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ETFs I DIGITAL ASSETS

THE TRANSATLANTIC DIVIDE IN ETF DISTRIBUTION PRACTICES

In more than 20 years, Europe has successfully launched over 2,300 ETF products but remains far behind the U.S. in assets under management.

WE EXPLAIN WHY.

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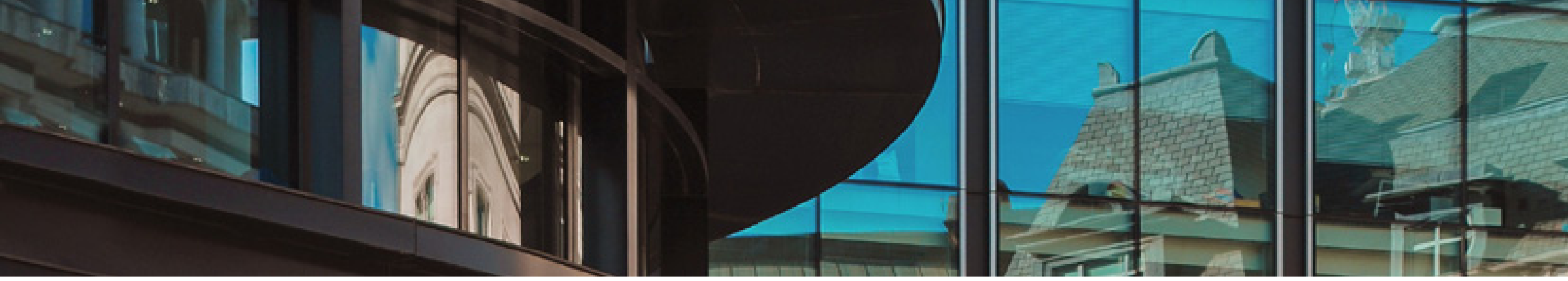
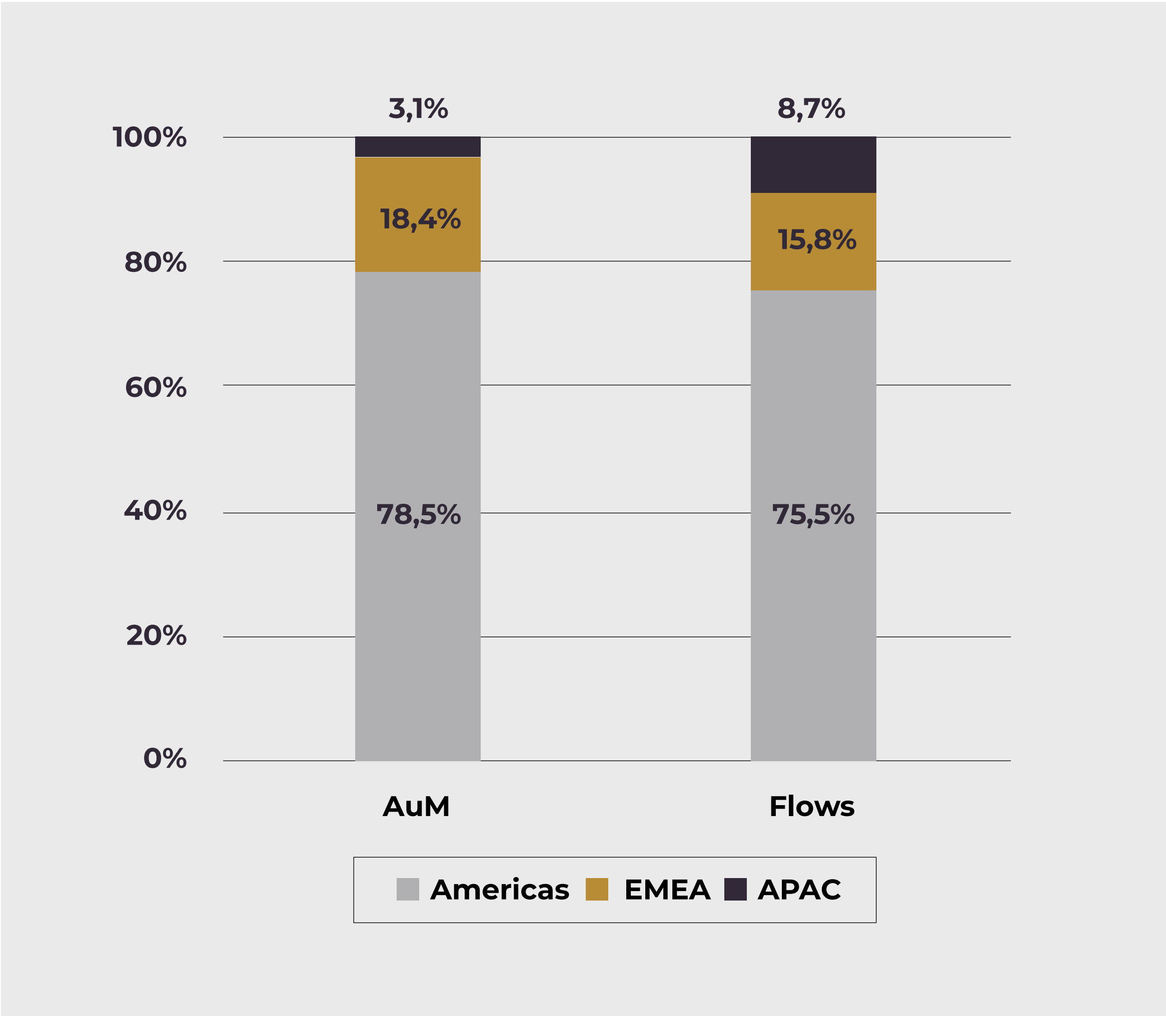


Some may wonder how Europe, with more than 2,375 of ETFs launched over 20-plus years, is so far behind the U.S. in terms of total ETF assets under management? In reality, the growth rate of ETFs in Europe is actually surpassing that of the U.S. so the continuous comparison of U.S. and European ETF markets has truly become a stale debate or at the very least unfair.

Trying to compare Europe to the U.S. market is akin to discussing why ski slopes in the Swiss Alps are better than those in New Zealand. They both exist, neither is better or worse (it's all subjective), and there is simply no point in the comparison. Here is why.

FIRST LET'S STATE THE OBVIOUS MAIN DIFFERENCES.



Source: Trackinsight (Q1, 2021)

The key issue: Fragmented Markets

At first glance, the most obvious difference stems from the singular market of the U.S. versus the fragmented markets of Europe. There are so many elements to fragmentation, but let's start with the stock exchanges.

In the U.S. there are over 170 ETF issuers, over 2,200 ETFs, and 13 stock exchanges, with the three most recognizable being the NYSE, Nasdaq and CBOE. The key here is that across these 13 exchanges, there is only *one* currency, *one* clearing agency and *one* depository through NSCC (a subsidiary of DTCC which provides straight through processing for all domestic-listed ETFs).

In Europe, the ETF market has over 80 issuers operating across 30 exchanges in 25 countries, and what feels like an endless number of regulatory bodies. This means that you are dealing with 13 different currencies for trading and settlement, different listing requirements for each exchange, varying country regulations and operating models, and different clearing agencies. The majority of trades are done OTC, and because of this combined with fragmentation, there is no consolidated tape making true transparency elusive.

And then you have to consider domicile and passporting which is not a factor in the U.S. The majority of ETFs traded in Europe are domiciled in either Ireland or Luxembourg, are registered for sale in many different countries, and listed on multiple exchanges and trading venues.

Asset management in Europe is increasingly a cross-border business, and without a doubt, this applies to ETFs. And for ETF issuers, funds have back-office hubs such as Luxembourg or Ireland, manage them from financial centres such as London or Paris, and sell them to investors elsewhere in the Europe. But they are supervised by the authority in their home country, all of which creates a fragmented regulatory environment and can make your head spin.

You only need to look up one fund name on a Bloomberg terminal to see how fragmentation affects even the simplest of things like a ticker. What does this mean specifically?

> **"In Europe, the ETF market has over 80 issuers operating across 30 exchanges in 25 countries, and what feels like an endless number of regulatory bodies"**

Nerds and Tickers is all you need

Well, think about some of the catchy tickers in the U.S. like NERD, tied to the Roundhill Esports & Digital Entertainment ETF – a gaming ETF. Great, memorable ticker and doesn't matter where your order is placed or filled in the US – the ticker stays the same, i.e., NERD. But in many instances in Europe, ETF development and marketing teams don't get to partake in the fun of creating a stick-in-your mind gimmicky ticker. Why?

Well, because in one word -- fragmentation.

Let's use the newest (at the time of writing) entrant to the European market, Global X and their gaming ETF, Global X Video Games & Esports UCITS ETF (HERU).

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You can download an entire spreadsheet of varying tickers for one product based on where it trades, the varying currency it can settle in, a suffix indicating whether it is accumulating or distributing, the list goes on. If you look at the London Stock Exchange, LSE, you'll find two different tickers. One is for USD currency accumulating (ticker HERU), and the other is USD currency but distributing (ticker HERG).

And then let's say you are a German investor and want to trade locally – the ticker there is H3R0 with a number of different suffixes based on currency, distribution class, you get the idea.

Here is a sample graph illustrating the complexities from Dillon Eustance:

	Possible to sell in country without listing?	Local Registration for Sale	Local Listing Sponsor Required	Listing Mechanism and Timing	Market Maker Required	Settlement System	Currencies Traded	Note
London Stock Exchange	Yes under UCITS passport Local listing preferred	FCA 10 days from filing with Home Competent Authority. Local Rep. required.	Yes Local Listing Particulars required	Allow 2 months to engage with sponsor and UKLA	At least 1	Crest Euroclear International Settlement System	Up to 3 currency lines per ETF GBP, EUR, USD, through Crest HKD and RMB through Euroclear	Simplified listing process if listed on another EEA exchange. No UKLA approval, no local Listing Sponsor and no Local Listing documentation required. EEA listings also trade on main ETF market segment with locally listed ETFs. Allow 2 weeks for listing application for EEA listed ETFs.
Deutsche Boerse	Yes under UCITS passport Local listing preferred	BAFIN 10 days from filing with Home Competent Authority. Local Rep. required	Yes No requirement for local Listing Particulars	"Fast-track" - Allow 8 business days	At least 1	Euroclear/ Euroclear International Settlement ClearstreamCSD/I CSD	AUD, CAD, CHF, EUR, GBP, SEK, USD, YEN, CNY	Simplified listing possible if listed on another EEA exchange. However, as such EEA listings do not trade on the ETF segment, most ETFs chose to seek a full DB listing.
SIX	Yes, only where ETF marketed to Institutional Investors Local listing preferred	FINMA 30 days from filing with FINMA. Local Rep. required	Yes No requirement for local Listing Particulars	Sponsor applies to SIX. Allow 20 business days	At least 1	SIX SIS Euroclear	EUR CHF USD GBP SGD AUD JPY CAD	No simplified listing available.
Borsa Italiana	Yes under UCITS passport Local listing preferred	CONSOB 10 days from filing with Home Competent Authority. Local Rep. required	Yes Italian translation of summary required	Issuer and Rep makes application Allow 3 weeks	At least 1	Monte Titoli	EUR	No simplified listing available.
BATS Chi –X Europe	Yes, under UCITS passport	FCA 10 days from filing with Home Competent Authority. Local Rep reqd.	No No requirement for local Listing Particulars	Application can be made by issuer or Rep. Allow one week	At least 1	Any European CSD or ICSD	All European Currencies USD YEN AUD CAD TRY	Simplified listing available from other EEA listing.

Source: Dillon Eustance

To Tax or not to Tax. That is the question!

In the U.S., ETFs are marketed as tax efficient vehicles, because unlike mutual funds, ETF issuers have the creation-redemption mechanism which can reduce potential capital gain distributions to the shareholders. This is due to the IRS interpretation of the creation and redemption process as a non-taxable event, as long as it is done as an in-kind exchange. There are some exceptions to this, like derivative-based ETFs, but that's a much longer topic so we'll spare you the details.

In Europe, ETFs are not promoted as tax efficient and certainly do not have that advantage over mutual fund products like they do in the U.S. Their taxation is also based on their domicile, in most instances Ireland or Luxembourg. Then you also have structure, physical vs synthetic, investor location, client type, etc.

Retrocessions

There are many arguments behind the primary driver of the massive ETF proliferation within the U.S., but many agree that much of the ETF adoption by the financial advisor community stemmed from the shift from a commission-based to fee-based structure. In this environment, financial advisors are compensated by clients paying a percentage fee on total assets and are no longer motivated to select more expensive trail-based products. Some argue this change was significant enough to propel financial advisors towards a mass acceptance of lower-cost exchange traded products.

In Europe, many countries still allow retrocessions aka commissions which some believe has hindered the growth of ETFs. And because many fund companies, private banks and independent financial advisors are still being paid through this commission format, they continue to be incentivized to sell higher-cost products. What happened to regulators protecting the little Joe's?

Thankfully, the United Kingdom eliminated this practice back in 2013 through the U.K.'s Retail Distribution Review (RDR). The Netherlands has also eliminated such payments.

We are not alone in our opinions on this. A recent Financial Times article addressed this very issue: "In Germany and France you still have the big kickback model in place and the situation is worse in Italy, it's outrageous, so this is going to hamper the growth of index funds," said Ali Masarwah, a member of the European research team at Morningstar.

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You can see the impact of the existence of kickbacks in countries such as Germany, where passive is just 11.1% of the domestic market, France (8.2%), Spain (2%) and Italy (0.05%).

Richard Withers, European head of government relations at Vanguard, was also critical of the retrocession model. "If a financial adviser is thinking about what is best for their financial position, they may be tempted to sell a product that pays a high commission, regardless of whether it's the best product or not," he said.

The power of self-directed Investors

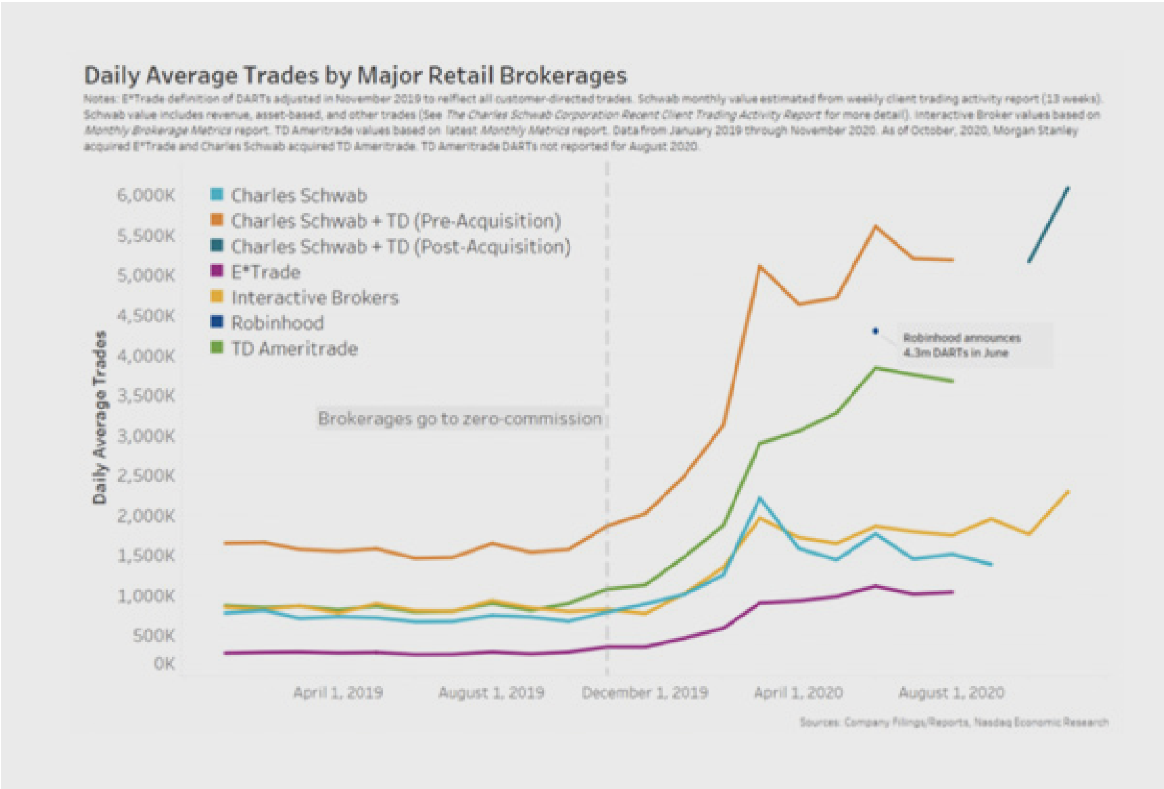
Generally speaking, in the U.S., ownership of ETF assets is spread across Institutional, traditional Financial Advisors, and retail investor communities. Compared to Europe, retail investors in the U.S. are a much larger portion of ETF investors and are much more active in self-directed investing and trading. While retail accounts for around 45% of the US market, in Europe it is estimated at between 10-15%.

Why ETFs are Popular with Retail Investors in the U.S.

Many individuals in the U.S. participate in their company 401K and through this arrangement, they tend to actively manage and monitor the performance of their own investments. Sometimes daily. Aside from brokerage windows – which a lot of 401ks don't have – this is the one place where ETFs have not taken hold. Most 401k sponsors look to protect the employee from themselves – it's a tricky situation.

You also have a large number of trading platforms that are popular with SDIs, e.g., Schwab, Fidelity, TradeStation, eTrade, TD Ameritrade, etc. These trading platforms produce a lot of media adverts through venues like CNBC, they are low-cost and tend to have technology that is advanced but at the same time easy to use.

Lastly, the marketing of Robinhood type firms, ease of use and excessive press around the success of these types of firms in attracting new clients and AUM may be fuelling the level of "irrational exuberance" not seen since the days of the dot.com bubble in the late '90s.



Source: Nasdaq

In Europe, the European ETF client base remains institutional in nature. There are no solid statistics on ETF client type, but the consensus amongst industry players is that more than 80% of ETF assets in Europe are in the hands of institutional investors, such as private banks, wealth managers, hedge funds, pension funds, and insurers.

Why is it so different? For one, Europe is more of an Institutional market which we will expand on later. In terms of less individual investor involvement, you can tie that to the existence of a larger pension scheme market where asset management is outsourced to an outside party – the individual and beneficial owner rarely touch that side. They are certainly not checking and managing their investments like Americans do with 401ks.

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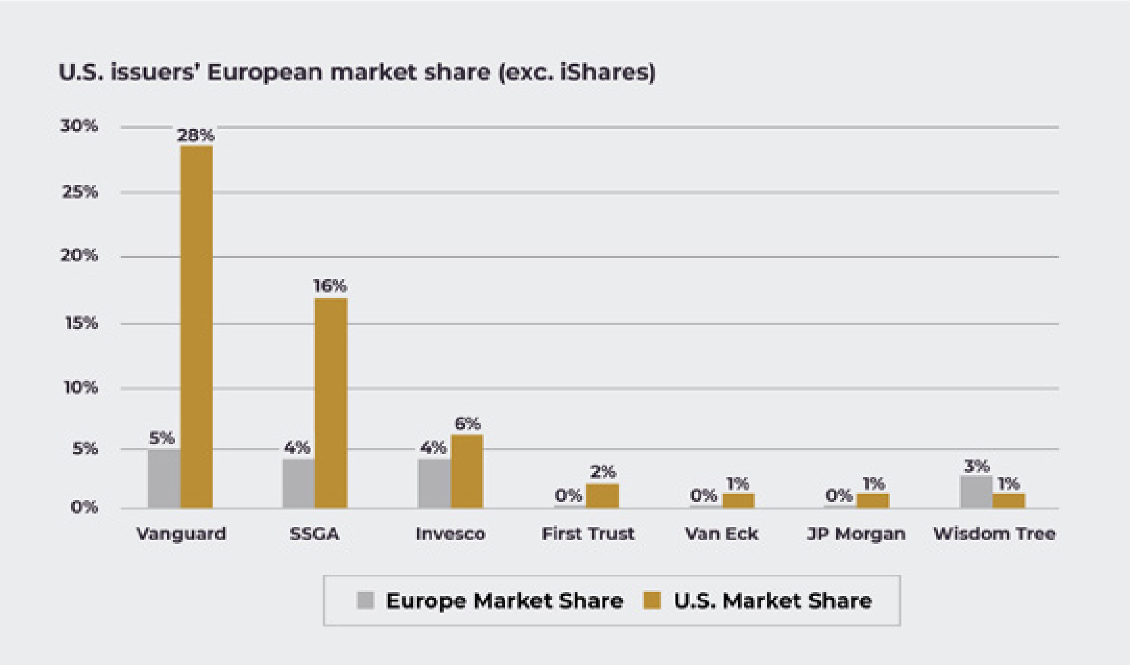
Also, in most European countries you have a very large, strong banking system where individuals will go to manage their money. And those banks are incentivized by the higher commission paying products mentioned prior.



Source: Bloomberg Intelligence

Old School Structure

There is certainly what some may say, an old school way of thinking when it comes to ETF investing in Europe. And without question, there is a very different investment profile in each country which is tied to culture, economics, and the investors' view of financial markets.

Not surprisingly, with 25 different countries where ETFs are available, there is a diverse range of investment cultures across the continent in Europe.

Looking at this through the lens of the individual investment culture, the U.S. does not have the same social security net that exists in most European countries. Because of this, Americans tend to take personal responsibility for their retirement accounts and have a lot more interest in the day-to-day movements of the S&P 500 and domestic marketplace.

This culture of checking and personally managing your own retirement account does not exist for most individual European investors. People tend to have pensions which are managed externally. Additionally, you actually have a much larger percent of people who tend to put most of their money into property – while that exists in the States, it pales in comparison.

Here is where the old school part comes in – the distribution of ETFs to investors, particularly retail, is a major obstacle because in Europe, especially outside the UK, ETFs are sold to retail investors via banks who control most of the ETF distribution but as mentioned before, are motivated to sell higher paying retrocession-based products. Since this commission is the main driver, passive funds, have been neglected by banks unwilling to market low-fee products.

> **“The U.S. has long had an equity culture, while in continental Europe people have traditionally bought investment products via banks”**

And then you have nuances like Italy, which based on a 2018 Deloitte report, mentioned that Italians have a reluctance towards investments and where a third of Italians income is kept in a bank account, un-invested. The main reason for this is undoubtedly the Italians’ lack of trust in the financial market and the economic uncertainty.
In short, the U.S. has long had an equity culture, while in continental Europe people have traditionally bought investment products via banks.

Sales Team

When you are talking about sales teams, you need to have boots on the ground in those individual countries and they need to speak the language, if you cover Italy, you live and work in Italy and you must speak Italian and English. Typically focus client segments may sound the same as the U.S., e.g., wealth managers, family offices, hedge funds, brokerages & platforms, advisors, private banks, insurers, etc. but culturally it is very different. And let's not forget Brexit – you can longer fly in and out of London to cover EU clients. You now need an office in the EU which, from a logistics and cost perspective, can be harder for smaller shops which initially setup in London.

In terms of individual investors which make up a large portion of ETF holders in the U.S., ETF issuers will utilize their Marketing teams to create content that is distributed to targeted retail audiences through mediums such as social media ads, paid google search ads, prints advertisements through various periodicals, e.g., Barron's, online ads through WSJ, blast emails sent to SDIs who sign up and register through the issuer website. There are also many ETF issuers who produce tv commercials which are usually shown on shows like CNBC, Bloomberg TV, ETF.com, etfdb.com, etc. None of this happens in Europe.

So, there you have it, our 30k foot level overview of how ETF markets and distribution differ in the US and Europe. Structurally they are clearly dissimilar, but it doesn't make one better or worse and, in our opinion, comparing them is not appropriate. But at the same time, we all like to have a benchmark so the comparisons probably won't go away anytime soon.

Blackwater Search & Advisory is a global boutique ETF | Digital Assets consulting and recruitment firm.

We specialise in helping asset managers build their ETF platform, grow assets under management and source the best talent the industry has to offer.

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