



Exchange Traded Funds

Exchange Traded Funds

Exchange Traded Funds (ETFs) are listed investment products that track the performance of a basket of Shares, Bonds or Commodities. An ETF can also track a single commodity such as oil or a precious metal like gold. ETFs give investors the chance to buy units that track whole indices as easily as buying shares listed on the Nairobi Securities Exchange (NSE).

Types of ETFs

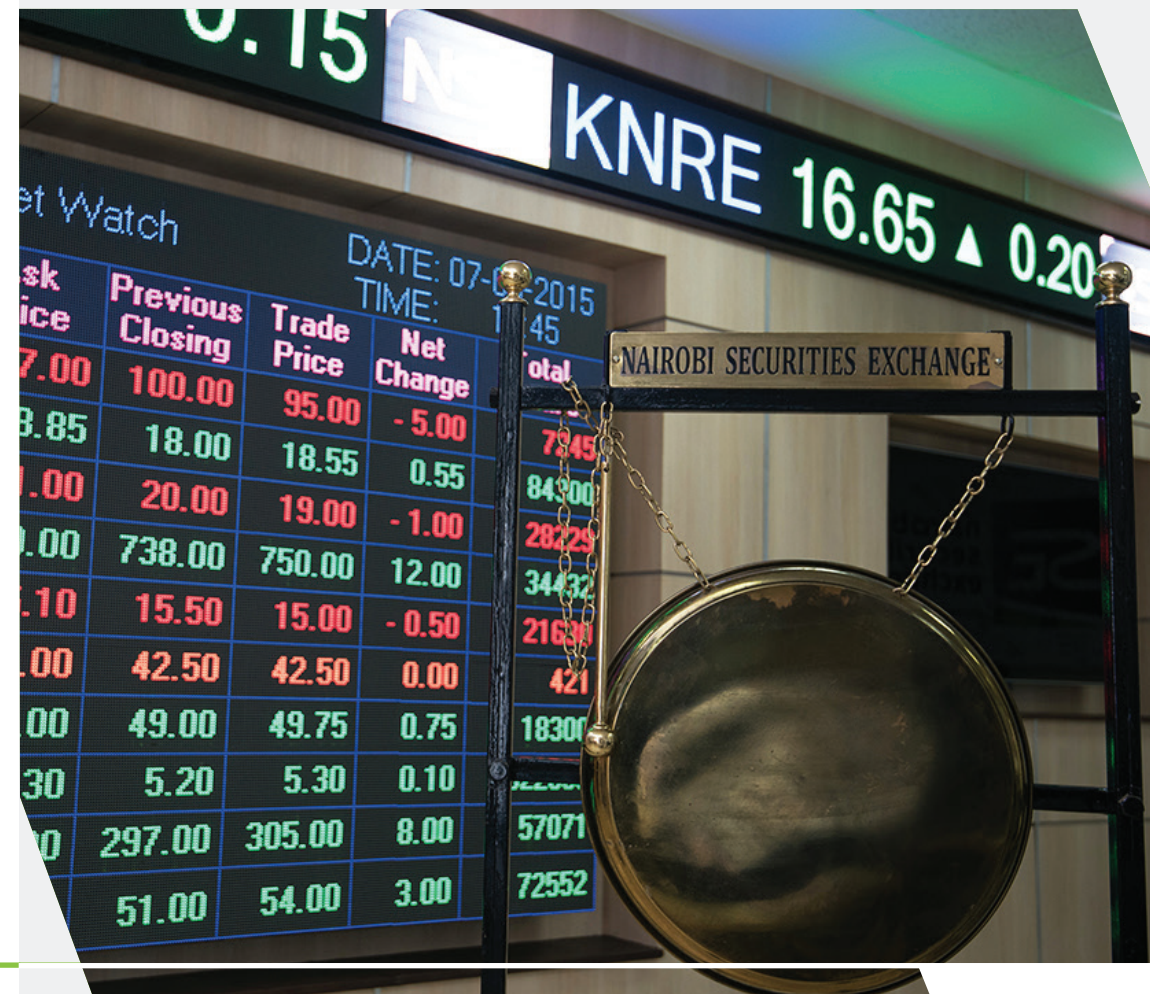
Types	Description
Index	An index fund tracks the performance of an index by holding in its portfolio either the contents of the index or a representative sample of the securities in the index. The index may be based on stocks, bonds, commodities, or currencies.
Equity	An equity ETF is traded just as a normal share of stock is traded on an exchange, but unlike a mutual fund it will have its price adjusted throughout the day rather than at market close. This type of ETF can include a basket of company stocks that enable the investor to invest based on a particular investment strategy for example providing geographical (East African companies), country (Kenya), or industry sector (energy) strategies.
Debt	A debt ETF is based on debt securities and depending on their investment strategy can invest in government, corporate, inflation linked, mortgage backed debt securities or money market instruments.
Commodities and physical assets	A commodity ETF is usually focused on either a single commodity, holding it in physical storage, or investments in futures contracts. Other commodity ETFs look to track the performance of commodities.

Regulation of the Product

The Exchange Traded Funds Policy Guidance Note was published by the Capital Markets Authority (CMA) on October 1, 2015 to allow the introduction of ETFs in Kenya. It will form the basis of the regulations for ETFs listed on the NSE. Their issuance, listing and trading on the NSE is overseen by the CMA and the NSE's Regulatory Department. Under the Policy, domestic and cross listed ETFs, must comply with internationally accepted principles of issuance and trading of ETFs.

Who can invest?

Anyone can invest in an ETF. ETFs make it easier and more affordable for first time, retail or institutional investors to access a wider range of investment opportunities previously only available to select investors.



Why invest in ETFs? (Policy Guidance Note-CMA)

Diversification

One fund can hold potentially hundreds—sometimes thousands—of individual stocks and bonds, which helps spread out risk. ETFs allow access to assets that were previously not available to all investors such as gold.

Professional management

You do not have to keep track of every single investment your ETF owns. The fund is managed by fund experts who take care of that for you. Reporting is done daily to the investor through the NSE.

Liquidity

ETFs offer you the same liquidity you get when trading stocks and bonds listed on the NSE.

Lower cost

Funds that track an index, like ETFs and index mutual funds, generally offer lower expense ratios than conventional mutual funds.

Transparency

The ETF is backed by its constituent underlying assets or assets of an equivalent value. Issuers produce a factsheet for their ETFs which states what investors are being exposed to and how the Net Asset Value of the ETF is calculated. By contrast, unit trusts, typically only provide historical information on portfolio holdings and not current holdings, for competitive reasons. Tracking performance is also published.

Investor owned assets

The constituent assets or securities shall be housed in a trust arrangement with a CMA approved trustee being appointed. Even in the case of insolvency by the ETF manager, administrator or issuer, through the trust arrangement, these assets are ring fenced, protected by law, and are the exclusive property of the ETF. Therefore owning an ETF does not give the investor the right to vote at Annual General Meetings (AGMs) of the underlying securities, as you own a portion (unit) in the fund and not the underlying securities themselves.



Why issue an ETF?

Watching costs

Underperforming fund returns in recent years have prompted investors and advisors alike to question the benefit of active management versus cheaper passive products. There is more focus on the costs of an investment and their overall impact on return.

Fee-based advisory models

A trend where advisors are compensated on total assets under management as opposed to commission, is aligning clients' and advisors' focus on low-cost products such as ETFs.

Simpler pricing structure

In an era of greater transparency, ETFs have an advantage over other more traditional asset management products, due to their comparatively simpler pricing structure. Regulators will also continue to demand greater disclosure from all asset managers, especially in matters of pricing.

Market making function

Market Makers earn commissions by providing two way quotes for buyers and sellers of ETF securities. For the privilege of being the sole market maker, a market maker can provide the initial seed capital for the ETF.

Market Maker

The most common type of Market Maker (MM) is a licensed stock broker or investment bank. Their profit comes from buying an asset at a lower price than which it is sold or, vice versa, selling an asset at a higher price than which it is bought. The market maker can also earn commissions through agreement with the issuers. The market maker wants to hold the asset for as little time as possible, ideally buying and selling simultaneously.

Increasing institutional investor appetite

While hedge funds and money managers have been focused on ETFs for some time, other institutions such as pension plan sponsors, endowments and foundations are just starting to show meaningful interest. ETFs offer institutions several benefits including the flexibility to easily maintain benchmark exposure while switching managers or deciding how to deploy cash. More importantly, ETFs also fit naturally into core-satellite strategies that are popular with institutions. Larger institutions can often realize cost savings with ETFs, thanks to their ability to generate extra yield through ETF lending. Lastly, investors are much more aware of costs and the impact these costs will have over their investment returns over the medium to long term. In response to this need, asset managers are offering more passive investment products such as ETFs.



Who can issue an ETF?

A legal person can issue an ETF. This can mean an investment bank, a fund manager or a competent individual can issue an ETF (Reference: ETF Policy Note (PGN) from the Capital Markets Authority)

The Listing Process

<p>1. Approval to list</p> 	<ul style="list-style-type: none"> All ETF issuers have to seek CMA approval to list and thereafter will be subject to the NSE listing and trading rules and ongoing disclosure regime. The detailed disclosures that should be included in the information memorandum are available in the Policy Guidance Note. Issuers of cross listed ETFs need to show that their home regulator has no objection to their listing on the NSE. Cross listed ETFs also need to disclose corporate actions affecting the underlying securities from their home jurisdiction and need to comply with the continuing listing obligations observed in their home jurisdiction. For purposes of regulatory oversight in Kenya, a cross listed ETF must appoint a domestic representative approved by the CMA.
<p>2. Parties involved</p> 	<ul style="list-style-type: none"> ETFs listed in Kenya must appoint one or more Market Makers. The issuer must also appoint a Trustee to hold and administer the underlying assets in the ETF on behalf of the ETF investors. The issuer may appoint a fund manager to manage the ETF. All the signed agreements between the ETF issuer and its partners – Fund Manager, Market Maker(s) and Trustee, must be submitted to the CMA and the NSE, together with the information memorandum. The Fund Manager, Market Maker(s) and Trustee must be licensees of the CMA. The Market Maker must be admitted by the NSE. On receiving CMA approval to issue the ETF, the issuer must comply with the processes and indicated timelines for issuance and listing of ETFs set out by the NSE.
<p>3. ETF Structure</p> 	<ul style="list-style-type: none"> All ETFs listed in Kenya have to be fully backed by an underlying asset of an equivalent value at all times. The minimum free float of the ETF should be equivalent to 25 percent of the assets under management. Calculation of an ETF's per unit value (whether an index or a commodity ETF unit) is done by a competent institution (an approved exchange or an independent organization that provides error tracking services). The methodology of computation of the ETF's Net Asset Value (NAV) must be clearly spelt out and be outlined in the ETF's information memorandum and marketing materials.

4.
Clearing and settlement of trades



- ETF units must be cleared and settled through an approved Central Securities Depository.

5.
Delisting and Winding up



- If circumstances are such that the ETF has to be delisted or wound up, this should be done based on the ETFs' NAV on the basis of the average price of the last traded month. This process should be clearly provided for and outlined in the Trust Deed.

NAV or Net Asset Value

Generally, NAV refers to the value of an entity's assets minus its liabilities.

For further information on how ETFs are regulated in Kenya contact the NSE or visit www.nse.co.ke



ETF Structure

As a passive investment, ETFs replicate the return of an underlying benchmark or asset.

Physical ETF

The ETF buys the underlying assets it is designed to track. Physical replication differs between products that track a benchmark and those that track a commodity.


Investors in ETFs purchase and sell securities on the stock exchange. This is referred to as the secondary market. There is also a primary market, where market participants, with a large basket of ETF units or the underlying shares, are able to deal directly with the issuer of the ETF. The market participants could be a Fund Manager, institutional investor like a Pension Fund, Market Makers or investment banks or any other third party.





When a market participant wishes to purchase (i.e. 'create') units from the ETF issuer, it will typically deliver the underlying reference assets (or the cash equivalent) to the ETF issuer. In return, the market participant will receive the ETF units from the ETF issuer. These transactions typically occur in large batches (e.g. 50,000 securities). Once the market participant has received the units, it can sell them to other market participants via the stock exchange.


Creation of ETF Units

In Kenya, minimum units or asset blocks in the case of creation, redemption or cancellation have to be agreed upon with the CMA and clearly indicated in the information memorandum, while minimum trading lots have to be equivalent to those on the listing exchange.

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The market participant submits an application to the ETF issuer to purchase (i.e. 'create') ETF units.
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The market participant then delivers the underlying reference asset or the cash equivalent to the ETF issuer (e.g. if the ETF is tracking the NSE 25 Share Index, the market participant will deliver shares of the NSE 25 constituent companies according to their weighting in the index or the cash value of the shares).
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In exchange, the ETF issuer transfers the same value in ETF units to the market participant.
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The market participant holds onto the ETF units or sells them to other intermediaries and investors via the NSE.

Redemption of ETF Units

The redemption process is the opposite of the creation process. When investors sell units in an ETF, the market participant will either hold them as 'inventory' or will redeem them with the ETF issuer.

-  1 The market participant submits an application to the ETF issuer to redeem (i.e. 'liquidate') ETF units.
-  2 The ETF issuer returns either the underlying reference asset or cash (e.g. if the ETF is tracking the NSE 25 Share Index, the ETF issuer will deliver to the market participant shares of the NSE 25 constituent companies according to their weighting in the index or the cash value of such shares).
-  3 In exchange, the market participant transfers the equivalent value in ETF units to the ETF issuer.
-  4 The ETF issuer cancels the ETF units. The outstanding number of ETF units in the market for this particular ETF is reduced by the number of cancelled units.

DISCLAIMER:

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**nairobi
securities
exchange**
Discover Opportunity



Tel: +254 20 2831000 /
+254 (020) 222 4200

Mobile: +254 0724 253 783 /
+254 0733 222 007

email: info@nse.co.ke

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