KPMG

Six key tech and ops factors critical to ETF success

kpmg.com

In football, a vastly underrated and unappreciated key 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 will not matter.

"The same holds true for exchange traded funds (ETFs)," stated Jim Penman, Director, Advisory, KPMG LLP (KPMG). "You can have a brilliant product, but if your foundation—your technology and operations (tech and ops)—is substandard, your product isn't going to break through the line and score touchdowns. If you're lucky, you will end up just kicking a long field goal."

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

Background

ETF and Exchange Traded Note (ETN) products have crossed the $3 trillion threshold in assets globally. Outside of the United States, ETFs account for nearly $1 trillion of global assets and now exist in over 50 countries. With ETFs increasingly becoming components of retirement plans, robo-advisors, advisory accounts, institutional investing, and self-directed investing, it's likely that ETFs' growth will continue to accelerate.

The vast majority of ETF assets are considered passively managed ETFs.[1] However, the ETF industry is experiencing tremendous innovation 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 4).

But 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 is worthless 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 tremendous simplicity for investing in a veritable supermarket basket of investments. They can simply open and fund a brokerage account and immediately start trading ETFs.

But what happens behinds 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 the vast majority of ETFs, tech and ops functions are outsourced to third parties. "Only the largest five 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 are commonly service providers to other ETF providers." Because of behind-the-scene 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

[1] In Q1 2016, of the 1,836 ETFs listed on U.S. stock exchanges, only 136 were considered actively managed. http://seekingalpha.com/article/3965416-etf-stats-march-2016-17-births-17-deaths

As a result, the biggest tech and ops decision for most 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 3 illustrates the various 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 and why they are important, please refer to the Glossary.

Selecting the right service providers

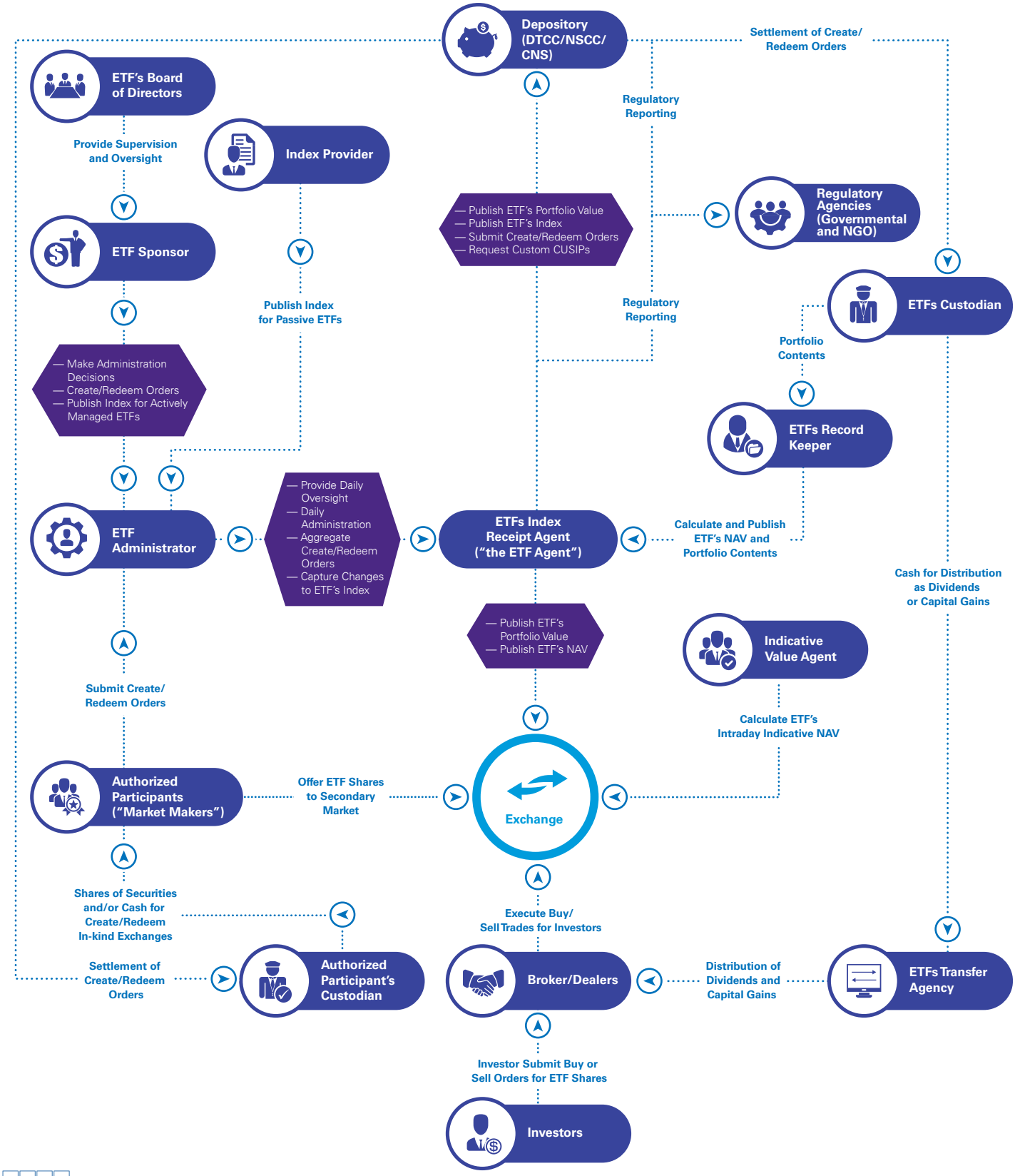
It is vital that you conduct vigorous due diligence with each service provider and ensure their tech and ops capabilities meet your current and future requirements.

Before you go about selecting your ETF service provider, there are six key business decisions that an ETF sponsor must make:

1. Who is going to administer 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 record keeping?
   - What is your experience with administering global securities, derivatives, physical assets, real estate, leveraged or shorted positions, and other non-tradable 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 non-reoccurring 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?
   - 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)?
   - Which types of exchange traded products (ETPs) and other funds have you offered legal counsel (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?
4. 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.



KPMG

5. Select an index receipt agent, custodian, record keeper, 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?
6. 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 non-reoccurring fees)?

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

There are four types of ETFs 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: Recently gaining traction are actively managed ETFs. In this case, 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. ETMFs: This is the newest evolution of an actively managed ETF. 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 "non-transparent ETFs."

   ETMFs provide active managers with the ability to make investments privately without the marketplace being aware of what security positions are being taken.
4. ETNs: ETNs trade and operate like ETFs, but they actually 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: In part because the regulators and exchanges have not provided clear guidance on 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 hold huge potential, it is unlikely that ETMFs will take full flight until the financial industry comes to a consensus on how they will be traded," observed Penman.

The ETF playbook series

Our ETF playbook series is designed to provide practical insights to help firms of all sizes compete and enhance their game plans for success in the growing and highly competitive ETF market.

In addition to the current tech and ops article, the series includes the following chapters:

— ETF playbook: Drawing up a game plan for success

— ETF tax efficiency: Fact or fiction

Stay tuned for the final section that focuses on audit and regulatory requirements.

Conclusion

The ETF market will continue to grow rapidly, perhaps doubling in size within the next eight years and rivaling mutual funds. Additionally, the ETF market is likely to experience tremendous 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 imperative that you have an effective tech and ops strategy. Your platforms and your service providers' platforms must be in place and ready to service whatever types of ETFs you are planning on offering if you hope to be successful in the long term.

How KPMG can help

KPMG is a leading provider to the financial services industry, serving more than 70 percent of the FORTUNE 1000 financial services companies in the United States.[2] And through the global KPMG network, member firms serve clients worldwide with more than 2,700 partners and almost 39,000 professionals in the Financial Services practice.

We provide 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.

Specifically with regard to ETFs, KPMG can help assess and evaluate whether it makes sense for you to develop and implement your own ETF technology and operations systems or whether you should contract with third-party service providers. If it is the latter, we can assist you in finding and vetting service providers to help ensure that they align with your ETF investment strategy.

Additionally, KPMG can provide assistance to all of the service providers in the ETF ecosystem and can help them expand and grow their ETF capabilities during this period of rapid innovation.

We offer:

— Deep industry experience: Regardless of where your firm is in its evolution—from launch to globalization to exit—our professionals have the passion and experience to help you deal with the issues and challenges that impact you today, as well as prepare you for what lies ahead.

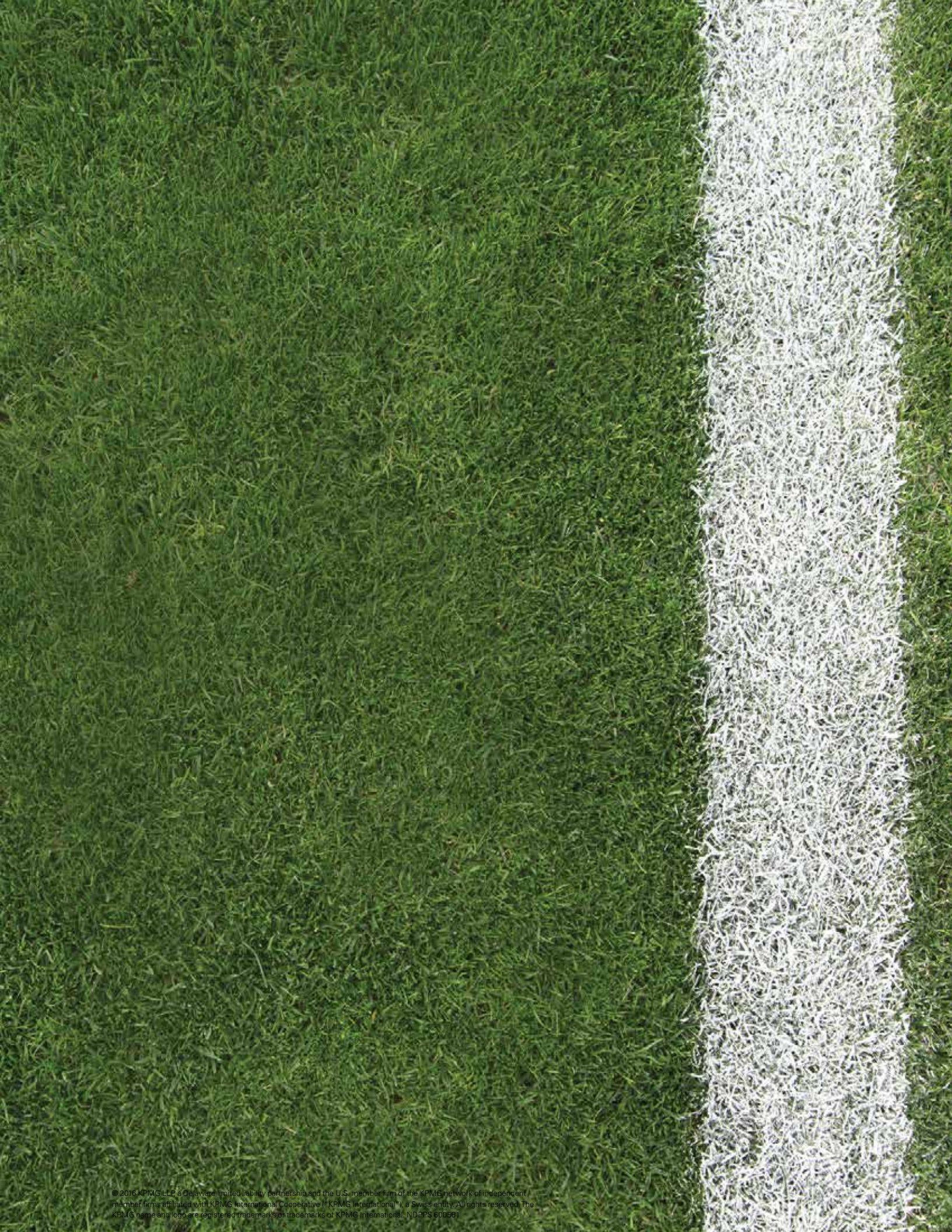
— Global strength and capabilities: The KPMG global network of member firms includes professionals located in all of the world's commercial hubs, enabling us to serve our clients wherever they do business.

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

— Advanced technology and innovation: We supplement our hands-on approach with industry-leading technology capabilities that help enable you to operate and leverage your resources—people, vendors, legacy platforms, and equipment—more efficiently.

[2] FORTUNE 1000, 2015.

KPMG



Contact us

For more information about KPMG's ETF-related services, please contact:

Deanna Flores
National Tax Leader for Public Investment Management
Washington National Tax Principal
T: 858-750-7340
E: djflores@kpmg.com

Sean McKee
National Practice Leader,
Public Investment Management
T: 817-339-1220
E: smckee@kpmg.com

James Penman
Director, Advisory
Financial Services
T: 203-940-2256
E: jpenman@kpmg.com

kpmg.com/socialmedia