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# ETFs: GROWING UP

Exchange-traded funds have been lauded for their efficiency and cost effectiveness over traditional fund structures. As their global and market expansion quickens—assets are on pace to exceed \$2 trillion by 2015, according to a new study—Joe Keenan, head of Global Exchange Traded Fund Services at BNY Mellon Asset Servicing, speaks with *Global Custodian* about what is behind the growth and what the world's largest global custodian can do for ETFs as they evolve

**GC: What are the major reasons behind the rapid growth of exchange-traded funds and related products?**

**JK:** The primary reason is that the exchange-traded fund product structure simply offers a better mousetrap. It is a fundamental enhancement over more traditional fund structures. Depending on the market, some of the inherent costs have been either addressed, or improved upon, by ETFs. For instance, with most traditional funds investors buy or sell their shares at the end of day net asset value. Inevitably, you get the price that reflects the impact of all the market decisions that have happened throughout the day. So that is one fundamental restriction that ETFs address, because you can buy and sell them throughout the day based upon the quoted price on the exchange. This offers a real advantage.

There are also several other benefits. Broadly, the structures are more efficient from an expense perspective than traditional mutual funds, because you don't have to pay for costly transfer agency fees to keep track of the underlying investors, as these shares trade just like stocks. They are also very flexible, because investors can buy or sell as little as one share. In the United States, the fundamental benefit in terms of efficiency is actually tax efficiency. One of the real challenges that the traditional fund space has struggled with is that whenever a portfolio manager has to buy or sell underlying securities, it creates a taxable event. The vast majority of ETFs shrink and grow through the free delivery or receipt of an underlying basket of shares and, as a result, do not trigger a taxable event. So all of these things: the flexibility, the lower cost, the tax efficiency, the ease at which you can trade these securities, and finally the ability to use these products, the vast majority of which are passive, actively in portfolios, are all key drivers behind the exponential growth of the business.

Our expectation is that asset gathering will continue throughout the rest of this decade,

at a minimum. We recently partnered with mutual fund research and consulting company Strategic Insight (SI), sister company of *Global Custodian*, on a research paper titled "ETFs 2.0: The Next Wave of Growth and Opportunity in the US Market." The report speaks broadly to some of the macro-drivers of growth in the industry, but most importantly this research validates what we have believed for some time, which is that ETFs will hit \$2 trillion in assets before 2015. This means a virtual doubling of the market from today. So for us, as the leading service provider to exchange-traded funds both in terms of number of products and clients, we're really bullish on this space, and we're glad that SI agrees that we should be.

**GC: What does BNY Mellon do for ETF issuers?**

**JK:** We have tenure in this space. We helped the American Stock Exchange bring the second ETF in the United States to market, the MidCap SPDR. Today we continue to provide a bundled solution including acting as the trustee (MDY) for that product, which has about \$11 billion in assets. While MDY was launched just over 16 years ago, in June of 1995, very early on we appreciated the fundamental benefits of the structure and the potential for the product to become a real game changer. I was first exposed to ETFs back in 1997 when a leading institutional indexer, Barclays Global Investors (BGI), began their initiative to launch a whole family of ETFs. I opened our office in the mid-'90s in San Francisco and led the team that pursued the mandate for what became iShares. While we offered a turnkey solution, back then BGI, which is now BlackRock, opted for more of an unbundled solution where they worked with multiple service providers. However, today we are pleased to support their nearly \$20 billion in precious metals funds. It was clear to our entire team that this was going to be the new "new" thing in the funds busi-

ness. Our early focus on this space and our commitment to partnering with clients resulted in our developing the fastest-growing business within BNY Mellon. For example, assets under administration grew by a whopping 45% last year alone. Today, we service more than 550 products globally. In the United States, our more than two-dozen clients are expected to launch more than 100 funds during 2011, and we see no real abatement to that continued growth in terms of total assets, new products and new clients.

So what do we offer that differentiates BNY Mellon? I think we offer deeper expertise and a greater passion for this business than anybody else in the industry. Whether it's an entrepreneurial startup or an established asset manager, this is really unknown territory for firms that want to get into this space. We're able to, in a truly consultative manner, engage our clients and prospects on the front end, by getting into the lab with them and helping them construct a product or products that will offer the greatest potential for success. We engage across the spectrum—whether it's constructing the underlying portfolio, discussing best practices in terms of services that are provided or working with them to ensure a successful launch at the bell ringing on opening day. We also ensure that our clients maximize visibility of their products and will help them with distribution through our subsidiary Pershing. Distribution through Pershing means access to the largest provider of services to regional broker-dealers who are, of course, among the primary buyers and sellers of ETFs. We are not in the ETF sponsorship business ourselves, so we don't compete with our clients. We really try to position ourselves as partners focused on their success. If our clients succeed by launching products that gather assets, everybody wins. We are also willing to work with the industry broadly to raise visibility and maximize education for all the users, whether they be sophisticated institutions or the retail investors. We find that all investors need to



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understand the intricacies of these products, particularly as they have evolved quickly and become more complex. So we offer a turnkey solution—an unmatched breadth of capability, consultative insight—on the front end and partnership throughout the entire relationship, again recognizing that all these products start small and hopefully have the potential to grow to be very successful. Our passion for the ETF business is demonstrated. Our clients and prospective customers pick up on this enthusiasm, and it's infectious. If you're going to enter this business you're taking some risks. ETFs offer terrific potential, but there's nowhere to hide in the ETF space. It's an exciting arena, but if you trip or stub your toe everyone's going to see it, so it's our job to make sure that our clients get out of the gate fast and never stumble.

**GC: How does your technology help clients and the services they are looking to outsource?**

**JK:** When it became clear that we were going to go through a multi-year period of exponential growth, we developed technology we called the Authorized Participant Interface (API). This has been a key driver of our success. API is a trade-order management tool that sits on the desktop of all these institutions that creates and redeems shares in the products. It is highly automated, and is designed to mitigate risk in terms of order flow. Some competitors still have to take these trades over the phone and then receive fax confirmations to validate that trade. It would be physically impossible for us to handle the business that we have today, which is well over \$230 billion in assets across 550 funds, if we were doing that in a manual environment. So this is one area where the vast majority of sponsors

simply have BNY Mellon or the other service providers handle that trade order operation at the primary market level. Where we truly differentiate ourselves, and again have built technology to support this, is that we are also the index calculation or the basket calculation agent for the vast majority of our clients. This was a natural extension of what we do for those early products that are structured as unit investment trusts, where we act as the trustee. We built a tool which we call EPIC, which is in essence powerful middleware. EPIC takes data from our core accounting platform, from the index providers when the products are based upon underlying benchmarks or from the client if they are actively managed products, and based upon customized rule sets, calculates the investable basket each and every day. We then disseminate that basket as a communication provider out to the street, so that those institutions know each and every day what securities and cash they need to deliver, or will receive if they create or redeem with the particular fund. Those two tools, the API and EPIC, communicate with each other so that we can manage and maintain the order flow in a highly automated and efficient manner. That is very unique. None of our competitors, to the best of our knowledge, offer that capability. We have more than 600 people who are supporting the exchange-traded fund business at BNY Mellon; it is a core competency for us. We build technology to make sure that we are as efficient as we can be, but not just efficiency from a cost perspective. We want to absolutely drive out manual processes where we can, to eliminate, or at least minimize, inherent risks. So more often than not, our clients elect to outsource all services to us because we offer a mature and stable operating platform. This is true even of clients that may have a predisposition to performing some services, such as calculating the daily net asset value, themselves. When they see the standard of care and the breadth of capability we've developed, they become interested in outsourcing functions to us. Most of these firms want to focus on a couple of core things—constructing products, managing them and then effectively distributing them—and all of the middle-office support that they provide to their traditional funds can be a distraction when launching a new venture. For instance, there are a number of products now that rely upon derivatives in

the US and Europe, and what we see is an increase in our collateral management business, because whenever you have derivative exposure there's a requirement for collateral. We act as an independent evaluator of all forms of collateral to monitor its daily value and liquidity, so that if there were some kind of a market dislocation, that underlying collateral could be sold for the benefit and protection of the underlying investor.

**GC: Other trends you are seeing in the market?**

**JK:** One is the interest among our clients in leveraging off the UCITS structure and the portability that UCITS funds enjoy globally. So a number of firms are looking at this structure as a springboard for cross-border distribution, such as cross-listing in Latin America and Asia. This gives them an initial foot on the ground, and then ultimately they may elect to launch locally registered products as well. So if I looked at our franchise, the most mature segment is here in the United States, but if we look to our growth, we absolutely think it is going to be in EMEA and in Asia, and the UCITS structure is going to be the primary driver. We are already in active dialogue with clients and local market participants on these issues. There is no question that BNY Mellon is committed to this business and will offer the same depth of expertise in these emerging ETF regions as we do currently in the US and Europe. We will be at the forefront with our clients driving the next wave of growth, as we develop new markets and even more exciting products.

CONTACT DETAILS

JOE KEENAN  
Managing Director, for Global Exchange Traded Services  
BNY Mellon  
F: 212 635 7150  
E: joe.keenan@bnymellon.com



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