Education

Product Development

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The US ETF Ecosystem

Roles and Responsibilities of Key Players

STATE STREET GLOBAL ADVISORS SPDR®

Contents

Executive Summary

State Street launched the first US-listed exchange traded fund (ETF) in 1993 — the SPDR® S&P 500® ETF (SPY). Since then, ETFs have become an increasingly popular investment vehicle for both individual and institutional investors. Today, there are more than 2,300 US-domiciled ETFs, with $5.4 trillion in assets.[1]

However, there is still a great deal of misunderstanding of how ETFs are structured, traded and regulated. Increased disclosure, greater transparency and improved investor education are vital to helping investors understand the potential benefits of investing in ETFs.

This article describes the US ETF Ecosystem, defining the major participants and how they interact with the funds and their shareholders. For each of these key industry players — ETF Issuer; Service Providers Hired by the ETF Issuer; Independent Trustees and Related Oversight Functions; Capital Markets Participants; and Regulatory Bodies — we outline their roles and responsibilities, how they're regulated and, where applicable, how they are compensated.

What is an ETF?

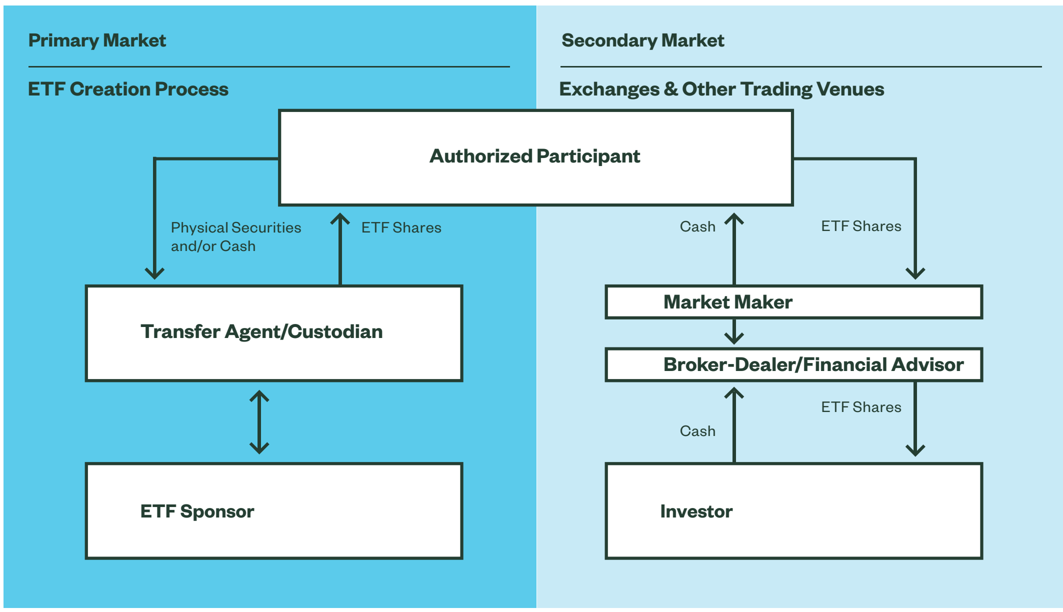
An exchange traded fund (ETF) is an investment vehicle whose shares are traded intraday on stock exchanges at market-determined prices. Investors buy and sell ETF shares through a broker just as they would shares of any publicly traded company. Blocks of ETF shares may also be created or redeemed through the ETF primary market.

Trading in ETFs

Primary Market: Primary market refers to the creation or redemption of ETF shares. Most investors do not trade in the primary market; rather, large institutional traders authorized by the fund are allowed to transact directly with the fund in the primary market. ETF shares are created when an authorized participant (AP) delivers an ETF's portfolio holdings to the fund sponsor in exchange for equally valued ETF shares. ETF shares are redeemed when an AP delivers ETF shares to the fund sponsor in exchange for an equally valued amount of the ETF's portfolio holdings. Due to creations and redemptions, an ETF's assets and number of shares can change at end-of-day.

Secondary Market: ETFs primarily trade on exchanges or other trading venues, known as secondary market trading. Most individual investors trade ETFs in the secondary market on trading venues through their broker. Secondary market refers to the trading of existing ETF shares throughout the day. It's important to note that, on average, 90% of daily activity in all ETF shares occurs in the secondary market.[2]

ETF Primary and Secondary Markets



Source: State Street Global Advisors.

What This Means for Investors

- ETFs are investments made up of a portfolio of stocks, bonds or other assets that trade like stocks on exchanges throughout the day.
- Most investors buy and sell ETF shares in the secondary market, on trading venues through their broker.
- Primary market trading refers to the process by which authorized participants create new shares or redeem existing shares in exchange for the ETF's portfolio holdings and cash.

ETF Issuer

Also known as the ETF Sponsor, the ETF Issuer manages the development and administration of the ETF. More specifically, the ETF Issuer develops products, determines funds' investment objectives and monitors and tracks the ETF's correlation to the benchmark. Acting as an Advisor (often the same entity), the Issuer monitors and manages the day-to-day operations of the ETF and its other service providers.

The ETF Issuer is regulated by the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA), the ETF's Board of Trustees and, if the ETF Issuer is a bank, the US Federal Reserve (Fed). The ETF Issuer is paid out of the fund's fees (a percentage of fund net assets) as outlined in the fund's prospectus, and pays all service providers out of this fee.

An ETF Issuer meets its responsibilities via the following positions:

Portfolio Manager The Portfolio Manager is responsible for managing all or part of an ETF investment portfolio in accordance with the fund-governing documents and often determines the composition of the ETF's basket of securities eligible for in-kind trading by an AP with the fund. The Portfolio Manager may be part of the same firm as the ETF Sponsor or may be hired as a Subadvisor. The Portfolio Manager is regulated by the SEC and is also overseen by the Advisor and Board of Trustees.

Portfolio Manager's Trading/Execution Desk The Trading/Execution Desk executes stock, bond, foreign exchange and derivatives trades on behalf of the ETF Portfolio, as directed by the Portfolio Manager. Works with market participants to source liquidity, minimize trading costs and seek best execution for trades on the underlying holdings of the ETF.

The Trading/Execution Desk is regulated by the SEC, exchanges, and the US Commodity Futures Trading Commission (CFTC) (if the ETF holds commodities, futures or other derivatives), and it is overseen by the Advisor and Board of Trustees.

ETF Sales/Distribution Team The ETF Sales/Distribution Team works with financial advisors, brokerage platforms, strategists and institutions (e.g., asset management firms, pensions, endowments and insurance companies) to provide solutions to the end client by means of the Sponsor's ETF products. The Sales/Distribution Team is regulated by the SEC and FINRA and is accountable to the Advisor and Board of Trustees.

Medallion Distributor The Medallion Distributor acts as a legal underwriter and is authorized to approve creation and redemption orders submitted by Authorized Participants; maintains licensing of ETF Sponsor's staff (acts as Principal, provides procedures/training); prepares, updates, executes and maintains AP agreements; reviews and files all marketing materials with FINRA and acts on FINRA's comments. The Medallion Distributor function can be performed by the ETF sponsor or outsourced to a firm that performs this service. The Medallion Distributor is regulated by FINRA and is overseen by the Advisor and Board of Trustees.

Compliance The responsibilities of Compliance include implementing and administering written policies and procedures reasonably designed to prevent violations of the federal securities laws and regulations. Compliance is regulated by the SEC and is responsible to the ETF's Advisor and Board of Trustees.

Sponsor/Advisor Legal Counsel The Sponsor/Advisor Legal Counsel provides legal analysis and advice on all matters affecting ETFs, including product development, obtaining necessary regulatory relief, registration, portfolio management, investment strategy changes, service provider arrangements, regulatory compliance and valuation matters.

External Legal Counsel External Legal Counsel is responsible for representing the ETF in connection with legal matters relating to its operations. Provides continuous legal advice on behalf of the ETF under federal and state laws, with respect to SEC registration, regulatory matters, transactions, compliance issues, product development and valuation.

What This Means for Investors

- The ETF Issuer, also known as the Sponsor, is the fund company that is responsible for the development of an ETF and the ongoing management of its strategy, operations and oversight.
- Depending on the firm, the ETF Issuer can perform many of these functions in-house or outsource them to a firm that specializes in this particular service.
- The ETF Issuer is responsible for ensuring that each function, whether performed in-house or outsourced, operates as designed and in the best interest of shareholders and is responsible to the ETF Board of Trustees and regulators.

Service Providers Hired by ETF Issuer

Service providers can play a key role in reducing friction in the primary market to help boost secondary market liquidity and price efficiency. Because this can reduce an ETF's total cost of ownership (TCO), an ETF Issuer should choose these service providers carefully.

Custodian Holding and maintaining ETF assets to protect Shareholder interests, the Custodian is responsible for overseeing trade settlement, asset servicing, disbursements and inflows. The Custodian also manages connectivity to clearing agent (Depository Trust & Clearing Corporation (DTCC) & National Securities Clearing Corporation (NSCC)) for settlement and asset servicing, ETF portfolio basket processing and communication of basket components, monitoring in-kind ETF transactions and underlying settlements and facilitating Continuous Net Settlement (CNS) processing at DTCC. Custodians are regulated by the Fed and SEC and are responsible to the Advisor and the ETF Issuer's Board of Trustees. The Custodian contracts with the ETF Sponsor for services provided. Compensation typically includes some combination of asset-based charges, annual service fees and transaction-based charges. Custodian services can be bundled with Fund Administration and Transfer Agent services if performed by the same firm.

Sub-Custodian Network The Sub-Custodian Network is comprised of local banks contracted and overseen by the Custodian to safeguard assets (securities and cash) in each country where the ETF does business. They are responsible for settling trades, cash and foreign exchange in accordance with local laws, regulations and schedules. The Sub-Custodian Network is overseen by the Custodian bank and regulated by local and international banking regulatory bodies.

Fund Administrator Often the same firm as the Custodian, the Fund Administrator provides Fund Accounting and Net Asset Value (NAV) calculation services for the ETF and may perform other services such as financial reporting, portfolio compliance, tax, legal services, ETF basket file production and dissemination, cash and holdings reporting. The Fund Administrator is regulated by the Fed and SEC and is responsible to the Advisor and Board of Trustees. The Fund Administrator is compensated in a manner similar to the Custodian.

Transfer Agent The Transfer Agent acts as institutional order-taker for Authorized Participants (APs) who create or redeem ETF shares with the ETF Sponsor in the Primary Market. The Transfer Agent performs shareholder recordkeeping and works with the Clearing Agent to deposit or withdraw ETF shares for creation or redemption after receiving approval from the Medallion Distributor. ETF Shares are held at the DTCC in omnibus accounts, with a single position recorded on the transfer agent system. The Fed and the SEC regulate Transfer Agents and the Advisor, while the ETF's Board of Trustees oversees them. Similar to the Fund Administrator and Custodian, the Transfer Agent contracts with the ETF Issuer for services provided.

Securities Lending Agent Acting as an agent of the ETF to manage the lending portfolio of securities, the Securities Lending Agent works in tandem with the Custodian to facilitate borrowing of ETF holdings with proper recordkeeping.[3]

Securities Lending Agents are regulated by the SEC and FINRA and overseen by the Advisor and Board of Trustees. The loaned assets generate revenue based on their value and the demand from the borrowing community. The lending revenue is split between the lending agent, the fund, and the ETF Sponsor based on the lending agreement, subject to approval by the ETF Board of Trustees.

Index Provider Indexes are used by ETFs as benchmarks. The Index Provider creates the benchmark index and develops the methodology, selection criteria and rebalancing schedule. The index provider also publishes daily closing index composition, closing index values, and often intraday index values.

The Index Provider is overseen by the ETF Issuer. Index Providers collect licensing fees from asset managers and fund companies that benchmark their assets to the index and charge for use of their index data.

Index Calculation Agent The Index Calculation Agent is responsible for daily calculations and dissemination of Index Provider index data. Ensures day-to-day rules of the index are carried out. May be performed by the Index Provider or a separate entity.

The Index Calculation Agent is responsible to the Index Provider (if separate entity) and ETF Sponsor and charges the Index Provider a fee for services, if separate.

IOPV Agent Indicative Optimized Portfolio Value (IOPV) Agents, also known as Indicative NAV (iNAV) Agent, or Intraday Indicative Value (IIV) Agents are hired to provide an indicative value for the ETF via the consolidated tape throughout the trading day. IOPV Agents perform this calculation using the index, trading basket or fund holdings (as received from the Fund Administrator on a daily basis).

The IOPV Agent is overseen and monitored by the ETF Sponsor and in certain cases, the Listing Exchange. The IOPV Agent may charge a flat annual fee per fund to the ETF Sponsor.

What This Means for Investors

- The ETF Issuer will partner with service provider firms to manage various aspects of an ETF's reporting and daily operations.
- Service providers play a key role in optimizing the shareholder's experience by helping reduce friction in the primary and secondary markets. This helps to increase liquidity and ensure that shareholders have the information they need to trade the ETF's shares efficiently.
- Service providers also provide necessary reporting (i.e., NAV calculation, financial reporting) to shareholders.

Independent Trustees and Related Oversight Functions

ETFs, like mutual funds, are required to elect a Board of Trustees to oversee the actions of the ETF Issuer/ Sponsor and service providers, the general management of the Trust, and to ensure that shareholders' rights and interests are being protected.

An ETF's Board of Trustees reviews and approves proposals for new strategies and changes to existing strategies. The Board also approves the hiring of ETF service providers. New ETF Board members are elected by the existing Board Members or the Funds' shareholders. All Board members have a fiduciary duty to shareholders.

Independent Trustee Counsel The responsibilities of the Independent Trustee Counsel include assisting the Independent Trustees in carrying out their responsibilities under federal and state law. The Independent Trustee Counsel advises on the Board process, helps prepare the Board for meetings and ensures proper documentation of Board deliberations.

Audit Firm Hired by the Board of Trustees, the Independent Auditor examines the procedures, controls and year-end financial statements of the ETF, ETF Sponsor and its service providers. The Audit Firm reviews and signs off on fund distributions to shareholders, consults on potential fund structure and investment strategy changes and ensures that ETFs are operating within the accounting guidelines that govern the region in which they are traded. Audit Firms operating in the US are regulated by the Public Company Accounting Oversight Board (PCAOB). Audit Firms charge a fee to the ETF Sponsor for their services.

What This Means for Investors

- The ETF Board of Trustees acts on behalf of shareholders to oversee the ETF issuer and its service providers to ensure shareholders' rights and interests are protected.
- ETFs are subject to periodic audits of their financial statements and procedures by an external audit firm, and the auditor's findings are included in their annual report.

Capital Markets Participants

The unique creation and redemption process and secondary market trading of ETFs require an understanding of the various Capital Markets players involved in the ETF ecosystem. These include:

Authorized Participant (AP) As defined by the SEC, an Authorized Participant is a member or participant of a clearing agency registered with the Commission that has a written agreement with the ETF or one of its service providers that allows the Authorized Participant to place orders for the purchase and redemption of creation units.[4] Typically self-clearing broker-dealers that serve many other functions, APs play a key role in the primary market for ETF shares. APs are the only counterparties allowed to enter creation and redemption orders directly with the fund. The ability of APs to create and redeem an ETF's shares helps balance supply and demand for the ETF shares in the secondary market, which helps keep the price of the ETF shares tied to their intrinsic value.[5] Analysis from the Investment Company Institute (ICI) found that, on average, each ETF has 34 AP agreements. It is important to note, however, as mentioned on page 5 under Secondary Market trading, that, on average, 90% of daily activity in all ETF shares occurs in the secondary market (where existing shares are traded).[6] APs are regulated by the SEC, FINRA exchanges and are monitored by the ETF Issuer.

APs can place orders to create or redeem ETF shares on their own behalf, or on behalf of other market participants (such as other broker-dealers holding inventory). When placing orders on behalf of others, APs earn a commission — either a flat fee, cents per share, or percentage of value traded.

Market Makers Market Makers are firms that simultaneously make offers to buy (bid) and sell (ask) securities at specified prices, providing liquidity to other market participants. Market Makers may or may not be APs. Market Makers facilitate the trading of ETF shares among investors. They serve as liquidity providers, bridging the gap between the time when natural buying and selling interest enters the market. Market Makers also help with price discovery by engaging in arbitrage, which helps keep the ETF prices in line with underlying value.

Regulated by the SEC, FINRA and Trading Venues, Market Makers seek to profit from the bid/ask spread — the difference between the lower price at which they buy a security and the higher price at which they sell it. Exchanges may offer rebates to encourage their services. Market Makers can commit capital to clients and can earn commissions when filling client orders on an agency or principal basis.

Lead Market Maker (LMM) Selected by the Primary Listing Exchange to be the primary liquidity provider in a given ETF on that exchange, LMMs are required by the exchange to meet minimum performance standards, such as best bid and offer, minimum displayed time and minimum quoted spread. LMMs are regulated by the SEC, FINRA and the exchanges. Receiving the same incentives as Market Makers, they also receive enhanced exchange economics (e.g., lower transaction fees and higher rebates) from the Primary Listing Exchange for fulfilling contractual requirements. LMMs need to have the capacity to use their balance sheet in order to take the opposite side of customer orders, from which the LMM can realize a profit or loss.

Broker-Dealer Brokers act as intermediaries between buyers and sellers of securities, executing transactions by routing orders to trading venues or matching buyers and sellers directly. Dealers buy and sell securities for their own account.[7] Broker-Dealers act in both capacities.

Broker-Dealers are regulated by the SEC, FINRA and Exchanges. Broker-Dealers can profit by earning commissions when filling client orders. They may realize a profit or loss through trading positions held as a result of taking the other side of client orders.

Proprietary Trading Desks Proprietary Trading Desks trade ETFs using their firm's own money instead of trading on behalf of clients, serving as another source of liquidity in the marketplace. Regulated by the SEC, FINRA and Exchanges, Proprietary Trading Desks seek to profit through a variety of trading strategies, including arbitrage.

Execution Desks Wealth management or investment advisor execution desks execute trades on behalf of their clients by routing orders to trading venues or seeking liquidity in block size from Broker-Dealers. Execution Desks are regulated by the SEC and FINRA and can earn client commissions.

Create-to-Lend Desks Create-to-Lend Desks create ETF shares (through an AP) for the purpose of lending them to clients seeking to borrow the shares and hedge position to minimize price risks. This helps reduce costs for Market Makers, who may look to borrow ETF shares to satisfy client demand, reducing bid-ask spreads. They can also help add liquidity in the market by allowing investors to express an opinion through a short position in an ETF. Regulated by the SEC and FINRA, Create-to-Lend Desks profit from lending fees, if the value of lending the shares is greater than the cost of holding and hedging their position.

Listing Exchange Listing Exchanges provide an organized and continuous trading market for the ETF shares at market-determined prices.[8] An ETF's Listing Exchange provides market oversight and regulation of exchange members, administration of Lead Market Maker and other programs to incentivize liquidity provision, and marketing support (e.g., bell-ringing, website exposure, launch announcements). An ETF must meet the exchange's listing standards. Regulated by the SEC, each Listing Exchange has different fee structures. Exchanges earn revenue from transaction fees paid by Broker-Dealers, market data and connectivity fees (paid by market participants), and listing fees (paid by corporate issuers and ETF Sponsors).

Trading Venues Trading Venues are platforms where buy and sell orders meet and transactions occur. While ETFs are generally listed on one exchange, trading of ETF shares occurs across many trading venues. These include (1) national securities exchanges (~60% of market volume); (2) alternative trading systems (ATSs) (~10% of market volume); and (3) non-ATS off-exchange venues (~20% of market volume).[9]

Trading Venues are regulated by the SEC and FINRA. Trading venues may earn revenue from transaction fees paid by members or subscribers, market data and connectivity fees paid by market participants, and listing fees paid by corporate issuers and ETF Sponsors. For non-exchange trading venues operated by Broker-Dealers, the economics are often indirect: for example, reducing costs the client and/or Broker-Dealer may otherwise incur when transacting on exchanges.

What Are ATS and Non-ATS Trading Venues?

National securities exchanges are registered with the SEC under the Securities Exchange Act of 1934. ATSs are SEC-regulated trading systems that meet the definition of "exchange" under federal securities laws but are provided certain exemptions. Most ATSs are "dark pools," which allow users to place orders without publicly displaying the size and price of their orders. Non-ATS off-exchange venues include individual Broker-Dealer desks and single-dealer platforms, where users transact directly with a single Broker-Dealer.

Clearing Agent A subsidiary of the Depository Trust and Clearing Corporation (DTCC), the National Securities Clearing Corporation provides clearing, settlement, risk management, central counterparty services and a guarantee of completion for certain transactions for virtually all broker-to-broker trades, including ETFs.[10] NSCC nets trades and payments among its participants within the Continuous Net Settlement (CNS) system, generally on a T+2 basis. Regulated by the SEC, NSCC receives transaction fee revenue and market data and connectivity fees.

What This Means for Investors

- ETFs are unique in that they offer two markets for trading — the secondary market, where most investors trade, and a primary market that supports the ETF's liquidity and allows it to trade close to Net Asset Value throughout the day.
- There are several parties within the Capital Markets ecosystem that act as sources of liquidity for ETFs. Each plays a unique role for their clients, which has the effect of allowing the ETF to trade more efficiently throughout the day, which benefits both buyers and sellers.

Regulatory Bodies

ETFs are subject to numerous and sometimes overlapping government regulations.

Securities and Exchange Commission (SEC) The SEC is a US Federal Government agency, responsible for enforcing federal securities laws and regulating the securities industry and exchanges. Important SEC departments include, among others:

- The Division of Investment Management, formed under the Investment Company Act of 1940, is responsible for issuing rules that regulate the organization of companies that engage primarily in investing, reinvesting and trading securities and whose own securities are offered to investors (investment funds, such as mutual funds and ETFs).

- The Division of Trading and Markets is responsible for providing oversight of major securities participants (securities firms, Broker-Dealers and Self-Regulatory Organizations (SROs), such as exchanges and FINRA) ensuring the orderly and efficient operation of markets. The division was formed under the Securities Exchange Act of 1934, which gave the SEC the broad authority to regulate the securities industry and the power to register and oversee brokerage firms, transfer agents, and clearing agencies.

- The Office of Compliance Inspections and Examinations is responsible for the SEC's examination of registered SROs, Broker-Dealers, transfer agents, investment companies and investment advisors.

- The Division of Economic and Risk Analysis was created in September 2009 with the goal of better integrating data analytics and financial economics into a broad range of SEC activities, including enforcement, examination and rulemaking.

The Financial Industry Regulatory Authority (FINRA) FINRA is a non-governmental self-regulatory organization that acts as an independent regulator for all securities firms in the United States. FINRA aims to protect investors and ensure fair markets by regulating trading in securities and conducting periodic exams. FINRA has the authority to levy fines and arbitrate disputes between customers and member firms.

Regulated by the SEC, FINRA is funded by member firms and applicants, annual fees paid by members, and the fines that it levies.

US Federal Reserve Bank (Fed) The Fed and its 12 regional banks are responsible for supervising and regulating segments of the financial system, including bank holding companies, savings and loan holding companies, state member banks and financial market utilities.

US Department of the Treasury The Financial Stability Oversight Council (FSOC) was created by the Dodd-Frank Act and is housed within the Department of Treasury. The group is made up of the heads of all of the various financial regulatory agencies (e.g., the Fed, FDIC, SEC, CFTC, etc.) and is responsible for identifying risks to financial stability.

What This Means for Investors

- ETF trading in the US is subject to the authority of various regulators.
- Federal Regulators, such as the SEC, and self-regulatory organizations, such as FINRA, oversee the orderly functioning of securities markets — in which ETFs participate — in order to ensure that shareholders' best interests are being protected.
- Regulators enforce rules to protect investors and can levy penalties to parties that fail to comply with those rules.

Endnotes

1 Bloomberg Finance L.P., as of December 31, 2020.

2 "The Role and Activity of Authorized Participants," ICI. https://ici.org/pdf/ppr_15_aps_etfs.pdf.

3 "ETF Ecosystem," ETF Trends. https://etftrends.com/etf-ecosystem/.

4 SEC Rule 6c–11.

5 "The Role and Activity of Authorized Participants," ICI. https://ici.org/pdf/ppr_15_aps_etfs.pdf.

6 "The Role and Activity of Authorized Participants," ICI. https://ici.org/pdf/ppr_15_aps_etfs.pdf.

7 "BrokerCheck Glossary," FINRA. http://finra.org/investors/brokercheck-glossary.

8 SEC rule 6c–11.

9 SSGA analysis based on data from Cboe Global Markets and FINRA, December 31, 2020.

10 "Businesses & Subsidiaries: National Securities Clearing Corporation (NSCC)", DTCC. http://dtcc.com/about/businesses-and-subsidiaries/nscc.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

Start with Rigor We take a highly disciplined and risk-aware approach built on exhaustive research, careful analysis and market- tested experience to meet client needs. Rigor is behind every decision we make.

Build from Breadth Today's investment problems demand a breadth of capabilities. We build from a universe of active and index strategies to create cost-effective solutions.

Invest as Stewards We help our portfolio companies see that what is fair for people and sustain-able for the planet can deliver long- term performance. As fiduciaries, we believe good stewardship is good investing.

Invent the Future We created the first ETF in the US and are pioneers in index, active, and ESG investing. Using data, insights and investment skill, we are always inventing new ways to invest.

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 31 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with US $3.47 trillion* under our care.

* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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