

Sprouting an ETF *Seed Capital: an ETF's Origin*

Not Without a Seed:

All of planet Earth's most vibrant, unique, and strong plants have one thing in common; they were born out of an initial seed that gave them the opportunity to flourish, develop, and thrive. Not unlike planet Earth all Exchange Traded Funds (ETFs) have a common bond in their creation, aptly named *Seed Capital*. Seed Capital is an important piece in bringing all potentially fruitful ETFs to market. The alliance between an ETF sponsor and its Seed Capital provider is a fundamental step toward future success.

As this article discusses, the relationship between a new ETF and its necessary seed capital it is important to identify the parties involved in the formation of a new ETF. They are as follows: the SEC, the ETF Issuer ("Issuer"), Authorized Participants ("Participants"), and the ETF's investors. The SEC is responsible for initially granting or denying the Issuer's request for exemptive relief to bring an ETF to market. The ETF Issuer develops the ETF product, its underlying components and prospectus potentially profiting from a management fee that is typically a percentage of Assets Under Management (AUM). The Participant is responsible for borrowing the underlying securities and packaging them into creation units of the ETF, controlling the trade flow of the product, and ultimately benefiting from commissions based on these actions. The investor benefits from the opportunity to invest in a basket of securities with greater liquidity, lower tax expenses, and greater transparency than Mutual Funds to which ETFs are often compared.

Farming an ETF:

The process of bringing an ETF to market begins with the Issuer applying to the SEC for permission to manage an ETF. Typically, ETFs are established as open-end investment companies and are registered under the Investment Company Act of 1940. However, they can also be established as unit investment trusts, which have different tax implications and structures.

Exhibit 1. Comparison of Open End Investment Company and Unit Trust Investment Trust Structures

	Unit Investment Trusts	Open-End Investment Company
Under Investment Company Act of 1940	Yes	Yes
Use Derivatives	Yes	Yes (Rarely Used)
Granted Income for Loaning Securities	Yes	No
Voting Rights on Tracked Securities	Advisor	Trustee
Tax Implications	In-kind redemption is not taxable to fund	In-kind redemption is not taxable to trust
Participant Creation/Redemption	# of ETF Shares: 50,000-100,000	# of ETF Shares: 50,000-100,000
Purchase Requirement		
Tracking of Index	Optimize positions to Index	Must follow index

Source: "Exchange-Traded Funds: ETFs May Offer Attractive Alternatives to Open-End Mutual Funds." Mar. 24, 2010. Morgan Stanley.

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Like the wide variety of plants that can sprout from a seed, Issuers are capable of bringing a broad scope of combinations of financial securities they wish the ETF to track. After the approval from the SEC the Issuer must find someone to create the initial shares of the ETF in order to bring it to market. This is where the Active Participant and Seed Capital come in.

The Seed Capital is put up by an Active Participant to bring a basket of specific securities including other ETFs, stocks, fixed income securities and/or derivatives to market. The basket of securities is placed in a Trust in exchange for a creation unit, typically representing a block of 50,000 shares of an ETF. Seed Capital provided by the Active Participant brings the creation unit to market allowing investors to purchase shares of the constructed ETF. In a typical Seed 100,000 shares (2 creation units) of an ETF are brought to market at a Net Asset Value (NAV) of \$25.00 for a total seed capital requirement of \$2.5mm. The standard \$2.5mm needed to initially seed an ETF today is minute compared to the standard of four to five years ago when the amount of seed capital would range from \$25mm to \$50mm. One could argue that smaller seed capital has made it more difficult for issuers to attract institutional investors who need the ability to move in and out of large share blocks with minimal repercussions.

After the Issuer and Active Participant collaborate to bring the initial creation units to market the ETF shares are sold off to investors. After acquiring the created shares in the open market the investor is free to hold or trade them as they see fit. Once the Active Participant creates the initial fund, it is successfully seeded.

As with a mutual fund manager an ETF issuer incurs costs while managing an ETF that include but are not limited to custodial expenses, legal expenses, trustee expenses, compliance expenses, printing expenses, accounting expenses, index licenses, distribution fees, software and other logistical overhead costs, etc. Theoretically, in order for an ETF Issuer to break even, the management fee multiplied by the ETF's AUM must be equal to the total expenses. Per exhibit 2, if an Issuer has a management fee of 100 basis points and expenses totaling \$250k he/she must have at least \$25MM in AUM. As seen in Exhibit 2, clearly it is important for an ETF to attract significant assets in order to be profitable, a feat that has become increasingly challenging with the smaller sized launches of today.

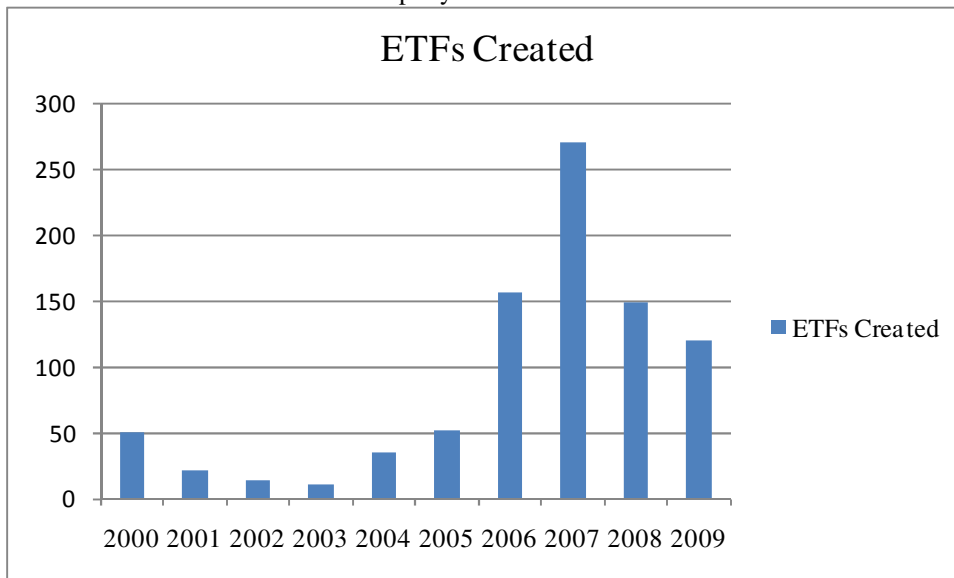
Exhibit 2: A Matrix depicting an ETF Issuer's needed AUM and annual management fee to breakeven, assuming annual costs of \$250k. It should be noted that the \$250k is an estimated average based on discussions with various industry professionals.

		Assets Under Management										
		In Millions of Dollars										
		10	20	30	40	50	60	70	80	90	100	
M a n a g e m e n t F e e	I n B a s i s P o i n t s	20	0.02	0.04	0.06	0.08	0.10	0.12	0.14	0.16	0.18	0.20
		25	0.03	0.05	0.08	0.10	0.13	0.15	0.18	0.20	0.23	0.25
		30	0.03	0.06	0.09	0.12	0.15	0.18	0.21	0.24	0.27	0.30
		35	0.04	0.07	0.11	0.14	0.18	0.21	0.25	0.28	0.32	0.35
		40	0.04	0.08	0.12	0.16	0.20	0.24	0.28	0.32	0.36	0.40
		45	0.05	0.09	0.14	0.18	0.23	0.27	0.32	0.36	0.41	0.45
		50	0.05	0.10	0.15	0.20	0.25	0.30	0.35	0.40	0.45	0.50
		55	0.06	0.11	0.17	0.22	0.28	0.33	0.39	0.44	0.50	0.55
		60	0.06	0.12	0.18	0.24	0.30	0.36	0.42	0.48	0.54	0.60
		65	0.07	0.13	0.20	0.26	0.33	0.39	0.46	0.52	0.59	0.65
70	0.07	0.14	0.21	0.28	0.35	0.42	0.49	0.56	0.63	0.70		
75	0.08	0.15	0.23	0.30	0.38	0.45	0.53	0.60	0.68	0.75		
80	0.08	0.16	0.24	0.32	0.40	0.48	0.56	0.64	0.72	0.80		
85	0.09	0.17	0.26	0.34	0.43	0.51	0.60	0.68	0.77	0.85		
90	0.09	0.18	0.27	0.36	0.45	0.54	0.63	0.72	0.81	0.90		
95	0.10	0.19	0.29	0.38	0.48	0.57	0.67	0.76	0.86	0.95		
100	0.10	0.20	0.30	0.40	0.50	0.60	0.70	0.80	0.90	1.00		

The Current ETF Dust Bowl:

The ETFs issued blossomed from 2003 to 2007 with the number of seeded ETFs increasing exponentially from 10 to 270.¹ The boom in ETFs coming to market was attributable to high investor demand, innovative ETFs with unique investment strategies, and Participants profiting from seeding ETFs. However, the seeding of ETFs hit a drought during 2008 as the number of ETFs seeded decreased by 121 to 149 in 2008.² Three possible explanations for the lack of new ETFs: 1) the number of Participants decreased due to regulation and less liquidity, 2) the number of innovative ETFs decreased as most sectors and investment strategies had already been provided, and 3) the ETF industry was reaching a maturation phase. It should also be noted that the recent market downturn may have contributed to the decrease in annual seeded ETFs from the year 2007 to 2008 and 2008 to 2009.

Exhibit 3. The number of new ETFs created per year



Source: Investment Company Institute

Participants responsible for seeding new ETFs are currently cautious and have become hesitant to supply the necessary capital. Olivier Ludwig's article titled "New ETF Seeding Models Elusive" claims the lack of seed capital is due to the implementation of Reg NMS in 2005 and advances in computerized trading technology.³ The purpose of Reg NMS was to "modernize and strengthen the regulatory structure of the U.S. equity markets."⁴

Under Reg NMS's "Order Protection Rule" a security is guaranteed to be traded for the best possible price, in theory narrowing its bid/ask spread.⁵ This decrease results in less profitability for the Active Participant. The Participants' profit margin has also decreased significantly due to smaller cash rebates received on trades. In

¹ Investment Company Institute. "2010 Investment Company Fact Book." ICIFactBook.org. 50th Edition, 2010. Date Accessed: Sept. 17, 2010

² Investment Company Institute. "2010 Investment Company Fact Book." ICIFactBook.org. 50th Edition, 2010. Date Accessed: Sept. 17, 2010

³ Ludwig, Olivier. "New ETF Seeding Models Elusive." IndexUnivers.com. Published: August 31, 2010. Date Accessed: Sept. 20, 2010.

⁴ Securities and Exchange Commission. "Regulation NMS." SEC.gov. Published: Aug. 29, 2005. Date Accessed: Sept. 20, 2010.

⁵ Securities and Exchange Commission. "Regulation NMS." SEC.gov. Published: Aug. 29, 2005. Date Accessed: Sept. 20, 2010.

addition, newer trading technology coupled with the changes in trading regulation has opened up the market to more traders, making it harder for Participants to control the trade flow, thus decreasing profit margin.

The “Access Rule,” enacted through Reg NMS, provides greater access to quotes by opening the trade flow of securities to more trading centers.⁶ This change has allowed for more traders to access an ETF’s trade flow. In order to attract trade flow these trade centers typically ask for narrower spreads to undercut the Participant. As a result, the Participant no longer controls the majority trade flow from its seeded ETF. These problems have dramatically changed the ETF landscape and have caused many Participants to withhold seed capital until a more efficient and effective business strategy is developed to seed an ETF.

Noticing these problems, Exchanges began to offer more incentives for Participants providing seed capital. For instance, in the beginning of 2008, the NASDAQ increased the rebate per 100 shares from 25 cents to 40 cents.⁷ Exchanges also began encouraging multiple Participants to seed a single ETF, lowering the amount of seed capital needed. Continued creative innovation between Participant and ETF Issuer as well as new entrants to the seed capital arena should help facilitate continued successful launches and growth in AUM in the ETF industry. To date the additional incentives have not been enough to entice providers of seed capital resulting in a significant drought in supply.

Innovation to Increase ETF Creation:

The ETF industry is set for a change in order to recapture the growth in the number of ETFs issued it previously enjoyed. According to Morgan Stanley, the ETF market will continue to grow in assets; however, the outlook for newly seeded ETFs is grim as new products find it difficult to come to market.⁸ Despite an inflow of new assets of about 25% per year there is an expected decrease in new ETF listings.⁹ As a result of the majority of segments being covered, it is expected that the direction of seed capital will likely be seen flowing toward new actively managed ETFs that are expected to gain traction through inflows over other actively managed investment vehicles going forward. In line with the recent inflows of AUM to ETFs, it is expected that more mutual fund companies will also enter the ETF market increasing the number of ETF launches. According to indexuniverse.com, in 2009 & 2010, eleven mutual fund firms have recently entered the ETF landscape as issuers and there are 22 more mutual fund companies that could potentially break into the ETF market soon (see Appendix A and B for a list of companies).¹⁰

A recent example of the future trend in ETFs is the Mars Hill Global Relative Value ETF. The ETF was formed with two creation units totaling \$2.5 million. The ETF, listed on the NYSE under the ticker GRV, is an actively managed ETF offering a long/short equity offering with the goal of outperforming the returns of the MSCI World Index, while avoid being correlated with the MSCI World Index. The fund is designed to find alpha, remain market neutral, and primarily invests in other ETFs, derivatives and other securities. GRV may represent the type of innovative product that will lead to the future of ETFs as it was able to attract investors in a dry market. The innovation and attraction behind GRV rests in that it provides investors with essentially the same benefits that only a long/short equity hedge fund could provide. The demand for innovative ETFs is evident in the fact that one month since the fund was launched; it accumulated over \$39MM in assets. This accumulation makes GRV the largest equity-focused active ETF in the United States. As with the introduction of water to

⁶ Securities and Exchange Commission. “Regulation NMS.” SEC.gov. Published: Aug. 29, 2005. Date Accessed: Sept. 20, 2010.

⁷ Ramage, James. “Sweetening the Pot: Nasdaq Soups Up ETF Rebate to Entice Specialists.” TradersMagazine.com. Date Accessed: Sept. 20, 2010

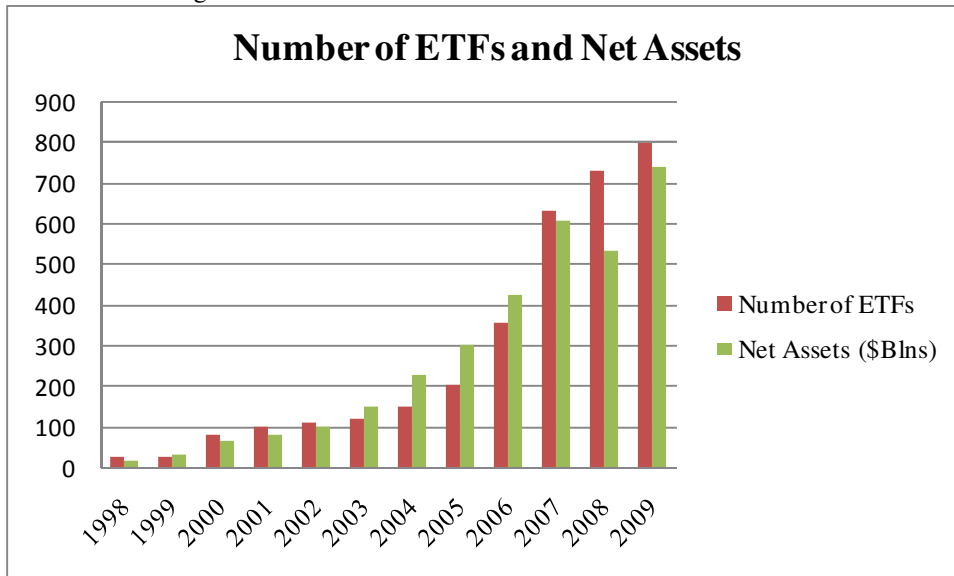
⁸ “Exchange-Traded Funds: Overview and Strategies.” Feb. 26, 2010. Morgan Stanley.

⁹ “Exchange-Traded Funds: Overview and Strategies.” Feb. 26, 2010. Morgan Stanley.

¹⁰ Bell, Heather. “ETF Watch: September 19 –September 25.” IndexUniverse.com. Published: Sept. 27, 2010. Date Accessed: Sept. 27, 2010.

plant a seed, the actively managed ETF and the entry of new seed capital participants will continue to facilitate the development and growth of the ETF industry.

Exhibit 4. The outstanding number of ETFs and net assets in billions of dollars



Source: Investment Company Institute

The Future of Seeding ETFs:

It is apparent that the business of seeding an ETF has changed. Whether the drying up of seed capital has been caused by the recent recession, a lack of innovation on the part of the issuer or a decrease in economic incentives for the participant, it is clear that obtaining seed capital is a critical ingredient in bringing an ETF to market. As more firms follow in the footsteps of ETF specialists and innovators, like Esposito Securities, that are currently combining a variety of new strategies in providing seed capital to newly formed ETFs. The dry environment for ETF creation growth is destined for a change.

Appendix A. List of new ETF products 2009 and 2010 from existing issuers

Company	ETF Product(s)
Claymore	Actively managed commodity equity ETFs & Actively managed ETFs
Direxion Shares	Monthly Inverse/leveraged ETFs/130/30 ETF
First Trust	2020 Target Term Corporate Bond Fund & Dow Jones Corporate Bond Index Fund
IndexIQ	Debt ETFs & 130/30 ETFs
iShares	Active ETFs & Long/Short ETFs
Jefferies Asset Management	Fixed Income ETF & Equity ETF
State Street Global Advisors	Actively managed ETFs of ETFs & Hedge fund and commodity ETFs
Van Eck	Actively managed ETFs
Vanguard	Actively managed fixed-income ETFs
Northern trust	Fixed-income, equity index based ETFs
WisdomTree	Fund of Funds
Advisor Shares	Actively managed ETFs

Appendix B. List of potential future new ETF issuers

Company	ETF Product(s)
Alliance Bernstein	Active fixed income and equity quantitative ETFs
Arrow Investment Advisors	Index-based ETFs
Claremont	Index-based ETFs
Dreyfus	Actively & passively managed, international & domestic ETFs
Eaton Vance	Actively managed fixed-income ETFs
ETSpreads	Fixed-income ETFs
FactorETF	Leveraged/inverse ETFs
FFCM LLC	Actively managed ETF of ETFs
Georgetown Investment Management	Passive domestic ETF
Goldman Sachs	Index-based ETFs
The Hartford	Active global fixed income ETFs
Highland Capital Management	Actively managed fixed income ETFs
Huntington Asset Advisers	Actively managed equity ETFs (some w/ options strategy)
Janus	Active equities/fixed income domestic & international ETFs
John Hancock Advisers	Domestic & international equity ETFs & Actively managed ETFs
JP Morgan	Index-based ETFs & Actively managed ETFs
Legg Mason	Actively managed ETFs
Next Investments	ETF of ETFs & Nikkei 225 ETF
RiverPark Advisors	Actively managed ETFs
Russell	Actively managed ETFs
ShariahShares	Shariah-compliant domestic & international ETFs
T. Rowe Price	Actively managed ETFs

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