AN INTRODUCTION

ETFs

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ETF STYLES & EVOLUTION

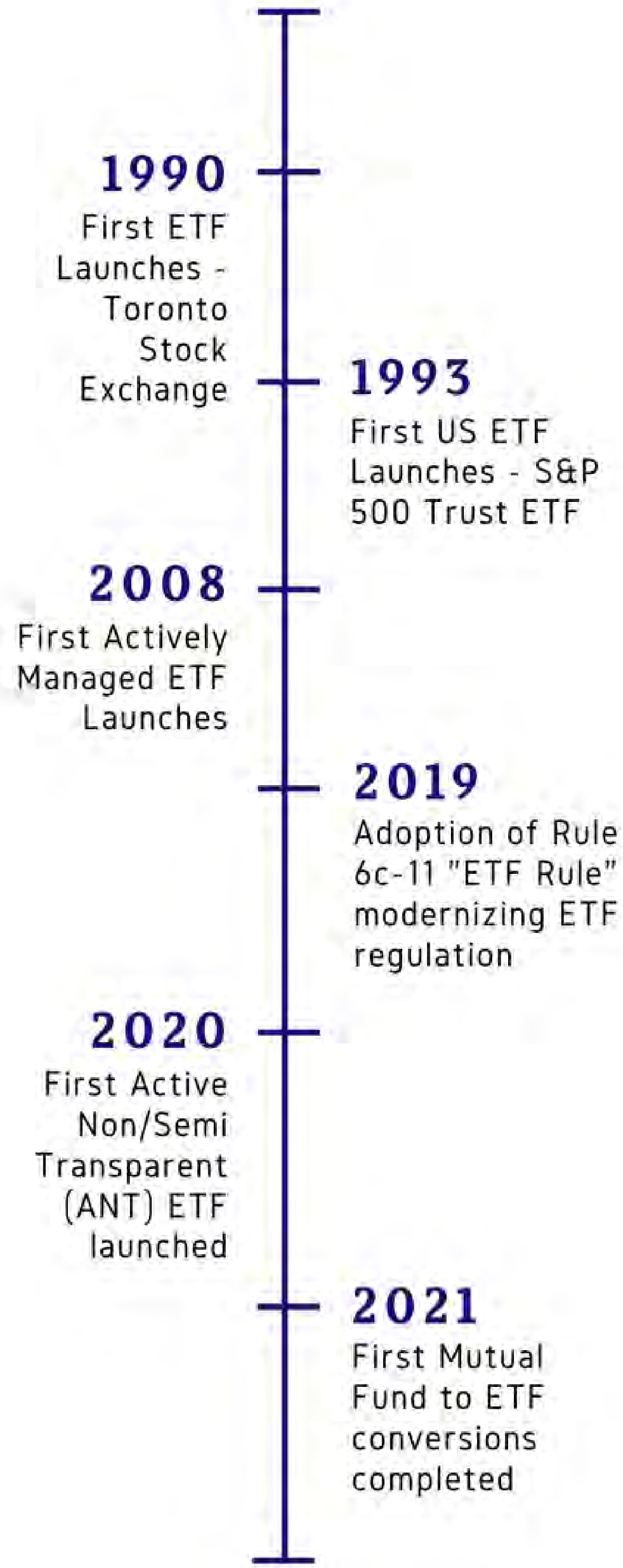
Since the first mutual fund was created almost 100 years ago, registered funds certainly have become a staple of the investment world evidenced by the more than $29 trillion in assets in the US registered fund space alone. While mutual funds have historically been the leader in this space, ETFs have seen a meteoric rise in recent years.

The first ETF was created in Canada over 30 years ago; the first US-listed ETF launched shortly after in 1993. Recent regulatory changes have eased restrictions to entry and broadened the field for advisors/sponsors interested in starting an ETF or converting an existing mutual fund to an ETF.

In 2021, US listed ETFs crossed over $900 billion of inflows, almost double the previous annual record for ETFs. The adoption of the "ETF Rule" in 2019 and the completion of the first mutual fund to ETF conversion in 2021 prove that the registered fund landscape will continue to evolve to meet investor need.

Passive, or index, ETFs which have constituted the majority of ETFs for the past 25+ years, have a static portfolio that is either a duplicate of or representative of an index of securities. The Dow Jones Industrial Average and S&P 500, for instance, are indices comprised of stocks that change infrequently. The index ETF either holds the same stocks to track the index or holds a representative sampling of the stocks in the index to mimic its performance. However, some indices rebalance more frequently, such as indices in new or emerging industries or market segments, to reflect the evolving nature of the market sector of the index.

Recently issued cannabis ETFs based on market indices are an example, as that industry segment is still in its infancy and evolving. The more mature an industry or market sector, the less the index will change. Regardless of the frequency of rebalancing, index ETFs are not actively managed.



ETF STYLES & EVOLUTION

(CONTINUED...)

Actively managed ETFs operate much like any mutual fund or SMA, with a portfolio manager making investment decisions on a continuous basis. An actively managed ETF may change its portfolio as often as the portfolio manager determines it is appropriate. Each day that the markets are open the portfolio manager may make investment decisions to buy and sell securities within the ETF portfolio.

Active ETFs have become more prevalent in recent years, but still represent a small percentage of the ETFs available today. Many industry observers believe this is due to the reluctance of portfolio managers to publicly disclose their full portfolio at the end of each trading day, as the portfolio composition and strategy is intellectual property.

In 2019 the SEC approved several new ETF structures that have become known as semi/non-transparent wrappers, which obfuscate, in varying degrees, the portfolio composition of ETFs. Using proxy portfolios or modified position weightings these structures protect the portfolio manager's proprietary information.

THE "ETF" RULE

ETFs are a form of open-end mutual funds and are governed by the Investment Company Act of 1940 (the 40 Act). Rule 6c-11 of the 40 Act replaced the exemptive relief requirement that mandated filing with the SEC for special permission to modify the rules regarding the ETF share creation and redemption process.

The new rule also permits ETFs to use custom baskets, allowing for a different basket of securities to be delivered or distributed by the ETF in exchange for shares, than the basket used by the market makers and stock exchange in pricing the ETF for shareholder transactions. The value must be equal, but the proportion may be modified, or the delivered basket may exclude some securities or include different securities.

Custom baskets are a key benefit of the ETF structure - providing flexibility to remove existing and/or add new securities to the portfolio in-kind, tax efficiently and with no trading costs (trading costs are covered by the AP).

ETFs vs MUTUAL FUNDS

An exchange traded fund ("ETF") is a form of mutual fund that is traded on a stock exchange.

Both ETFs and traditional open-end mutual funds are regulated under the Investment Company Act of 1940.

The 1940 Act allows a fund to hold a portfolio of securities and allocate that fund among its investors in the form of shares.

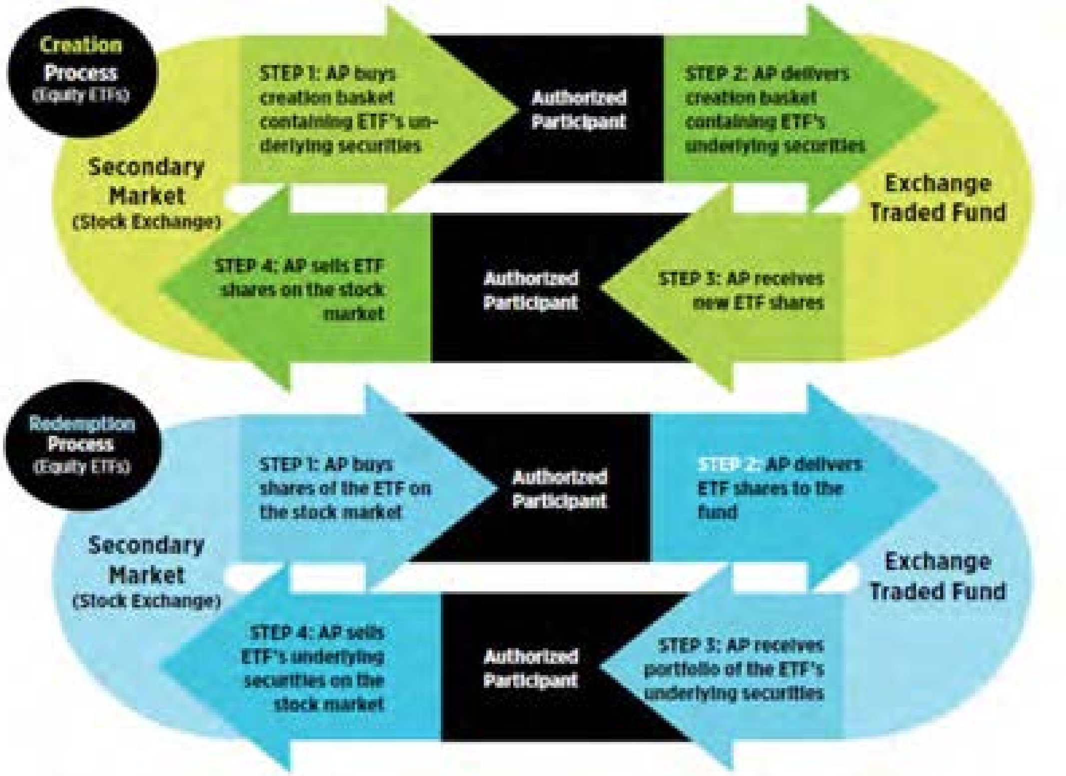
KEY DIFFERENCES

While portfolios of ETFs and mutual funds can be managed in the same way by their portfolio managers, there are several key differences in the structures:

	ETF	TRADITIONAL MUTUAL FUND
PURCHASE/SALE	Purchased through a broker dealer on a listed exchange any time during the trading day.	Purchased directly from the mutual fund company or via directed trade with a broker dealer at closing price at the end of the trading day.
SETTLEMENT	ETF transactions are settled by the AP either delivering a basket of securities in exchange for shares for new investor purchases or receiving a basket of securities from the ETF in exchange for shares that are being redeemed by investors.	Settled in cash with transfer agent or broker dealer. They do have ability to make redemptions in-kind, however it is rarely utilized.
NAV/BID/ ASK SPREAD	Valued electronically throughout the day based on estimated fund value. Estimated fund value is derived daily by reconciling the portfolio positions, accrued income and expenses, etc. Then a portfolio composition file is transmitted to the Exchange on which the ETF trades, for use the following day in calculating ETF value and an appropriate bid/ask spread for the market makers.	Valued at the end of each day based on closing price of each security held by the fund, accrued income and expenses, etc...
HOLDINGS DISCLOSURE	Transparent ETF holdings must be disclosed daily. Non/semi-transparent holdings are masked via proxy portfolios and/or modified position weightings.	Holdings must be disclosed quarterly within 60 days of quarter end. Most funds report holdings 30 days after quarter end.

FUNDAMENTAL DIFFERENTIATOR

THE CREATION AND REDEMPTION PROCESS



*SOURCE: ETF.COM

Baskets - An ETF basket is comprised of the same securities that are in the ETF. These securities are delivered to the ETF much like cash is delivered to a mutual fund, in exchange for shares in the ETF. For redemptions the ETF will deliver a basket of securities to the AP to redeem shares the AP has repurchased on the stock exchange from ETF shareholders.

ETF purchases are settled with baskets (standard or custom) of securities delivered in-kind to the Fund by Authorized Participants ("AP") who make a market in the ETF. The ability to predominately utilize in-kind transactions to avoid capital gains leads to better tax efficiency.

Custom Baskets - In certain circumstances the ETF portfolio manager may wish to ask for a slight variation in the basket so that it is different than the ETF portfolio. The portfolio manager may wish to rebalance the portfolio and does not want to receive additional shares in a particular security, so may ask the AP to deliver an equal value of a different security. Special baskets are even more important in the recently approved non-transparent and semi-transparent ETF structures, where the baskets are intentionally slightly different than the actual ETF portfolio, with a goal of not disclosing to the investing public a portion of the ETF portfolio to preserve the portfolio manager's strategy and proprietary processes.

Authorized Participant or "AP" – APs are a critical part of the ETF process. An AP is a broker dealer that may provide a bid/ask market for an ETF on the stock exchange on which the ETF trades. For ETF sales, an ETF holder can sell their ETF shares on the open market. APs offer to purchase those shares at a bid/ask spread, and then deliver the ETF shares in exchange for a basket of securities from the ETF of equal value. These settlements must be made through the Custodian and Transfer Agent, given the need to settle the securities in and out of the ETF custody account. Very few transfer agents and custodians have the experience and capability to operate this slightly more complex process.

Tax Efficiency - A portfolio manager to a mutual fund may choose to sell securities in the fund portfolio in which the fund has an unrealized capital gain. Once sold, the unrealized gain becomes a realized gain, and must be distributed to shareholders prior to year-end in the form of a taxable dividend. An ETF portfolio manager that wishes to liquidate or reduce a position in the ETF can either overweight that security in a redemption basket or create a special basket by agreement with an AP to deliver that security to the AP as a special redemption basket. Handled in this manner, the ETF does not recognize the capital gain within the ETF and does not have a resulting capital gain distribution.

*ETF.com, "What Is The Creation/Redemption Mechanism?", https://www.etf.com/etf-education-center/etf-basics/what-is-the-creationredemption-mechanism

LAUNCHING AN ETF – FAQ'S

How do you start an ETF?

- The process of starting an ETF is the same as starting an open-end mutual fund.
- A new fund can either be added as an additional series ETF in a series trust or started in a new trust and filed as the first ETF in that new trust.

How much does it cost to start an ETF?

- To add a new series in an existing series trust, expect a budget of $50k - $60k.
- To start a new trust and file an initial ETF in that new series trust, estimate a budget of $75k - $100k (costs vary by vendors selected – i.e., legal counsel, etc..).

How much does it cost to operate an ETF?

- ETFs are slightly less expensive to operate than open-end mutual funds because blue sky fees are not necessary for ETFs.
- The total operating cost not including investment advisor and/or subadvisor fees is a little less than $200,000, typically.

What is the break-even level for an ETF?

The break-even level for any investment fund can be calculated by taking the estimated expenses and dividing by the expense ratio. Most funds cap the expense ratio to help make a fund attractive and predictable for the investing public. If you assume, for instance, $200,000 in operating fund expenses and plan to cap the expense ratio at 1% or less, $200,000 is divided by 1% for a break-even of $20 million. For this example, at the $20 million asset level the advisor no longer has to pay out of pocket to cover any of the fund operating expenses, but the advisor is waiving their management fee in order for the fund to meet the stated 1% expense cap.

The advisor firm break-even will differ from the fund break-even depending on how much is spent for sales and marketing expenses. Once the fund AUM surpasses the fund break-even asset level, the advisor will begin collecting a percentage of the stated management fee as the fund AUM grows. The advisor firm break-even is the asset level where the advisor collects enough management fee from the fund to cover sales and marketing expenses incurred by the advisor outside of the fund. Those expenses are not billed to the fund, but rather handled by the advisor and can vary widely from firm to firm. It is important to budget for sales and marketing expenses in order to estimate the advisor firm break-even level.

SERIES TRUST VS STANDALONE TRUST

	SERIES TRUST	STANDALONE TRUST
Organization Structure	Existing trust that has established Board of Trustees, officers, services providers, and legal counsel	Organization of a new trust - client elects to select Board Trustees, officers, legal counsel, etc., and/or utilize Nottingham-recommended service providers
Timelines[1]	Transparent ETF: 5-6 months Semi/non-transparent ETF: 6-9 months	Transparent ETF: 7-8 months Semi/non-transparent ETF: 8-10 months
SEC Filing Review Timeline	75 days for established trust	No set timeline for review - typically 90 to 120 days, however timelines may be extended for new/innovative strategies
Organization Costs[2]	Transparent ETF: $50k-$60k Semi/non-transparent ETF: $60k -$75k	Transparent ETF: $75k - $85k Semi/non-transparent ETF: $75k -$100k [3]
Operational Expenses	Variable - Typical fund expenses (not including management fees) are around $175k - $200k annually dependent on fund size, strategy, holdings, etc....	Variable - Typically you can expect an additional $20k - $25k in additional annual operating expenses for a standalone trust, mostly due to legal and administration expenses and compliance oversight. Operation expenses (not including management fees) range from $200k to $225k annually, again dependent on fund size, strategy, holdings, legal counsel, auditor, etc....

1 *Timelines can vary based on advisor responsiveness and complexity of strategy*

2 *Organization costs can vary based on strategy complexity and in-process changes/modifications. For standalone trusts the costs will also vary based on legal counsel selected*

3 *Semi/non-transparent wrappers require licensing agreement with exemptive order owner which is not contemplated in costs or timeline.*

Additional Tasks for Standalone Trust Organization

- Organization of new Delaware Trust, Bylaws, amendments, certificate of trust, compliance manual and policies, etc....
- Formation Transactions – Seed Audit, Seed Capital & Completed Trustee and Officer Questionnaires
- Preparation for Organization Meeting, Creation of all Resolutions, Agreements, Power of Attorney, Trust Procedures
- Establishing new Issuer with stock exchange
- Establishing new Trust Authorized Participant Agreements with LMMs and APs

3 KEY CONSIDERATIONS FOR BECOMING AN ETF ISSUER

WHAT SIZE/AGE SHOULD A FIRM BE TO CONSIDER LAUNCHING AN ETF?

While there is not a particular AUM or tenure requirement, investors and fund boards typically want to see a level of experience/expertise and capital to support the fund's growth. **Having 7+ years of investment management experience/expertise and $250M+ in AUM are good starting points.** This does not mean there is not an opportunity for emerging managers with less tenure or assets, just more likely to require additional persistence and patience.

WHAT ADDITIONAL RESOURCES DO FIRMS NEED TO MANAGE AN ETF?

Portfolio Management and Marketing are the two most important aspects for any fund.

- From a portfolio management standpoint, **an ETF is a single pool of assets that is traded/managed, making it an efficient vehicle for portfolio management.** There are some compliance requirements, but it is typically manageable with current resources within a firm.
- From a distribution standpoint, **the ETF industry is very competitive and requires a diligent and multi-faceted marketing and sales plan to garner investor attention.** A quality fund administration partner will handle the ongoing fund operations, allowing the fund advisor to focus on the two most important jobs; Portfolio Management and Marketing.

HOW DO WE EFFECTIVELY POSITION OUR ETF /FIRM?

A strategic positioning plan is critical for long term success. Answering the Who, What, Why, and How questions are important to identify your targeted channels and plan market engagements effectively.

- WHO are the competitor funds and HOW do you compare/contrast to those products/firms?
- WHO are your targeted channels and WHEN/HOW do you engage that audience?
- WHY should investors select your fund/firm?
- WHAT does your fund solve/position the investor for, and WHAT does it replace in the existing portfolio?

SELECTING A SERVICE PROVIDER PARTNER

The ETF Ecosystem is a complex network of participants and technologies that work together to make ETFs unique and efficient fund vehicles. Working with an experienced service partner with well established relationships throughout the ETF landscape is critical so fund managers can focus on the most important aspects of operating a fund – the investment management and marketing/distribution.

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Selecting an experienced and consultative partner that will help you navigate from organization/launch to ongoing operations will enable you to have that focus. Ideally this partner should offer comprehensive and customizable service solutions specific to your fund that include robust technology and connectivity, an established network of partner relationships, deep industry knowledge, and perhaps most importantly a strong client service culture.

Nottingham has been providing highly responsive, completely customized services for new and existing funds that value superior customer service for their advisors and shareholders since 1989.

With over three decades of 40 Act experience, Nottingham delivers a boutique, consultative partnership approach that supports all facets of launching and operating ETFs. Our team of professionals will help you evaluate your options and find a service solution to fit your needs.

- Established network of partner relationships (market makers, authorized participants, etc.)
- State of the art technology, proprietary AP portal, premier industry standard software and proprietary programming
- Fully turnkey with in-house fund accounting, transfer agency, CCO, legal, and compliance
- Passive, active, and non/semi-transparent licensing with Blue Tractor Shielded Alpha and NYSE AMS
- Series trust or standalone trust options
- Customizable

To learn more about launching an ETF and if it's a fit for your firm, please contact:

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