Global Asset
Management

RBC
Exchange
Traded Funds

What is the role of the market maker for ETFs?

When an investor buys or sells ETF units on a stock exchange, they are often transacting with a market maker. But what is a market maker? What exactly do they do, and what are they responsible for?

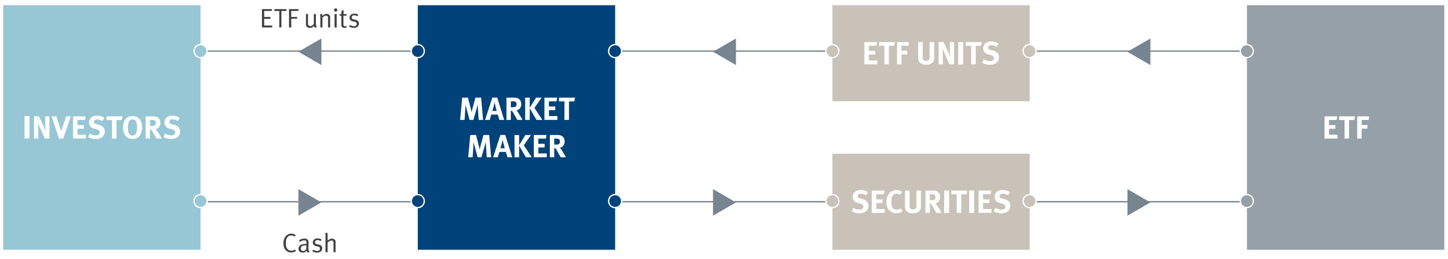
A market maker, sometimes called a designated broker (DB), is a broker, dealer or investment firm that plays an essential role in how an ETF trades and ensures the continued and efficient exchange of securities between buyers and sellers. They do this in multiple ways, including providing liquidity to the market by selling units to investors and purchasing units when investors sell.

Creation and redemption of units

Market makers create ETF units by delivering a basket of underlying securities to the ETF provider in exchange for a block of units (typically 50,000 units) of the ETF with the same market value. These newly created ETF units represent an inventory that can be sold on the stock exchange to investors. When the market maker runs out of units (because the investing public has purchased them all), they simply repeat the process, beginning with purchasing and delivering additional securities.

This creation process can be reversed into a redemption process, whereby the market maker exchanges ETF units with the ETF provider, for an equivalent basket of underlying securities from the ETF. This sometimes occurs if many investors in an ETF choose to sell their investments at the same time.

Creations and redemptions allow the ETF to be in equilibrium, which means the number of units demanded by the marketplace approximates the number of units supplied – which ensures that an ETF's market price and net asset value (NAV) are closely linked.



Buying and selling units to investors

Market makers are tasked with providing ETF liquidity to a given market. They do so by providing units for sale on the stock exchange at asking prices, and then posting bid prices they will purchase units at, for investors wishing to sell. The bids and asks are themselves calculated based upon the underlying asset values, and the costs and fees associated with buying or selling all of the underlying securities inside the ETF.

A valuable partnership

The market maker fulfills other important roles in addition to providing liquidity and maintaining market equilibrium – they also help to ensure the market price of each ETF unit reflects the value of its underlying securities intraday.

There are often multiple market participants with bids and offers on an ETF in the marketplace. Each market participant wants the opportunity to match buyers and sellers, and this competition drives them to post their very best bids and asking prices. Thus spreads not only reflect the market conditions (liquidity, etc.) of the underlying asset class, but can be improved even more than underlying asset class characteristics if there are multiple competing market makers providing liquidity on a given ETF.

Why is it important to understand the market maker's role?

The three-way partnership is valuable to all parties: the ETF provider, the investor and the market maker. Not only do market makers play a key role in the creation and redemption process for ETF units, but they also provide vital liquidity and proactive oversight for ETFs, ensuring the price investors pay to buy or receive when selling is fair and reflective of the value of the ETF's underlying securities.

About RBC Global Asset Management

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