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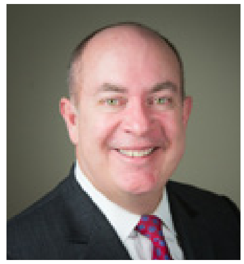
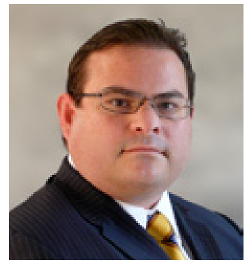
ETFs: What's Under The Hood Matters

How do ETFs cope with emerging markets?



Joseph Keenan
Global Head
Structured Products



Steve Cook
Chief Operating Officer
Structured Products

Exchange-traded funds (ETFs) make it seem so easy. From the comfort of your office chair, you can click a button and instantly buy exposure to stocks in places like Russia, Egypt and Vietnam. It's effortless, and most investors don't give it a second thought.

But behind the scenes, a huge amount of work goes into confirming each "effortless" transaction goes off without a hitch. How do you settle trades in Vietnam? What happens if Russia clamps down on capital flows? Can an ETF keep functioning during a political revolution?

ETFs have weathered all these challenges and more in the past 20 years, and have emerged with an impressive track record. One of the major reasons is people like Joe Keenan and Steve Cook at BNY Mellon. BNY Mellon is one of the largest service providers in the ETF industry, using its global network to do the behind-the-scenes work that keeps ETFs spinning.

Joe and Steve sat down with ETF.com to discuss why the people behind the scenes matter and how BNY Mellon's global reach gives them unique capabilities in today's volatile, fast-moving world.

You operate largely behind the scenes, but your skills directly translate into how investors experience ETFs on a day-to-day basis. What exactly does BNY Mellon do for ETFs, and how does that impact investor experience?

Joseph Keenan, global head of Structured Products, BNY Mellon: BNY Mellon is the world's largest custodian bank, with more than $27 trillion in assets under custody. We provide a range of services to support investors and investment managers globally. That includes custody, fund accounting, administration and everything in between.

Really, our services extend throughout the ETF ecosystem. When we bring on a client, we'll work to support distribution, both passively and actively. We also support their execution in terms of capital markets activity and can even support index construction and administration if they're interested in developing passive products.

Steve Cook, chief operating officer, Structured Products, BNY Mellon: And we're continually looking to expand those capabilities. For instance, in the capital markets space, we are now authorized participants and can directly support creation and redemption activity in new ETFs. Our Capital Markets group has even moved into, in some areas, supporting seed capital needs to a limited number of our asset-servicing clients in the ETF space. It's becoming a 360-degree offer.

That global reach has helped position you as a dominant player in the ETF servicing space. What's the size and scope of your position?

Keenan: In the U.S., we're the No. 1-ranked provider in terms of number of ETFs serviced. We provide servicing for 43% of the exchange-traded products on the market—which equates to more than 500 products. We work with three dozen different sponsor clients, both in the U.S. and abroad, and are in active dialogue with a number of other potential sponsors in the arena.

And if a new entrepreneur wants to enter the space, how would they go about working with you?

Keenan: It's still a very tight-knit industry, but we talk to potential new customers almost daily. And we'll always engage with prospects as subject matter experts as they make their plans. We serve as quasi-consultants, getting into the lab with existing clients and prospects, and helping them further refine the architecture of their potential product. Doing that work on the front end more than likely leads to us winning business.

Let's dig a bit into some of the more challenging things you handle and how it impacts investors.

Keenan: The ETF space is defined by continuous innovation, but as you move into more challenging markets, it's all about risk monitoring and risk management. Whether it's Egypt, Russia or China A-shares, you have to expand your view around the potential risks associated with supporting products that invest in those markets.

Let's talk about Russia. There's a lot of uncertainty in what's going on in Russia right now. How do you prepare for the unknown?

Cook: Simple: investing in technology.

A lot of things can go wrong. There can be delays in settlements, settlement failures, currency restrictions and so on. You need to have technology that's flexible and the foresight to have a plan. You have to know ahead of time what to do if there's no true settlement cycle or if your settlements start to fail because of market conditions. You need to have the plumbing to automate any solution quickly and the systems in place to convey critical information to clients that will allow them to make decisions. If the political environment continues to deteriorate in Russia, for instance, and there are further restrictions put on things like foreign ownership of certain securities, you need to be able to communicate that quickly to the ETF sponsor so they can decide how to react.

One place the worst almost occurred was in Egypt. Their markets closed for weeks during the first revolution there. What did that mean for investors in an Egyptian ETF?

Cook: When the markets closed in Egypt, the ability to trade in and settle securities there halted. One of our clients temporarily halted creations in the ETF, but it did continue to trade. The ETF actually became the bestavailable price discovery mechanism for Egypt at the time. And when the markets eventually opened back up, the ETF invested the cash it had, and the fund's NAV adjusted to the new opening levels.

I think the investors got into this product knowing there was a potential for volatility and knowing that frontier markets do pose geopolitical risks. But they were willing to ride out any short-term issue, and when they did, there was no real interruption in their investment. Most people didn't panic-sell. They had the opportunity to liquidate if they needed to—and it turned out the ETF did a good job at price discovery even when the markets were closed—most people rode through the storm.

Keenan: Right. But remember, just because a structure is passive and transparent doesn't change the age-old adage of caveat emptor. It's your money. You owe it to yourself to really understand the risks associated with that investment vehicle, including knowing how it's constructed. This entails learning how an index will be priced if there's a halt in a security, or worse yet, the whole market. In the case of Egypt, the product worked as advertised. Investor education is critical, because as a sponsor, you wouldn't want an investor to feign ignorance around how that product was going to perform if there were an unanticipated market dislocation.

Are there any issues in Egypt now that people should be aware of?

Cook: There are currently some currency restrictions in the Egyptian market. It's difficult to convert Egyptian pounds back into dollars and pull that money out of the country. You can do it, but it's a slow process. Any ETF with exposure to Egypt has to deal with that.

How does BNY Mellon help in a situation like that?

Keenan: Again, as the world's largest custodian, we're leaders at staying on top of situations like this. We have dozens and dozens of people who work exclusively just to gather and then disseminate material market-update information so our clients can be on the leading edge of what's new and what's changed since the last update.

We're also able to act as a foreign exchange counterparty. We can be their trading partner and provide liquidity to help issuers manage around certain currency constraints.

Speaking of trading constraints, we've seen a huge push recently for ETF issuers to bring China A-share ETFs to market. What should investors know about the A-share market?

Cook: We helped two of our clients come to market with ETFs offering exposure to A-shares, so we have a lot of experience here. The A-share market poses some challenges, even beyond the process of getting a qualified foreign institutional investor quota to allow you to buy A-shares in the first place.

One big hurdle is the potential for a lag between the time a creation order comes in and when the issuer can put that money to work. Traditionally, dollars have to go into accounts that are prefunded into Chinese renminbi before you can make purchases, and that can introduce a lag of a few days between when a creation takes place and when a fund is able to execute trades.

We have a large global presence, and we've used that to create a system where they can invest on the same day they get a creation. That has a material impact on an issuer's ability to go ahead and track their benchmark. Long term, I think that's going to have an effect on performance that people get out of different A-shares ETFs.

Let's go even further. As you move from China to true frontier markets, what challenges emerge?

Keenan: First, you have to determine if a given market has proper settlement procedures and find a custodian that can get things done. Our global custodian network covers more than 100 markets, so we start from a good base. It can take some work with the subcustodial network and the local subcustodian banks to handle the kind of volume you sometimes see in ETFs. Generally, when you see those types of products come to market, we're doing 10, 15, 20 trades a day every day, into and out of these accounts; that might be more volume than some of these countries have seen in the previous 10 years!

We spend a lot of time up front managing our network to prepare them for the volume that may come with a given ETF launch. That also means staying on top of collateral. In some of these markets, it could take more than *30 days* to settle any failed trades, so managing collateral for protection of the underlying investor is critical.

And there are some frontier markets that are just impossible right now. But increasingly, we've been able to break down those barriers with issuers and find a way to deliver solid exposure.

We've certainly seen a lot of interesting ETFs come to market recently, from the A-share products to bank loans to funds covering markets like Nigeria. Have we reached the end of innovation?

Keenan: Not at all. Our team has done a lot of heavy lifting around actively managed ETFs, which are currently in front of regulators for consideration. If and when the SEC declares them ready for prime time, I think it will really break new ground. There's been a lot of energy and excitement around those proposed structures.

Cook: A lot of people talk about the fact that the market's saturated and there's not much room for innovation. Just from the things I know we're working on right now, I'd say there are still probably three or four really innovative ideas in the hopper that will provide unique exposures to the market.

We look forward to seeing what you and your clients come up with. Thank you for your time.

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