ACA Foreside™

Guide

Building and Distributing an Exchange-Traded Fund from Start to Finish

Table of Contents

Introduction

Exchange-traded funds (ETFs) continue to garner increasing attention in the market from retail and institutional investors. Well-established asset managers and new sponsors are entering the space, and introducing innovative product lineups. ETFs have existed for about 30 years, but it is no secret that they have exploded in popularity with investors for a variety of reasons, such as ease of purchase, trading flexibility, and tax efficiency.

ETFs continue to see strong growth based on investor demand. The U.S. ETF market ended 2021 with total assets of $7.2 trillion and net flows exceeding $900 billion, while worldwide, ETFs exceeded $9.7 trillion over the same period.[1]

ACA Foreside partners with over 150 ETF issuers across 850 ETFs, including many of the most recognizable brands in the space. As the statutory distributor, we helped launch many of these firms from day one, and others chose to convert to ACA Foreside post-launch. Our diverse and expansive client base, coupled with our strong industry partnerships, allows us the benefit of being on the front lines to discern developing trends and determine best practices for navigating the ETF space.

If you are looking to launch an ETF, this guide is for you. We will walk you through everything you need to know to get started, including the differences between ETFs and other product offerings, startup costs, necessary service providers, and how to gain assets via distribution.

[1] Morningstar Direct Worldwide ETF Net Assets and Flows as of 12/31/2021.

ETF Ecosystem

Let's start with the **ETF Ecosystem**. *Figure 1* will help you understand the innerworkings of an ETF and all the players involved. Throughout this guide, we will touch on many of the service providers outlined in this diagram, including their role and key details of each of them.

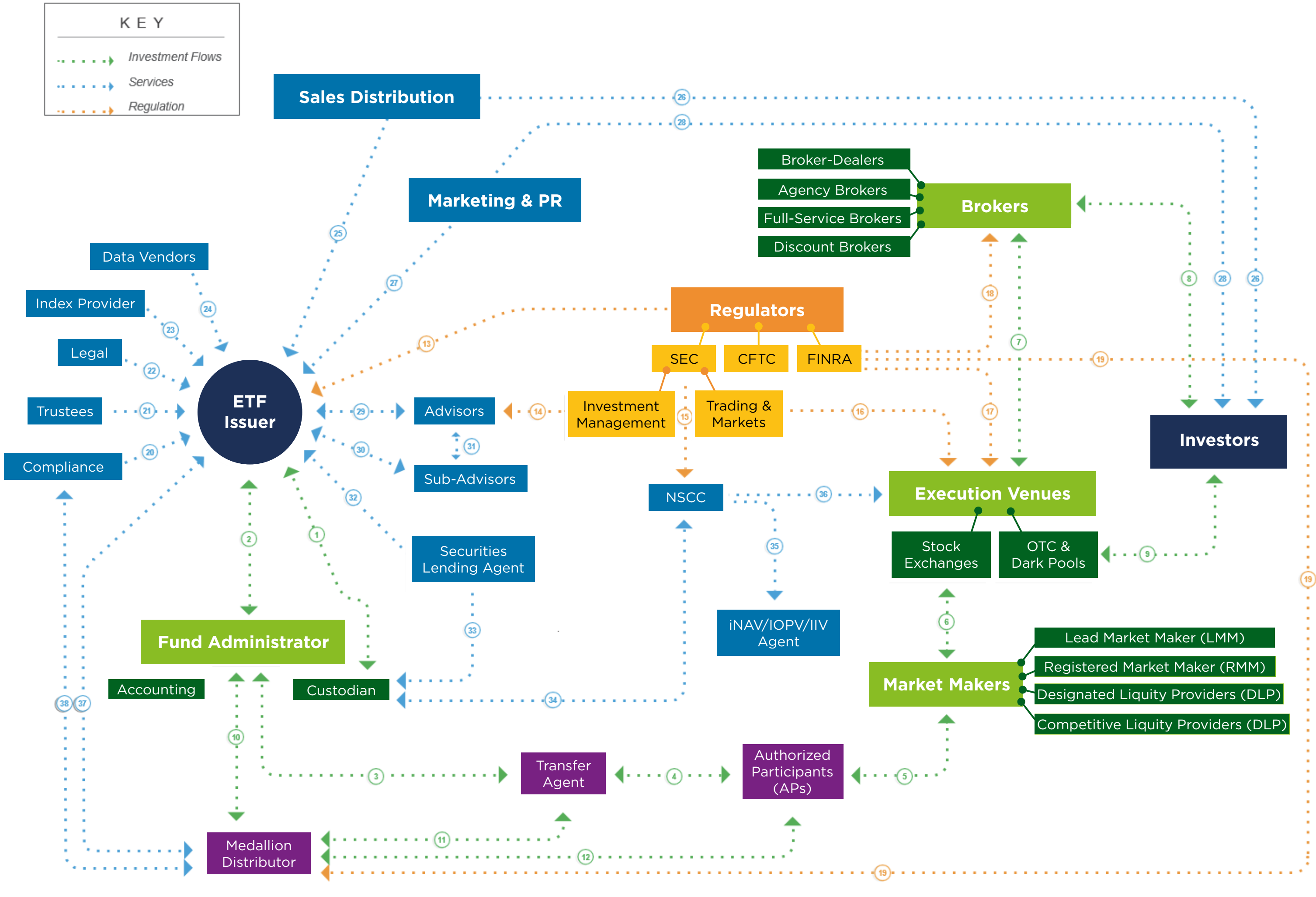


Figure 1
Produced by Arro Financial Communications in collaboration with ACA Foreside and ETF Trends.
Corresponding key with glossary available at end of this guide on page 26.

History and Flows

From the launch of the first ETF in 1993, the ETF market has continued to evolve in size and scope. For almost 30 years, innovation has been driving the growth of the market. Adoption of this popular wrapper has been driven by relatively low fees, transparency, liquidity, and potential tax efficiencies. The ETF structure allows investors access to a diversified basket of securities that track an index, asset class, or sector.

What began as a "plain vanilla" offering tracking the S&P 500 index has evolved to leveraged and inverse ETFs, gold and silver ETFs, exchange traded notes, and in 2008, the first actively managed ETF. In 2019, the U.S. Securities and Exchange Commission (SEC) approved the use of non-transparent and semi-transparent actively managed ETFs. Although over 90% of ETF assets are in passive, index-based funds, active ETFs are gaining momentum, as seen by actively managed ETF launches exceeding passive launches for the first time in July 2020.

Although growth of ETFs has been exponential over the past 10 years and flows have been positive, ETFs represent less than half of the assets in the vast mutual fund market. In the U.S. this totaled $20.8 trillion at the end of 2021.[2]

U.S. ETF assets continued to attract investors with over $900 billion in net flows in 2021, breaking their 2020 record of $506 billion. Growth favors the vehicle with the continued interest by new entrants evaluating the new innovative structures that continue to come to market.[3]

The ETF market has continued to grow at a healthy rate and seems primed for further growth globally as additional investors embrace and adopt the wrapper.

[2] https://www.morningstar.com/articles/1004522/us-fund-flows-show-investors-turning-to-etfs-in-september

[3] Morningstar Direct Worldwide ETF and US Mutual Fund and ETF Net Assets and Flows as of 12/31/2021.

Differences Between ETFs and Other Product Offerings

Table 1 walks you through the differences between ETFs, Mutual Funds, and Closed-End Funds, including costs, structures, tax efficiencies, and market size.

	Closed-End Funds	ETFs	Mutual Funds
Cost	Operating expenses $200-500k+	Operating expenses $200-500k+	Operating expenses $200-500k+
Structure	Stand-alone structure. Interval (23c-3) or tender offer	Stand-alone or series trust format	Stand-alone or series trust format
Exemptive Relief Filing	Multiple share class registration	No	No
Share Creation + Redemption	Investors purchase and redeem directly from the fund in cash at predetermined intervals	Primary market: authorized participants create/ redeem shares through an in-kind cash transfer to funds	Investors purchase and redeem directly from the fund in cash
Market	No primary market; focus on building brand awareness and scale in the secondary market through RIAs and broker-dealers	Focus on tactical solution products and brand awareness in both primary (APs) and secondary market	No primary market. Focus on building brand awareness and scale in the secondary market through RIAs and broker-dealers
Secondary Market Trading	Offered through a variety of distribution channels; Timing of activity dependent on structure of fund	Offered through an exchange. Intraday trading on secondary market typically end of day price at nav but can deviate	Offered through a variety of distribution channels end of day share purchases and redemptions at NAV on secondary market
Transparency	Portfolio holdings typically disclosed quarterly	Portfolio holdings disclosed daily	Portfolio holdings typically disclosed quarterly
Tax-Efficiency	Dependent on the chosen tax structure of the fund, a firm can choose to be taxed as a regulated investment company partnership or corporation	Investors only realize capital gains with sale of own shares; in-kind creation and redemption result in fewer taxable gains	All shareholders realize capital gains distributed in fund; mutual funds required to pay out dividends and capital gains on an annual basis
Platform Considerations	Specific requirements vary by platform	Fees vary by platform, platform fees for sales and marketing (commission fee platforms) and data transparency	Fees vary by platform Platform fees for on-boarding (due diligence, operational, sales and marketing 12b-1, ntf, revenue share, and partnership fees), and data transparency

Potential Benefits of an ETF

ETFs have several advantages over traditional open-end funds including:

Trading Flexibility

Mutual funds are traded only once per day after the markets close, whereas ETFs are bought and sold during the day when the markets are open. For mutual funds, investors must wait until the end of the day when the fund's net asset value (NAV) is announced before knowing what price they paid for new shares bought that day, as well as for the price when selling shares. The pricing of ETF shares is continuous during normal exchange hours and will vary throughout the day, based mainly on the intraday value of the underlying assets in the Fund. ETF investors know within moments how much they paid to buy shares and how much they will receive when they sell them.

Lower Costs

Operating costs for both a mutual fund and an ETF will include portfolio management fees, custody costs, administrative expenses, marketing expenses, and distribution costs to name a few. ETF costs are streamlined compared to a mutual fund. Lower costs are typically a result of not having to staff a call center to answer questions from investors, lower expenses from administrative items, such as monthly statements, notifications, and transfers (mutual funds are required to send statements and reports to shareholders on a regular basis), and lower overhead, all translating to lower overall expenses for an ETF provider.

Tax Benefits

There are structural differences between ETFs and mutual funds; therefore, capital gains taxes are different. Mutual funds typically incur higher capital gains taxes than an ETF. Specific to ETFs, capital gains tax is only incurred upon the sale of the ETF by the investor, where mutual funds pass the capital gains tax onto the investors throughout the duration of the portfolio holding. Dividends, however, are a bit different. ETFs issue two kinds of dividends – qualified and unqualified.
Dividends, however are classified as qualified if the investor holds the ETF for at least 60 days prior to the dividend payout date. The tax rate for qualified dividends ranges from 5-15% depending on the investor's tax rate. Unqualified dividends are taxed at the investor's income tax rate.

ETF Tax Risks

ETFs present some unique risks, and we have highlighted a few below. This is not an exhaustive list, but a sampling of what may present itself.

As a general rule, ETFs are tax efficient, but there are exceptions and therefore investors need to understand how taxes apply to the different types of ETFs. ETFs create tax efficiency by using in-kind exchanges with authorized participants (APs). Instead of the fund manager needing to sell stocks to cover redemptions, as they do in a mutual fund, the manager of an ETF uses an exchange of an ETF unit for the actual stocks within the fund. This creates a scenario where the capital gains on the stocks are actually paid by the AP and not the fund. Thus, you will not receive capital gains distributions at the end of the year.

However, once you move away from index ETFs, there are additional taxation issues that can potentially occur. For example, actively managed ETFs may not do all of their selling via an in-kind exchange. They can incur capital gains which would then need to be distributed to fund holders.

Tax Exposures to Different ETF Types

If the ETF is of the international variety, it may not have the ability to do in-kind exchanges. Some countries do not allow for in-kind redemption, thus creating capital gain issues.

If the ETF uses derivatives to accomplish its objective, then there will be capital gains distributions. You cannot do in-kind exchanges for these types of instruments, so they must be bought and sold on the regular market. Funds that typically use derivatives are leveraged funds and inverse funds.

Key Legal and Compliance Issues

Finally, commodity ETFs have very different tax implications depending on how the fund is structured. There are three types of fund structures: grantor trusts, limited partnerships (LPs), and exchange-traded notes (ETNs). Each of these structures have different tax rules. For example, if you are in a grantor trust for a precious metal, you are taxed as if it were a collectible. Investors should consult their tax professional for tax guidance and questions.

ETF Rule 6c-11: SEC Rule 6c-11 (the Rule) took effect December 23, 2019 and imposed specific requirements and disclosure amendments for most ETFs. The intent of the Rule is to foster greater competition and innovation by lowering barriers to entry. Specifically, the Rule allows ETF sponsors to operate within the scope of the Investment Company Act of 1940 and launch funds without the burden of obtaining an exemptive order from the SEC. ETFs that are subject to the Rule include active and passive strategies that qualify as open-end funds and provide daily transparency within the portfolio.

Conversely, ETFs that are structured as unit investment trusts (UITs) use leverage or inverse techniques, or are considered non-transparent are not subject to the Rule, and therefore, must continue to abide by the SEC's exemptive relief requirements.

Certain conditions imposed by the Rule include the following:

» **Transparency -** ETFs are required to provide daily portfolio transparency on their websites.

» **Website disclosure -** ETFs must disclose certain information on their websites to inform investors about the costs of investing in ETFs and the efficiency of an ETF's arbitrage process.

» **Custom basket policies and procedures -** ETFs are permitted to use baskets that do not reflect a pro-rata representation of the fund's portfolio or that differ from the initial basket used in transactions on the same business day, provided the ETF adopts written policies and procedures that speak to this topic.

» **Recordkeeping -** ETFs must comply with certain recordkeeping and filing requirements. For example, Form N-1A was amended to provide more useful, ETF-specific information to investors who purchase ETF shares on an exchange.

ETF Marketing Material and Marketing Activities

Let's start with some website requirements that are unique to ETFs. For example, the website must show:

» Each portfolio holding, unless the fund qualifies as a semi-transparent ETF

» The ETF's NAV, market price, and the premium or discount from the prior day

» The ETF's median bid/ask spread during the past 30 days, and

» A table and line graph at quarter-end listing each day that the ETF's shares traded at a premium or discount during the previous calendar year

Other marketing material items to keep in mind include:

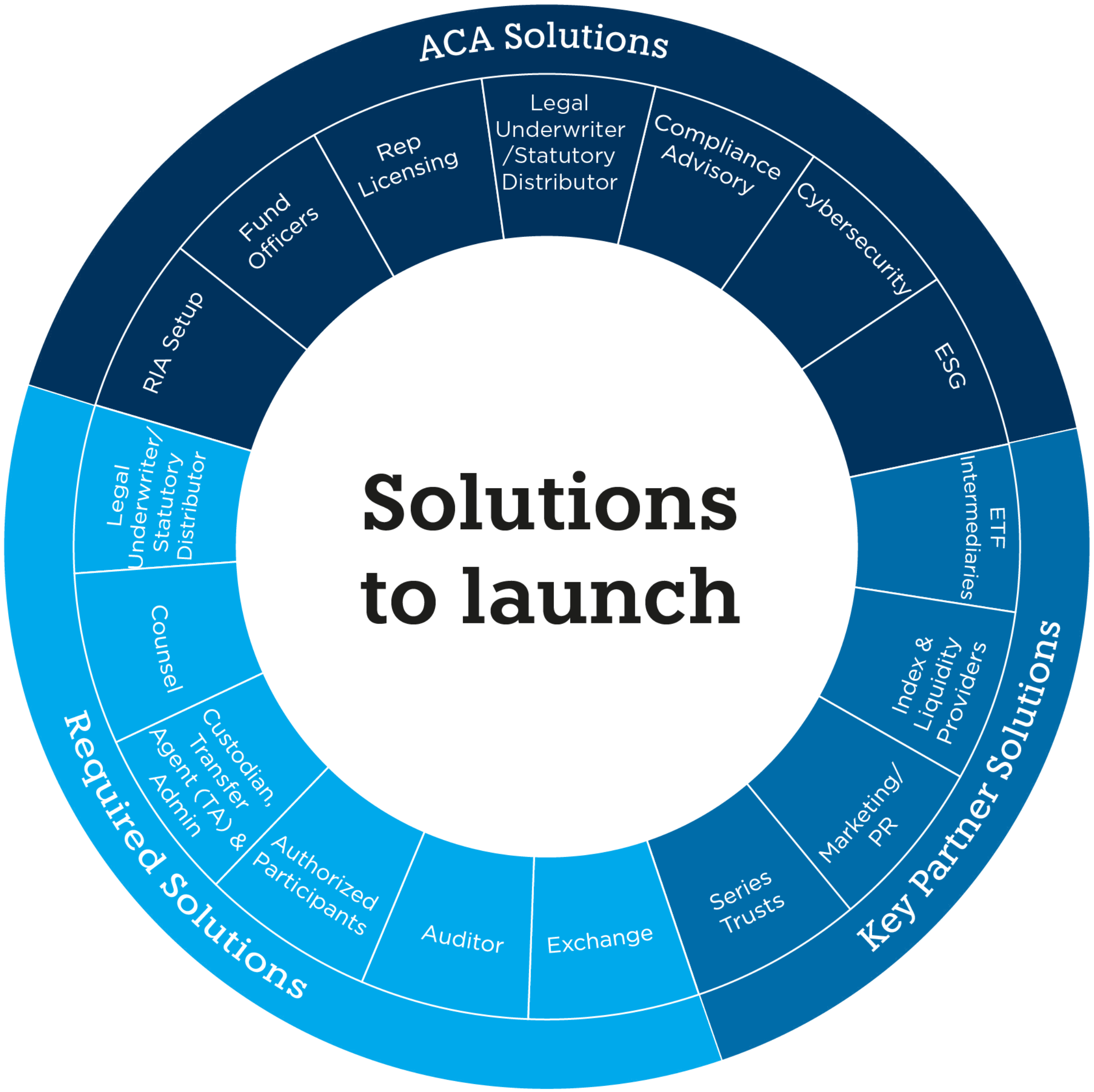
- If a passively managed ETF shows it's tracking of the underlying index, the ETF may be able to also show the pre-inception index performance. The caveat is that data can only be used with institutional marketing material that complies with the Financial Industry Regulatory Authority's (FINRA's) interpretive guidance.
- When presenting ETF performance, the NAV and market price must be defined in the material.
- Many ETF clients are active users of social media such as X (Twitter), YouTube, and LinkedIn. The use of social media presents unique issues and will trigger additional oversight and potential regulatory scrutiny. Therefore, your firm should scrutinize the type of social media you seek to employ and understand how these fit within SEC and FINRA rules.
- Interactive tools are becoming more common within ETF websites. Accordingly, dynamic websites with interactive technology must be functional, accurate, and follow regulatory guidance. Many tools contain performance information and other data that trigger specific disclosures that need to be prominently displayed within the marketing message.
- Funds that use leverage or derivative strategies also trigger additional risk disclosures, which can be found in the prospectus. These risks need to be prominently displayed, which may mean including them within the main text of the material versus the disclosure passage.
- Lastly, ETF managers need to ensure that their marketing materials comply with SEC Rule 6c11 or the fund's exemptive order.

Most ETF fund sponsors use wholesalers to market their funds by hiring a third-party marketing firm or engaging sales staff who are employees of the sponsor. Because these wholesalers are required to be licensed with a FINRA member broker-dealer, they are subject to FINRA rules and regulations as well as the broker-dealer's oversight and supervisory procedures. For example, wholesaler registered representatives must:

- At a minimum hold SIE, Series 7, and 63 licenses.
- Be knowledgeable of the ETFs they represent (e.g., regulatory structure, management style, investment objectives, indices tracked (if applicable), unique risks and expenses, and tax treatment).
- Ensure their communications to financial intermediaries are fair, balanced, and not misleading, and participate in mandatory training, education, and compliance meetings.

Solutions Needed to Start an ETF

Figure 2 below provides an outline of the service providers you will need to create and launch an ETF.



Solutions offered by ACA Foreside

Legal Underwriter

The legal underwriter (aka principal underwriter or distributor) serves as the underwriter for new shares, must be registered as a broker-dealer with the SEC under the Exchange Act, and be a member of FINRA. Among other things, the underwriter reviews and approves fund marketing material in accordance with SEC and FINRA rules, enters into agreements with authorized participants, verifies and confirms authorized participant orders, and often is the entity that maintains the FINRA licenses for personnel who market the funds.

Fund Officers

ETFs are required to designate a chief compliance officer (CCO) and principal financial officer (PFO or Treasurer) who are qualified professionals. Although the CCO and PFO perform multiple functions, the CCO is primarily responsible for administering the fund's compliance program and reviewing the adequacy of the policies and procedures for the other fund service providers. The PFO will establish, maintain and/or supervise fund disclosure controls and procedures, review and certify Form N-CSR, and participate in valuation committee

RIA Set-Up and Ongoing Compliance

The entity that manages the investments of the ETF as defined in the prospectus must be an SEC-registered adviser and appointed in accordance with guidelines established in Section 15(c) of the Investment Company Act.

Additional services that are needed which are not provided by ACA Foreside.

Legal Counsel

Internal and external groups that provide legal and regulatory advice concerning fund formation and strategic planning, as well as acting as a liaison between the ETF and the SEC and other regulatory entities.

Stock Exchange

Markets where individual equity securities, including ETFs, can be bought and sold.

Liquidity Providers

Market makers provide ETF liquidity by posting double-sided quotes on the national stock exchanges.

Custodian

Firm that holds records of asset ownership, facilitating instructions for corporate actions, and typically providing transfer agency services. There are several custody requirements, including areas such as use of margin and foreign custody arrangements.

Administrator

The firm that provides regulatory, business, and financial support services to assist the ETF in operating as an ongoing entity. Often this will include accounting, preparing financial statements, determining NAV, and filing SEC reports.

Transfer Agent

Transfer agents work closely with administrators and custodians by monitoring which broker-dealers have custody of ETF shares and investors who own the shares.

Authorized Participants

Entities that transact in the primary market by creating and redeeming new ETF shares, which can then be sold in the secondary market.

Marketing & PR

The group or firm that provides sales collateral, educational content, and advertising in support of asset-gathering, as well as the sales force.

ETF Intermediary

An entity that facilitates a financial transaction between two parties, such as a broker-dealer (BD). Intermediaries can be broken down further into subcategories: Wirehouses, Regional BDs, Independent BDs, Banks, Registered Investment Advisors (RIAs), etc. Intermediaries sit at the center of the overall distribution universe and serve the needs of their end investors, as well as support and manage the operational and strategic components of fund relationships.

Start up Costs

One of the most important decisions impacting advisers looking to launch an ETF is whether to sponsor and operate a proprietary fund trust or launch a product as a series of an existing shared trust. See *Table 2* for more details on Series Trusts.

This decision is based on many factors, including the strength of the advisory firm's brand name, the existing product lineup, and how the firm wants to position in the market. A proprietary fund trust allows you to control all aspects of the fund, including selecting the board of directors, policies and procedures, service providers, and contract terms related to launching, marketing, and operating the trust. Selecting this structure also means the investment manager will be building distribution infrastructure from scratch.

ETF Series Trust vs. Stand-Alone

In the case of a shared (or series) trust, many of these decisions are made by the Series Trust provider. The board of directors is in place, and you will be asked to adopt the policies and procedures of the trust and their existing service providers. With this loss of control, there is a gain in efficiency. For example, much of the distribution infrastructure, such as agreements, are already established by the trust. Managers who launch funds into a shared trust are typically quicker to market, enjoy cost savings when compared to a proprietary trust, and can rely on the expertise of certain service providers concerning the intermediary landscape.

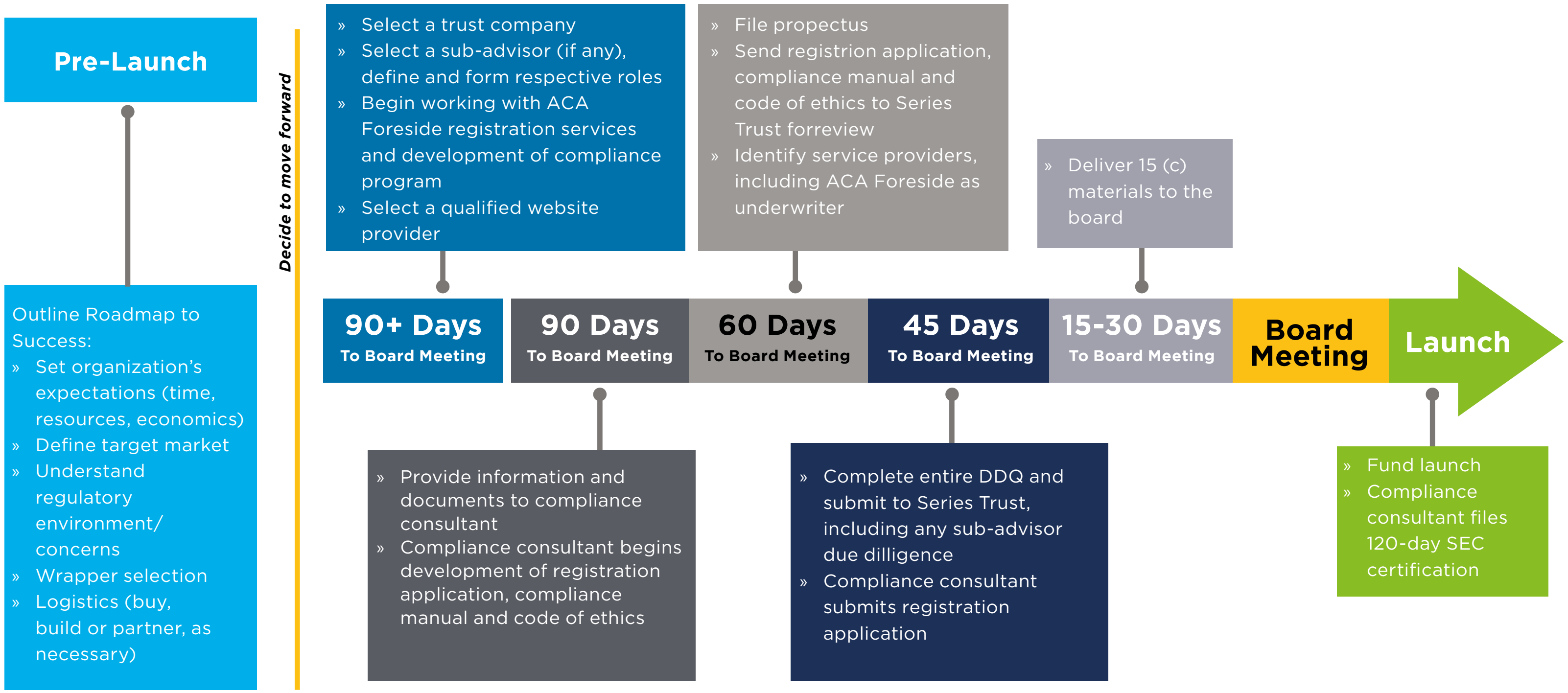
Table 2

	Series Trust	Stand-Alone
Business Model	For start-up fund families and smaller asset managers looking to get to market quickly by leveraging existing infrastructure, have low expense, willing to give up control of board and service providers to focus on portfolio management and sales	Typically, mid-to-large firms where brand, control of selecting service providers and board members are important, expenses are higher, but the firm has full control
Cost*	Operating costs: approximately $200-300k+	Operating costs: approximately $300-500k+
Control	Minimal control, focus is on sales and managing the portfolio, if not outsourcing that piece	Full control including ownership of the Exemptive Relief
Service Providers	Service providers are already in place selected by the existing board	You choose the service providers, conduct interviews, do due diligence, and negotiate pricing
Board	The trust and board members are already established; the firm has little to no say in selection	The firm chooses its board members based on preexisting relationships and industry expertise
Time To Market	3-6 months	8-12 months
Authorized Participant Agreements	Your fund(s) will be able to leverage existing Authorized Participant agreements in place at the trust level	The firm must negotiate agreements with each Authorized Participant separately to be able to trade in your product(s)

* Dependent on what your firm decides to add on (eg. website, external counsel, factsheets, etc.) the price increases within this range.

Expectations and Timeline for a New Series Trust ETF Manager

Figure 3 is a timeline of key dates and events a new ETF manager, who is not yet registered as an investment adviser, should keep in mind when launching an ETF to be offered inside an existing Series Trust.*



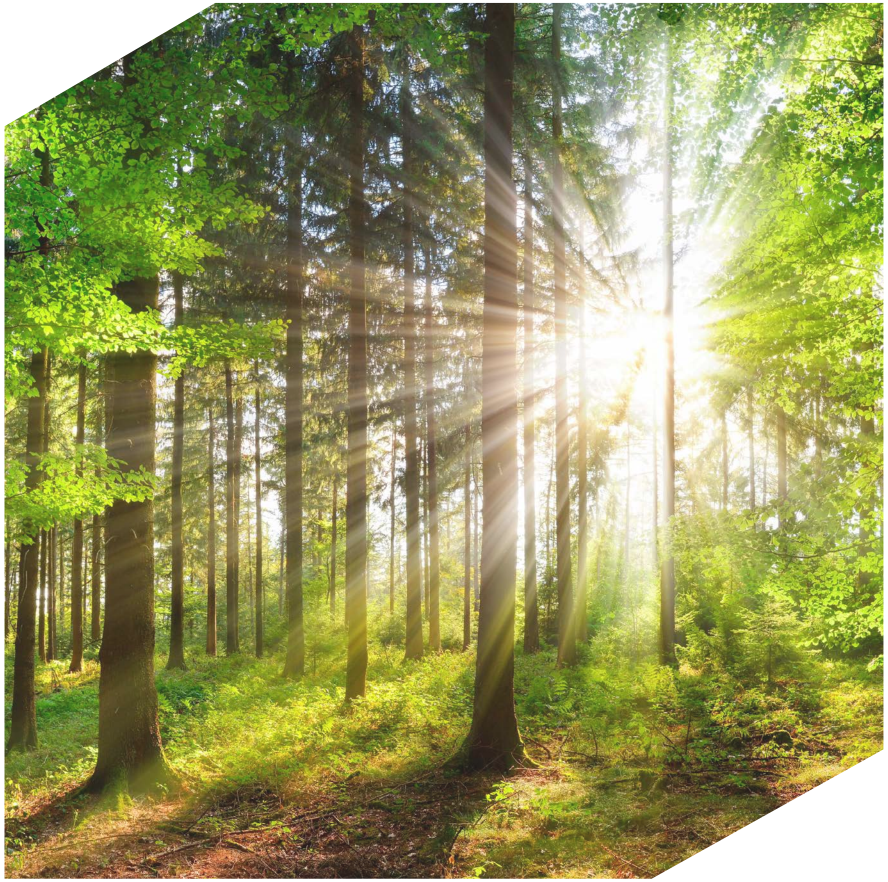
* The above illustration is intended to be a general guideline. The timeline may vary depending on facts and circumstances. Some Trusts may require additional time.

The Semi-Transparent ETF Ecosystem

New approaches to ETF structures have received SEC approval, including semi-transparent ETFs. These new ETFs selectively disclose portfolio holdings information to the public on a schedule similar to traditional actively managed mutual funds while still striving to maintain market and NAV parity. This is accomplished through the use of alternative methods of signaling the value of an ETFs portfolio to the market.

Since actively managed ETFs seek to outperform a benchmark through security selection and innovative weighting schemes, many money managers have been reluctant to adopt the traditional ETF structure because it demands a transparency that could expose proprietary security selection and weighting methodologies to the public. Moreover, since most ETFs' holdings are disclosed each trading day, and their rebalances occur on a regular basis, transparent ETFs open themselves up to "front running," a scheme where traders bid up the price of an ETF's underlying holdings with the foreknowledge that the ETF itself will need to purchase those shares for a rebalance.

For asset managers who wish to harness the advantages of the ETF structure – including its tax efficiency and intraday tradability – but want to avoid some of its transparency pitfalls, semi-transparent ETFs may offer a solution. With a few minor exceptions, semi-transparent ETFs utilize all the same structures and relationships as fully transparent ETFs. They are mostly distinguished from fully transparent ETFs by the methods utilized to signal the value of the ETFs underlying portfolio.



Semi-transparent Licensing Models

Table 3 outlines the various semi-transparent solution licensing models that have received SEC approval and are available in the marketplace.

Model	Method	Notes
Blue Tractor	Shielded Alpha	» Disclose holdings and weightings, but disclosed weightings deviate 10% from actual weightings.
Eaton Vance	ClearHedge	» Discloses a basket of liquid interests designed to have a high-degree of correlation to the fund itself. The ETF's actual holdings and weightings are shielded from public view. A swap administration agent stands ready to issue new swaps every second over the course of the trading day, which can be used to swap the performance of the actual underlying securities.
Fidelity	Tracking Basket	» Discloses a Tracking Basket designed to closely track the daily performance of the ETF's actual holdings and weightings, which are shielded from public view.
New York Stock Exchange/ Natixis	Proxy Portfolio	» Discloses a Proxy Portfolio designed to recreate the daily performance of the actual portfolio using a factor model analysis of the ETF's actual portfolio. The ETF's actual holdings and weightings are shielded from public view.
Precidian	ActiveShares	» Trusted agents, also known as Authorized Participants Representatives (APRs) use confidential accounts to execute creations and redemptions for Authorized Participants.
T. Rowe Price	Proxy Portfolio	» Disloce a proxy portfolios to the public with holdings that exhibit a high correlation to the fund's true underlying holdings.

Mutual Fund to ETF Conversions

Trend Known as "Bring Your Own Assets"

In response to investor interest in the ETF vehicle, firms are rolling their existing assets from another product (usually a mutual fund or SMA) into an ETF to kickstart their ETFs. Rule changes and regulatory guidance have also laid the foundation for conversions prompting interest by asset managers.

However, converting a mutual fund to an ETF is not a straightforward process, and it is important that firms do their due diligence when considering such a move and assess time, costs, and the changing product landscape.

What Needs to be Considered?

This complicated undertaking will require commitment across an organization. The first course of business is to set a realistic timeframe that reaches beyond regulatory approval to manage this in-depth event. The framework will help organize your understanding of the various considerations and guide the decision of whether converting a mutual fund to an ETF makes sense for your firm.

The framework consists of three pillars:

Strategic Analysis

Governance

Compliance and Operational Considerations

Strategic Analysis

- Determine if the investment strategy can be supported in an ETF. Assess if transparency of an active ETF is acceptable for the strategy, or if there are concerns around immediate disclosure of intellectual property that is prompting the need to evaluate exemptive relief options utilizing a semi-transparent ETF wrapper.
- Understand if an ETF wrapper makes sense for the type of investors or programs the mutual fund is in to alleviate loss in transition.
- Review the requirements of onboarding and ongoing support of ETF products at intermediaries (secondary market), *discussed in further detail later.*
- Acknowledge that ETFs do not soft or hard close. The creation/redemption mechanism is required to confirm that the arbitrage mechanism works. Evaluate the capacity constraints of contemplated strategies.
- Review the share class structure of the mutual fund to determine if collapse of multiple classes into one is the best process to move forward.

Governance

- Conversion mechanism - Think through which type of conversion mechanism to use. Either reorganize the existing mutual fund or merge it into an ETF.

  Determine whether to file a registration update that states the date that the fund will be offered as an ETF or that the merger will occur. When considering mergers, decide whether to fold the mutual fund into a new shell ETF or an existing one.
- Governing documents - Review governing documents to determine if your trust permits you to offer ETFs and to understand if a shareholder vote is necessary.
- Board approval – Keep your board fully informed throughout the entire process regarding how the conversion will impact shareholders.

Compliance and Operational Condsiderations

- Comply with ETF-specific rules, such as the SEC's ETF Rule for active transparent ETF structures or conditions of that relief for a semi- or non-transparent structure.
- Ensure the ETF's compliance program addresses new entities that the fund encounters in the ETF ecosystem, such as authorized participants, website vendors, and ETF - specific data providers.
- Fractional shares – ETFs are measured in units, but mutual funds are measured in dollars.
- Shareholder accounts – ETFs are held in a brokerage account. For any mutual fund direct clients, a brokerage account would need to be established.
- Focus on new and existing service provider relationships.
- Changing intermediary relationships - Although the traditional mutual fund dealer agreement ecosystem does not apply to ETFs, the relationship between the ETF asset manager and intermediaries still exists.

Weaving this all together

- The ETF Rule and regulatory guidance have laid the foundation for mutual fund to ETF conversions.
- Continued investor adoption and market flows in ETFs are signaling that the timing might be right for firms looking to enter the market with a conversion that allows firms with existing products to bring assets and a track record into the ETF structure.
- The ETF ecosystem requires a cultural shift for firms requiring them to embrace new roles, implement new workflows, and educate stakeholders.
- Implementation of the conversion framework (strategic analysis, governance, operational reviews) will provide the necessary infrastructure to evaluate if a conversion makes sense.
- Set expectations internally and externally to ensure the organization and its' service partners understand the scope of the proposed conversion project and are committed to its success.
- The scope of the conversion project will touch all aspects of your business and relationships.
- Early and ongoing communication is necessary for success.

Distribution

- Your plan is in place.
- Your team has been assembled.
- Your investment objectives are set.

You are almost ready to launch your exchange-traded fund. Yet before your fund enters the marketplace, you will need a distribution plan.

- How will investors find your fund?
- Who will be your target market?

Primary Market

To maintain a liquid secondary market with tight bid-ask spreads for ETF shareholders, there needs to be a mechanism through which new shares can be created and added to the market or liquidated and removed from the market. This mechanism is called the creation and redemption of shares.

Large financial institutions, called Authorized Participants (APs) place orders with the ETF's custodian at Net Asset Value (NAV) to create or redeem shares in large units, usually 25,000 or 50,000 shares minimum at a time.

Due to the in-kind and primary market nature, an ETF can maintain tax efficiency and allow shares to trade in the secondary market without needing the fund to buy or sell securities in the portfolio.

Legal underwriters for ETF issuers, such as ACA Foreside, engage with APs to execute an Authorized Participant Agreement that sets parameters for how creation and redemption orders will be placed and processed.

The AP Agreements also have an Authorized Persons Annex where the AP firm designates authorized individuals to place trades within the ETFs that fall under the ETF to which the agreement pertains.

Once the AP Agreement is fully executed, it is provided to the custodian of the ETF who then opens access in their order management system for the traders listed in the Annex to place creation and redemption orders in the ETF.

The legal underwriter of the ETF reviews creation and redemption orders as they come into the custodian's system. Generally, they are confirming the order attributes conform to the procedures described in the fund's offering documents and AP Agreements.

To maintain a liquid secondary market with tight bid-ask spreads, it is strongly recommended a new ETF complex have at least 3 to 5 APs signed up ahead of the initial ETF launch. A healthy distribution network benchmark after a year of operation is to have 10 APs signed up to place creation and redemption orders.

With over 40 APs in the industry, some are specialized in specific mandates (i.e., global, domestic equity, fixed income, etc.). Knowing this information and doing initial research will help narrow down which APs will be the right fit for your firm.

ETF distributors and custodians work closely with the AP community and have relationships that ETF firms can leverage. Having the right contacts can significantly assist with a smooth fund launch and a successful path forward for your funds.

When communicating and meeting with APs, be prepared to discuss your product in detailn including overall product strategy (i.e., what is your value proposition). Additionally, APs will want to know other essential operational information, such as how you expect your product to trade, liquidity requirements, and fees (overall expected fund expenses and AP transaction fees).

The trade desk at the AP will want to know what the underlying securities in the basket are to ensure there are no liquidity concerns. Additionally, APs will be interested in your sales and marketing plan and how you will plan on raising assets, including how you are seeding your product. Being prepared with all these answers will alleviate concerns APs may have when it comes to the decision-making process of entering into an agreement with your firm. It is important the capital markets team of an issuer also build strong relationships with the APs signed up in their ETFs.

Secondary Market

Initial focus by firms entering the ETF space is around navigating the primary market, with new roles, players, and an ecosystem to grasp. While primarily a critical focus area, firms also need to ensure they are seeing the full perspective of adding the wrapper to their client solution tool-kit. The secondary market is where end investors will buy and sell your ETF and where dedication from the organization to resources, such as time and economics, will provide the foundation to successfully build upon a great idea.

> "As part of your overall consideration for expanding your investor base with an ETF, distribution should be top of mind and weaved in throughout the ETF launch process."

Insight into the overall marketplace, as well as an understanding of how to best navigate the intermediary landscape, provides the foundation which is essential for developing an effective distribution approach for your product.

Understanding how your offering is unique and outlining the competitive universe will assist in aligning your fund and capabilities in the context of the broader market. The critical next step will be to determine where the overlap exists between your unique strategy and the opportunities available in the marketplace. In short, identifying your target audience. Focusing on this overlap or target audience will allow you to create a customized approach to follow and penetrate the ever-evolving retail marketplace.

In formulating your approach, it is helpful to establish a distribution framework to follow with the launch of your product. The process for establishing the framework will occur in three phases:

The first phase in your analysis will establish the initial firms to focus on. The latter two phases will be ongoing engagement and the framework build to support the expansion of your distribution footprint. The resulting roadmap, (details outlined below), will be a process of identifying, engaging, and incorporating new partners into your distribution footprint.

Initial **access** for your ETFs will be through the multi-channel supermarkets or custodial platforms. These intermediaries serve the needs of direct individual investors or financial institutions, such as RIAs or correspondent broker-dealers, acting on behalf of their clients with comprehensive investment platforms. The largest supermarket platforms are Fidelity, Schwab, TD Ameritrade, and Pershing. (Pershing does not support direct individual investor access). These platforms generally allow for an ETF to be available upon listing. Although having an open architecture, there can still be restrictions or additional hurdles for some ETF product types or structures. A few examples include the need for an agreement to be in place prior to making a semi/non-transparent ETF wrapper available at Schwab, or restrictions on access to levered, cryptocurrency, or futures-based types of products.

Once you have insight into your initial avenues for access, it is necessary to **engage** with those intermediaries and their clients. This will come in the form of expanding the adoption of the fund through proactive sales and marketing efforts to your client / adviser base, and to navigate centers of influence at the intermediary level.

Firms can engage with intermediaries and their clients in a few different ways. Digital marketing and sales efforts, such as digital advertising (Google, social media, online resources) and direct email campaigns, have all seen an uptick since the COVID-19 pandemic and are not looking to go away anytime soon.

Another way of engagement is at the intermediary's home office level by sponsoring a conference or webinar, or engaging research teams on your quarterly performance. Leveraging database tools to gain transparency into the firms available to many of the underlying RIAs and correspondent firm clients of those intermediaries will provide insights into who is buying or interested in your product.

In addition to a focused effort on deepening relationships at these current intermediaries, it will also be necessary to continually review and proactively **expand** the breadth of your intermediary footprint by prioritizing the selective onboarding on additional platforms. As your product reaches scale in assets and time in the market with a longer track record, it will be necessary to focus on the 3 C's – creating, cataloging, and communicating demand to expand your footprint with additional intermediaries. With the growth of your assets and your track record, make sure you also review additional opportunities on existing platforms such as engagement with research teams or home office opportunities (sponsorship/partnerships) as also stated in the engage section above.

As the ETF product marketplace matures, access points or requirements are becoming more robust, which can limit your adoption. Building awareness among these investor bases will require a formal distribution approach incorporating a unified team effort across marketing, sales, national accounts, and data integration. You can take advantage of momentum in building your ETF by balancing a traditional and an innovative approach.

Factors Currently Reshaping Distribution

Market catalysts, such as recent changes in regulations with the ETF Rule, commission-free investor access, and the launch of portfolio shielding wrappers with non- and semi-transparent options, are causing more asset managers to consider entering the space, increasing competition. Active ETF product development has been a continued focus for many issuers, as entrants into the space grow adoption. There has been a slower embracement at the broker-dealer level, as they are continuing to evaluate enhanced support and due diligence needs of both transparent and semi-transparent wrappers. It is no longer "build it and they will come." Market need and demand for your strategy in an ETF wrapper is what drives this journey.

Key Takeaways

- As investors search for more cost-effective, transparent, and liquid investment vehicles, all data points to ETFs being primed for growth globally.
- ETFs operate in two markets that involve different types of market participants: primary markets and secondary markets. Fully transparent (or not) is a key consideration when selecting a wrapper for your strategy.
- One of the most important decisions impacting advisers looking to launch an ETF is whether to sponsor and operate a proprietary fund trust or to launch a product as a series of an existing shared trust.
- Developing relationships with the right partners is critical, as they can help you come to market faster and build the necessary relationships.
- APs in the industry are specialized in specific mandates (e.g., global, domestic equity, fixed income, etc.). Knowing this and doing initial research will help narrow down which APs will be the right fit for your firm and strategy.
- "Build it and they will come" does not work. Firms need to have a proper distribution plan in place.
- As products continue to evolve, staying on top of market trends, regulatory and compliance updates, and innovative product structures will be crucial.

About ACA Foreside

ACA Foreside™

ACA Group (ACA) is the leading governance, risk, and compliance (GRC) advisor in financial services. We empower our clients to reimagine GRC and protect and grow their business. Our innovative approach integrates advisory, managed services, distribution solutions, and analytics with our ComplianceAlpha® technology platform with the specialized expertise of former regulators and practitioners and our deep understanding of the global regulatory landscape.

We work with asset management firms throughout the world to facilitate compliance and product distribution through legal underwriting, registered representative licensing, and DTCC/NSCC fund sponsorship. We have experience working with all types of pooled investment vehicles such as mutual funds, exchange traded funds (ETFs), alternative products, closed-end interval funds, business development companies (BDCs) and private placements. To learn more about our distribution services, click **here**.

For more information

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Or visit **www.acaglobal.com**.

Key and Glossary

1 The **ETF issuer** communicates the fund's market trades as well as details of the creation/redemption basket to the **Custodian**, who in turn provides safekeeping of the assets, as well as providing the ETF Issuer with an aggregate snapshot of the portfolio.

2 The **ETF Issuer** and **Accounting/Custody** work together to process and settle creation/redemption activity when there are orders.

3 When a creation or redemption order is processed, **Accounting/Custody** processes the underlying basket and the transfer agent processes the ETF shares.

4 In some operating models, the **Authorized Participant** places orders on the **Primary Market** with the **Transfer Agent** instead of directly with the **Distributor**.

5 **Authorized Participants** may buy or sell excess shares to the market through market participants. **Market Makers** may engage **Authorized Participants** to facilitate creations or redemptions.

6 **Market Makers** provide ETF liquidity by posting double-sided quotes on the national **Stock Exchanges**.

7 **Brokers** who wish to buy or sell retail quantities of ETF shares will facilitate these transactions on the **Secondary Market** through one of the national **Exchanges**.

8 **Investors** who wish to invest in ETFs will engage with a **Broker**, who buys or sells shares on their behalf.

9 Large **Institutional investors** may buy or sell ETF shares on the **Secondary Market** through alternative trading venues such as **OTC (Over-the-Counter) and Dark Pools**.

10 When a creation or redemption order is processed, the **Medallion Distributor** approves the order and provides final order details to **Accounting/Custody**.

11 The **Medallion Distributor** provides the **Transfer Agent** with creation/redemption activity for record keeping, and the **Transfer Agent** maintains this data for the use of the **Medallion Distributor** in shareholder communications.

12 **Authorized Participants** initiate creation and redemption activity on the **Primary Market** through **Medallion Distributor** systems, and the Medallion Distributor provides confirmations to Authorized Participants.

13 ETF Issuers operate under various rules and regulations including the **SEC** for asset management activities, **FINRA** for sales activities, and the **CFTC** when certain derivatives are involved.

14 The **Investment Management** division of the **SEC** monitors the **Investment Advisor** to ensure compliance with multiple federal regulations.

15 The **NSCC (National Securities Clearing Corporation)** is regulated by the **SEC**.

16 The **Trading and Markets Division** of the **SEC** monitors and works alongside **Execution Venues** to ensure efficient, transparent markets, as well as overall capital market integrity.

17 **FINRA** regulates member **brokerage** firms and **exchanges**.

18 **FINRA** monitors **Brokers** to ensure federal regulations are being followed. It also seeks to protect **Investors** from unscrupulous sales tactics.

19 As a FINRA-member broker-dealer, the **Medallion Distributor** interacts with FINRA on behalf of the **ETF Issuer**.

20 **Compliance** monitors the **ETF issuer** and funds for compliance with regulations, policies, and procedures.

21 The **Trustees** monitor vendors and the general management of the trust to ensure shareholders' rights and interests are being protected.

22 The **Legal** team assists the **ETF Issuer** with contracts and provides general counsel. It also sets the agenda for regular and special meetings of **Trustees**.

23 The **Index Provider** transmits daily index constituents to the **ETF** for the purpose of tracking the portfolio.

24 **Data Vendors** communicate various data points such as securities pricing, corporate action information, and website informatics to the **ETF Issuer** and its service providers.

25 The **Sales Distribution** team of an ETF issuer is usually in-house, but can be outsourced to a 3rd party.

26 The **Sales Distribution** team works to sell the ETF to **Investors**.

27 **Marketing and PR** sets messaging strategy as well as methods of communicating the **ETF Issuer's** products to investors.

28 **Marketing and PR** communicates key information about the ETF to **Investors** by shaping branding, educational content, and messaging, as well as arranging media opportunities and appearances.

29 The investment **Advisor** monitors and manages the day-to-day operations of the **ETF** and its other service providers.

30 A **Sub-advisor**, if engaged, manages all or part of the investment portfolio of the **ETF**.

31 A **Sub-advisor** may be engaged on behalf of the primary investment **advisor** to manage some, or all, of the portfolio's assets.

32 The **Securities Lending Agent** acts as agent of the **Fund** to manage the lending of portfolio securities. This service generally does not start until the fund has some scale.

33 The **Custodian** and **Securities Lending Agent** work in tendem to facilitate the borrowing of securities with proper record-keeping

34 The **Custodian** transmits creation/redemption baskets nightly to the **NSCC** (National Securities Clearing Corporation) who then disseminates it to all member firms including back to the custodian.

35 The **NSCC** (National Securities Clearing Corporation) transmits ETF constituents to the **IOPV** (Indicative Optimized Portfolio Value) calculation agent each morning to generate estimated intra-day share price

36 The **NSCC** (National Securities Clearing Corporation) transmits official creation/redemption basket to **Exchanges** for public dissemination.

37 The **ETF Issuer** appoints the **Medallion Distributor** as a Service Provider of the Trust.

38 The **Medallion Distributor** is a function of the **ETF Issuer's Compliance**, as it is tasked with reviewing and approving all ETF marketing materials prior to use for compliance with **SEC** and **FINRA** advertising rules.