THE DIFFERENT TYPES OF EXCHANGE TRADED FUND (ETF) TRADERS

Zach Hascoe – Capital Markets
11/19/2013

The content of this post is relevant for investors who have access to ETF traders. Individual investors do not always have access to trade ETFs as referenced below. It is important for investors who are utilizing exchange-traded funds (ETFs) to understand all the market participants that exist in the ETF marketplace. It doesn't matter if you are an individual investor or an institutional investor, understanding the ETF capital markets landscape is important to navigating the ETF market efficiently. There are a variety of ways to access liquidity in ETFs. There is "on-screen" liquidity (secondary market liquidity) vs. underlying liquidity (read the previous blog post on the topic here). Understanding all the different types of market makers, liquidity providers and brokers and how they interact with one another will help give investors the proper perspective on the entire ETF trading landscape. A good way to think about it is that there are traders that commit capital and traders that don't. Committing capital means using firm capital to facilitate client order flow. In other words, these firms are typically using their firm's balance sheet (capital) to provide liquidity in the ETF through the underlying basket. For instance, if a client wants to buy a domestic ETF, the ETF trader will sell the client the ETF and typically hedge themselves by buying the underlying stocks (or hedge with a correlated security). Then the trader will either unwind their position via the creation process or they will unwind in the open market. Once clients start utilizing the ETFs that are outside the top 50 most actively traded ETFs, their order is probably eventually interacting with one of the traders below that use their balance sheet to provide ETF liquidity. **Different Types of ETF Traders** There are two main types of liquidity providers that use their balance sheet to provide ETF liquidity: traders that can speak directly to clients and traders that cannot.

ETF Traders That Do Commit Risk Capital

- **Institutional ETF Trading Desk**
- **Electronic Market Makers/Proprietary Traders/Liquidity Providers**

Institutional ETF Trading Desk: These are the ETF trading desks that sit at major broker-dealers/investment banks in the sales and trading divisions. These include the major banks in the world, such as Goldman Sachs, J.P. Morgan, Citigroup, Credit Suisse, Deutsche Bank, Cantor Fitzgerald or Morgan Stanley as well as large, global institutional trading firms such as Susquehanna or Knight Capital Group. These institutional trading desks facilitate large ETF order flow for institutional investors and large registered investment advisors (RIAs) and are typically committing capital to facilitate buy/sell orders from their client base. These broker-dealers also typically are set up as authorized participants (APs) and have the ability to create and redeem ETF shares directly with the ETF issuers when appropriate. **Electronic Market Makers/Proprietary Traders/Liquidity Providers:** These are proprietary trading firms that are posting bids/offers electronically on the exchanges. These firms typically do not speak directly to clients and engage electronically with buyers and sellers. They are a very important piece of the liquidity picture in ETFs, as they provide the liquidity[1] that investors see on the screens when they pull up a quote in an ETF. Some of the major investment banks and trading firms mentioned earlier also have electronic ETF desks that provide liquidity electronically in addition to their client facing facilitation desks. Depending on the type of client and their custody relationship, there are a variety of ETF trading platforms that source liquidity on their client's behalf. These firms do not commit capital directly; rather they source ETF liquidity either electronically or through their block liquidity network. **ETF Traders That Do Not Directly Commit Risk Capital** • **Custodian ETF Execution Platforms** • **Wire House ETF Execution Platforms** • **Liquidity Aggregators** Wealth management advisors typically have ETF execution platforms in their organizations. These ETF execution platforms do not commit capital. They typically will have electronic order systems that send client orders out to the market. In addition, these desks have the ability to source block liquidity from the capital-committing market makers, which has become a larger part of their business as financial advisors are trading larger blocks of ETFs. **Custodian ETF Execution Platforms:** These are the ETF trading platform teams at the large brokerage/custody platforms, such as Charles Schwab, TD Ameritrade, Fidelity or Pershing. These brokerage houses[2] have ETF trading platforms, where ETF execution traders help their clients with ETF execution. These firms do not commit risk capital. These platforms typically have relationships with the major institutional ETF trading desks as well as the electronic market makers and liquidity providers. They can also source liquidity through liquidity aggregators. **Wire House ETF Execution Platforms:** The major wealth management platforms at firms such as Morgan Stanley Smith Barney, Bank of America Merrill Lynch and UBS have ETF execution desks that help financial investment advisors with ETF execution. The platforms do not commit risk capital. These wire house trading platforms will typically call a few of the ETF trading desks that do commit capital, and the platform trader will come back to the financial advisor with a price they can buy or sell the ETF. The execution trading desks at these wire house platforms are essentially extensions of the financial advisors' business, and these execution traders are working on behalf of the advisors to help them with their ETF execution. Often, the major institutional ETF trading desks are in the liquidity networks of these platforms, but it is important to note that every platform will have different relationships across the trading community. The liquidity aggregators are also in the liquidity network of the wire house ETF execution platforms. **Liquidity Aggregator:** Liquidity aggregators do not commit risk capital. RIAs and institutional clients will use liquidity aggregators' source liquidity in ETFs. WallachBeth Capital, Street One Financial and Wolverine Execution Services (WEX) are all well-known ETF liquidity aggregators. RIAs and institutional clients often times do not want to deal with only one trading desk or counterparty, so they have the option of setting up an account with a liquidity aggregator, who will essentially put all the trading desks in competition with each other, and the liquidity aggregator will execute on behalf of the client. Often, liquidity aggregators have a combination of electronic trading firms and institutional trading desks in their liquidity network. **Conclusion** The WisdomTree Capital Markets group is in constant communication with all the different ETF traders, liquidity providers and market makers that exist in the ETF landscape. We are constantly speaking with financial advisors, wealth managers, asset managers and institutional clients about ETF market structure, the ETF mechanism, trading, liquidity and best execution strategies. We work to connect these investors with the appropriate trading counterparties so they can build a robust and sophisticated ETF trading process. Having the proper infrastructure in place to trade ETFs efficiently is critical to the growth of global ETF portfolios. [1]Electronic market makers provide the on screen liquidity in lower volume ETFs. They place electronic bids and offers in a particular size for clients to buy or sell. In more actively traded ETFs, there is ample two-way flow from market participants buying and selling so the liquidity "on screen" may not be a liquidity provider in a high-volume ETF. [2]When you custody your assets at Charles Schwab, TD Ameritrade, Fidelity or Pershing, typically you have to trade through your custodian.

Important Risks Related to this Article

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DEFINITIONS

Market participant : Anyone interacting with the ETFs in some capacity. It can be end investors, market makers, hedgers, authorized participants.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Secondary market liquidity : The liquidity shown visibly on the exchange. When you pull up a "quote" in an ETF, you will see the secondary market liquidity shown by the size offered on the bid and the ask.

Underlying liquidity : The liquidity in the underlying basket of the ETF. This liquidity is not always visible on the stock exchange, but market makers can facilitate large investments into ETFs if there is sufficient underlying liquidity.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Creation and Redemption Process : The process whereby an ETF issuer takes in and disburses baskets of assets in exchange for the issuance or removal of new ETF shares.

ETF order flow : The amount of buy and sell orders a particular trading desk is receiving.

Authorized Participant (AP) : An entity, usually an institutional investor, that submits orders to the ETF for the creation and redemption of ETF creation units.

Sourcing block liquidity : Calling the market makers and liquidity providers and find who can make the client a market in the size they are requesting (buy or sell).

Risk capital : When a broker deal firm accepts the risk of holding a certain number of shares of a particular security in order to facilitate trading in that security.

Liquidity aggregator : An agency broker (does not commit capital) that takes a client buy or sell order and contacts a variety of market makers. This puts the market makers in competition with one another and this process helps client source liquidity for their order. The liquidity aggregator typically has access and relationships with market makers that the client does not.