

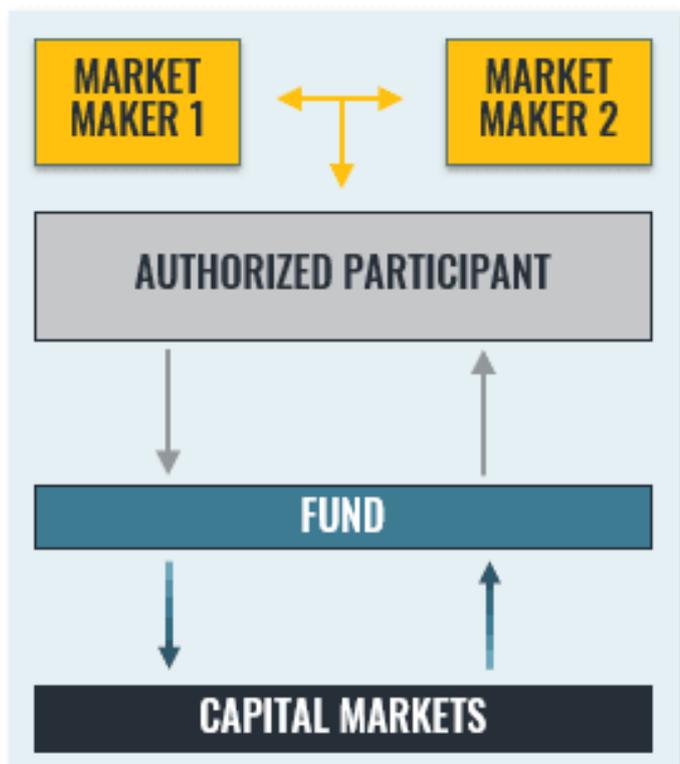
# Market Makers – What You Should Know

March 7, 2022



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Market makers are broker-dealer firms that provide pricing for ETFs and liquidity in the secondary market. The leading market maker will maintain a bid-ask spread and accept orders from other brokerages for purchases and sales of the ETFs for which they make a market. Market makers often carry a small, long inventory of shares in the ETFs to fulfill the orders received. When the demand for shares exceeds inventory, market makers place an order with their preferred authorized participant (“AP”) partner to create new shares of the ETF in the primary market. The AP delivers these shares to the market maker to complete the order. In the reverse, if enough shares to sell are requested then the market maker will place a redemption order with their AP partner to redeem shares in the primary market.



ETFs need to have at least one market maker before listing their product. This market maker will act as lead and participate in the seed event. Being the lead market maker on a product introduces additional risk for the market maker. They need to adhere to exchange rules and are required to always offer liquidity and pricing. The leading market maker will look for ways to expand the relationship with other services they can offer the issuer. Often other market makers will price and provide liquidity shortly after an ETF lists, though if not leading they are not required they consistently price and provide liquidity.

#### **What questions will a market maker ask during an introduction?**

1. Seed Capital: Is the issuer bringing their own assets with which they can buy the seed shares in the secondary market shortly after listing? This reduces the risk to the market maker's balance sheet and their inventory costs.
2. Distribution Plan: Making a market does not bring much revenue to a market maker unless there is high volume. Having a comprehensive distribution plan will help drive volume.
3. Brokerage Services: The market maker will be interested in expanding the business relationship with the issuer. Such activity can include rebalance or reconstitution trades for the ETF, or brokerage services for other products the issuer may offer.
4. Product Specifics: What types of securities make up the basket? Liquid, domestic, large-cap constituents are more easily priced, whereas less-liquid, foreign, or fixed-income securities can be more difficult to price. This will impact the market makers' ability to hedge and deliver in-kind baskets.
5. Product Attributes: What types of trades are allowable per the offering documents? Items of interest are cutoff times, transaction fees,

settlement cycle, payment type.

6. Authorized Participants: Market makers need to clear their trades through an authorized participant and have preferred relationships with specific participants. They will be interested to know the authorized participants who are set up to create and redeem in the ETF.
7. Differentiators: What about the strategy differentiates it from others already available?
8. ETF Experience: Is the issuer new to the ETF space or do they have experience talking through trading issues? If new to the industry, are they partnering with a sub-advisor?
9. Wrapper: Is the ETF transparent and are there other nuances to consider?

Foreside has deep relationships with many of the largest market-making firms participating in the ETF community. We can advise clients on which market makers may be a good fit for certain products and strategies. Further, we will provide introductions to these firms to help clients find a market maker willing to lead their product. Having strong market-making relationships will help maintain orderly ongoing ETF operations, liquid secondary markets, and tight bid-ask spreads. By keeping strong relationships with their market-making partners, an ETF issuer can more easily conduct rebalances, reconstitutions, and other brokerage services they may need. When an issuer launches new ETF products, an existing relationship with a market maker enhances the ability to bring new offerings to market.

Issuing an ETF requires working closely with market makers to price, provide liquidity, and fulfill orders for investors in the secondary market. While it is vital for each issuer to have its own relationships with these firms, Foreside has the expertise to help its clients find a partner.