

How ETFs Are Created and Redeemed

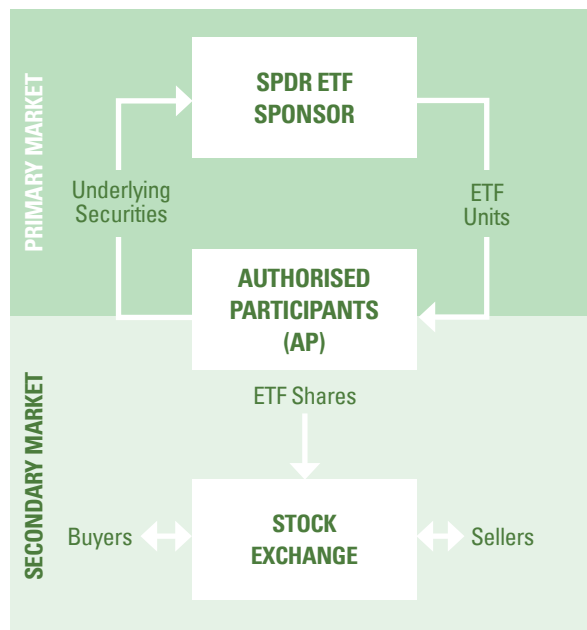
As the European ETF market continues to expand, understanding the unique structure of ETFs will allow investors to buy and sell ETFs more efficiently and with greater confidence. The creation/redemption process is key to what sets ETFs apart from other investment vehicles like traditional mutual funds or stocks.

Exchange traded funds (ETFs) are a collection or ‘basket’ of securities that track a specific market index. ETFs have characteristics of both stocks and mutual funds. Similar to a stock, they are priced intraday and trade on an exchange. Like indexed mutual funds, ETFs are transparent¹ with their expenses and holdings. ETFs in the marketplace today cover a wide variety of asset classes, with ETFs that track broad market indices and specific sectors, as well as fixed income, multi-asset, and smart beta products.

The main difference between ETFs and other investment vehicles like traditional mutual funds or stocks is the process through which fund shares are created and redeemed. This is called the ‘creation/redemption’ process and takes place in the primary market between the fund and authorised participants (APs). The AP’s role is crucial to the liquidity of ETFs: Understanding how they operate to introduce liquidity into the secondary market is vital for investors trying to invest in ETFs in the most cost-effective way.

APs are regulated investment firms who meet certain criteria and sign a participant agreement with a particular ETF sponsor or distributor to become authorised participants of the fund. On each business day, APs are provided with an ETF portfolio composition file (PCF) from the ETF fund sponsor that contains details of the securities and/or cash elements that are required for ETF creation/redemption. Using this, APs create fund shares in increments that meet a minimum creation unit size set by the fund sponsor — known as creation units. They do this by **assembling the underlying securities** of the fund in their appropriate weightings to reach creation unit size, and then delivering those securities to the fund sponsor in-kind (sometimes used for smaller, liquid indices) or in cash (which offers greater settlement flexibility and transactional risk control for both the fund sponsor and the AP). In return, the AP receives fund shares which are then introduced to the secondary market where they are traded between buyers and sellers on an exchange.

Figure 1: ETF Creation/Redemption



To help illustrate this process, let’s walk through a specific example (Figure 1). Suppose an AP wants to create shares of a SPDR ETF. First, the AP would reference a list of the exact securities and their weightings within the fund using the PCF list from the ETF fund sponsor. The AP would gather those same securities in their appropriate weightings into a creation unit. Next, the AP would transfer the creation unit in-kind or in cash to State Street Global Advisors in exchange for shares of the SPDR ETF. To complete the creation process, the AP would introduce these newly created ETF shares into the secondary market where they would be traded between buyers and sellers through the exchange.

APs also have the ability to redeem fund shares through the same process, but in reverse. Increments of fund shares — known as redemption units — are collected in the secondary market and then delivered to the fund sponsor in-kind or in cash in exchange for the underlying securities in the appropriate weighting equalling that redemption unit.

When the AP wants to redeem fund shares of a SPDR ETF, they would follow the same process in reverse. In the secondary market, the AP would gather increments of fund shares into a redemption unit. Then in the primary market, the AP would deliver the redemption units to State Street Global Advisors in-kind or cash in exchange for the underlying securities in the appropriate weightings equalling that redemption unit. Only APs are able to create or redeem ETF shares in the primary market.

For more detailed information about the characteristics of European ETF trading, please visit [spdrs.com](https://www.spdrs.com)

¹ Transparency is defined as the accessibility of information on the order flow for a particular stock, allowing knowledge of the quantities of stock being offered and the bids at the various price levels.

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