"Can an ETF Collapse?"
We think not.

In response to recent media coverage discussing "Can an ETF Collapse?" - SFG has outlined the following several points, a proper understanding of which we believe will serve to dispel the concerns that have been raised:

A. First and foremost – ***An ETF cannot be forced into liquidation by a redemption, or 'redeemed out of existence'***, as has been suggested.
   - An ETF manager generally reserves the right to reject a redemption request for an amount in excess of shares outstanding, which was the trigger event described in the alleged 'ETF doomsday' scenario.
   - This clause can usually be found in a fund's public registration statements and/or associated regulatory filings.

B. Most ETFs have safeguards in place specifically designed to protect against the possibility of an attempted redemption of more shares than are outstanding.
   - Among these is some form of a requirement that a redeeming Authorized Participant ("AP") must be able to represent that the shares tendered for redemption are in fact in a deliverable state.
   - ***Such a requirement ensures that only physically held long shares (i.e. those included in the shares outstanding) can be tendered in a redemption*** – not those out on loan to another market participant or that were borrowed and subsequently recalled by the lender.
   - Importantly, this fact does not imply that the 'shadow market' shares (those which are loaned out and thus not physically held in account) are in any way 'hollow' or 'empty' or otherwise not collateralized simply because they cannot be redeemed, as we shall see below.

C. It is important to note here that individual investors whose shares are held in a cash account instruct their brokers whether or not their shares can be hypothecated, or lent out, by the custodial broker. By electing not to allow it, an investor can ensure that physically settled shares backing long positions are always held in account.
   - That said, ***individual investors are not able to redeem in any event*** – whether they possess settled shares or not. APs by definition are the only market participants able to create or redeem an ETF.
   - Unlike a cash mutual fund in which an investor must redeem for liquidity, if an investor wants out of an ETF position – whether loaned out by his or her broker or not – they can do so by transacting shares in the secondary market. That's the very nature of an ETF's 'exchange-traded' structure.

D. Through the hypothecation process mentioned above – in which brokers lend out stock from theirs and their clients' accounts to borrowers who use them to cover short sales (or for whatever reason) – it is possible that the total number of long positions in the market can exceed the actual shares outstanding of a given issue.

- Shares can be bought, lent, sold by the borrower, and then re-lent and re-sold many times over. The sum of shares outstanding and short positions will equal the total long positions. (see illustration on next page)
- ***As a result of borrowing and lending it is possible that short interest can exceed shares out, while all of the trades are fully and properly settled, and none of the shorts are considered 'naked'.***
- There is no issue or problem inherent in such an event of itself.

E. Under existing SEC short sale rules (Reg SHO), mandatory covers ("buy-ins") are required if a trade fails to settle, whether due to short fails or long sales that fail due to shares being out on loan.

- ***These regulations prevent perpetual fails on securities – including ETFs – by forcing shorts to settle*** by borrowing existing shares, buying them at the prevailing price in the market, or creating new shares through a creation with the fund.
- Thus if an AP who lent out shares wished to redeem those same shares, they would have to call in the loan, requiring the borrower (i.e. short seller) to deliver shares. If there were insufficient float for the short seller to borrow or buy in the market for delivery to the recalling lender/AP, that short seller would have no choice but to create new shares from the fund, resulting in an increase in shares outstanding commensurate with the shares tendered by the AP for redemption.
- Because ETFs are open-ended, there is virtually no limit on how many new shares can be created.

F. Lastly***, in the event an ETF liquidates <u>for any reason</u>, all long holders are made whole*** with a cash payment into their account at the liquidating Net Asset Value (less liquidation expenses, if any) – whether or not their long positions were held physically or lent out.

- Cash payment is made 1) by the fund itself from the proceeds of the liquidated portfolio and 2) by outstanding short positions, if there are any.
- Since shares outstanding (paid out by the fund) plus short positions (which have to pay out to the corresponding longs), ***no one is left "holding the bag."***
- Short sellers are required to post collateral for their borrowed shares in the form of cash or securities in the amount of 102% of the daily mark to market value of the short position. In the event of an ETF liquidation, this collateral can be used to back the payments made to long holders if necessary.
- ***Thus, the existence of extreme short interest does not in itself pose a "hidden risk" to any long holders that their positions may not be fully collateralized.***

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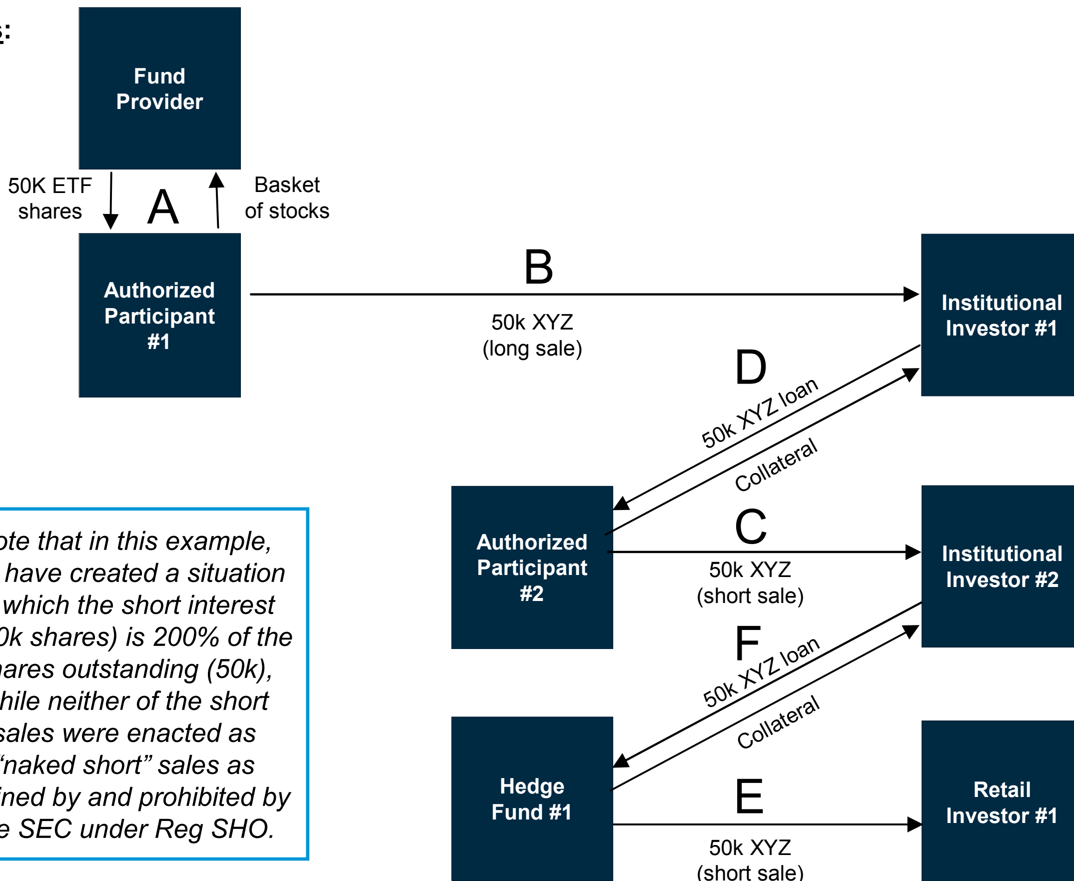
ETF Transaction Flow Chart

Resulting Exposure:	FLAT		SHORT		LONG
Net Position:	50k shares outstanding	+	100k short interest	=	150k long shares

Transactions:



**Note that in this example, we have created a situation in which the short interest (100k shares) is 200% of the shares outstanding (50k), while neither of the short sales were enacted as "naked short" sales as defined by and prohibited by the SEC under Reg SHO.*

A. Authorized Participant #1 creates 50k shares of XYZ ETF (1 unit) by buying a basket of stocks and delivering them to the fund provider in exchange for 50k shares.

B. Institutional Investor #1 buys 50k shares of XYZ from Authorized Participant #1.

C. Institutional Investor #2 buys 50k shares of XYZ from Authorized Participant #2, who sells short.

D. Authorized Participant #2 borrows the 50k of XYZ shares from Institutional Investor #1 in exchange for collateral posted to the Institutional Investor's prime broker and governed by FINRA regulation.

E. Retail Investor #1 buys 50k shares of XYZ from Hedge Fund #1, who is now selling short.

F. Hedge Fund #1 borrows the 50k shares from Institutional Investor #2 in exchange for collateral posted by the Hedge Fund's prime broker to the Institutional Investor's prime broker, and governed by FINRA regulation.

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