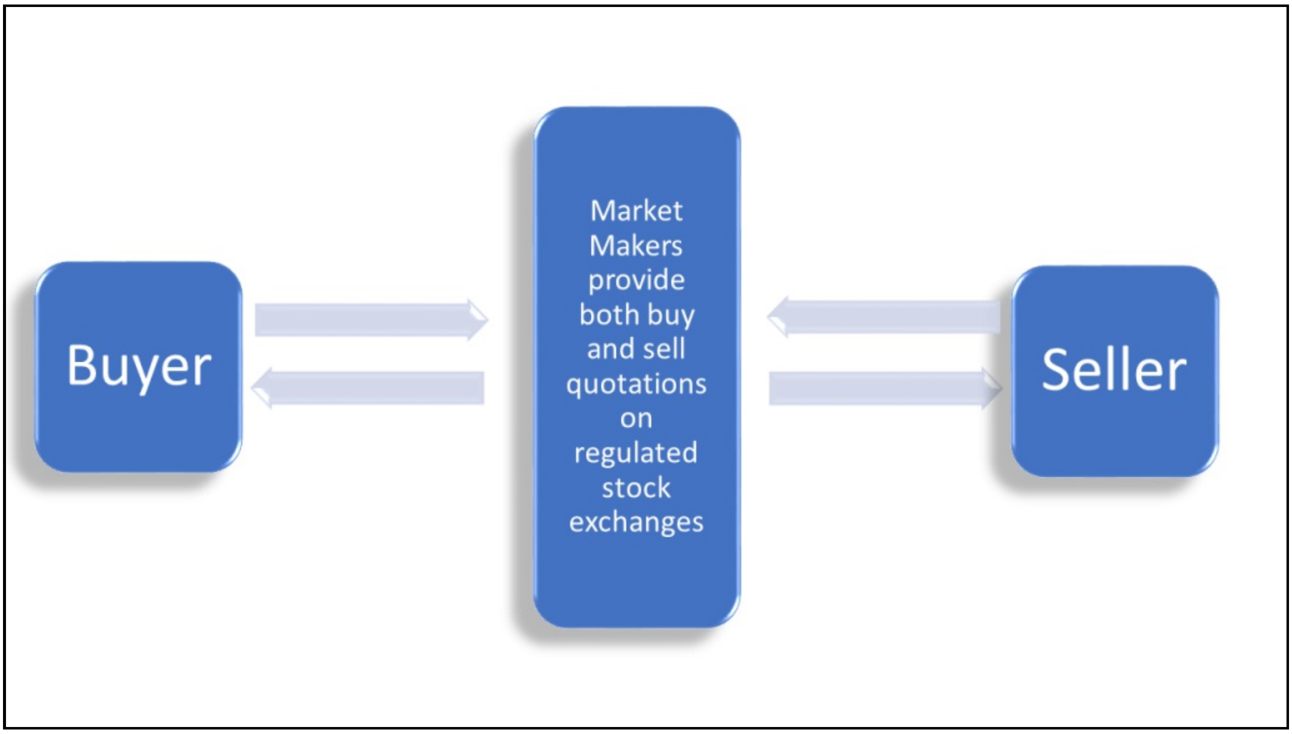
	Open-Ended Mutual Fund	Close-Ended Mutual Fund	Exchange-Traded Fund (ETF)
Open-or Closed-ended	Open	Closed	Open
Transparency	Monthly/Quarterly	Monthly/Quarterly	Daily
Exchange Traded	No	Yes	Yes
Shares	Number of shares can increase or decrease daily	Number of shares is fixed	Number of shares can increase or decrease daily
Trading/Liquidity	Net Asset Value (NAV) only	Second Market implicit only	NAV + Secondary market explicit
Pricing	NAV	Driven by demand, indirectly linked to NAV	NAV + Secondary market explicit

Now, let’s consider the functions that underpin ETF trading.

Market Maker

ETFs trade like single stocks on regulated stock exchanges, such as the London Stock Exchange, the New York Stock Exchange and other bourses around the world.

So-called “market makers” facilitate the trading of ETFs by setting buy and sell prices for the ETF shares. These market makers tend to be household banking or stock broking organisations, and they fulfil a similar role to market makers in traditional stock trading.



Authorised Participants

Like an open-ended mutual fund, ETF shares can be created or redeemed at the end of the day’s trading, based on net asset value (NAV[1]).

This is where the authorised participant (AP) comes in.

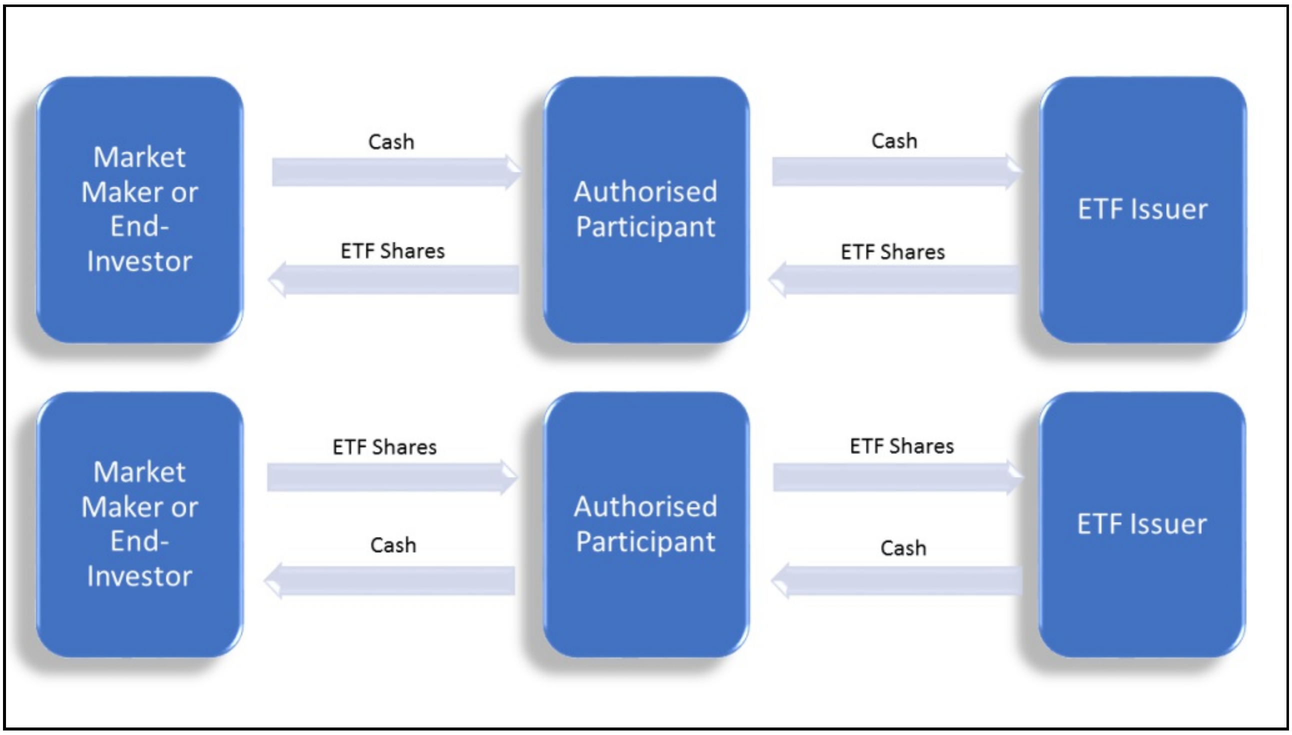
An AP acts as an intermediary between the buyer and seller of the ETF shares. Shares will only be created and transferred once the ETF issuer has received cash from the AP. The process is reversed for redemptions: only upon receiving shares from the AP would cash be transferred.

In the vernacular, we say APs “facilitate end-of-day primary trades on a delivery versus payment basis (DVP)”.

To continue the comparison with traditional mutual fund trading, APs carry out a similar function to mutual fund platforms or advisers acting on behalf of end clients.

However, not all market makers are APs, so there may be occasions in which market makers call on the services of an AP to create or redeem shares. In other words, APs may facilitate primary market activity on behalf of market makers.

The diagram below illustrates this process.



It’s important to understand who all the constituent parts of a transaction are and how they work together, but there can be a tendency to misunderstand the distinct roles and conflate their responsibilities.

For instance, we have occasionally received questions about the possible impact on ETF liquidity of APs failing or stepping away from the market.

Our response is that it’s market makers, not APs, that underpin the trading of ETF shares. But we recognise that confusion about those responsibilities can lead to questions about the resilience of these functions.

That’s a topic we’ll discuss in more detail in our next article.

View Jason Xavier’s previous articles here: http://global.beyondbullsandbears.com/author/pm-xavier/

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What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF's net asset value. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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1. Net Asset Value (NAV) represents an ETF's per-share-value. The NAV per share is determined by dividing the total NAV of a fund by the number of shares outstanding.