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Kauffman Foundation Paper Makes Accusations That Are Not Plausible

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A November 2010 paper on U.S. capital markets from the Kauffman Foundation shows a fundamental misunderstanding of how exchange-traded funds (ETFs) operate. The authors are respected industry authorities, and they offer some ideas that merit further consideration. But the paper levels several accusations against ETFs that are just not plausible. Here is an excerpt from our longer response to the paper:

One elementary misunderstanding that permeates the Kauffman paper rests in the concept of winding down—and up—an ETF. The paper suggests that an ETF may create systemic risk because, in the event of a selloff triggered by any type of market meltdown, the “rush to unwind” ETFs will aggravate a selloff, and that “some creators of ETFs may not be able to honor their obligations.” In the other direction, an ETF could be at risk of failure if it takes in a lot of cash to create shares, but its own demand for the underlying securities drives up the price of those securities, so the ETF does not have sufficient cash to track its index.

Both of these scenarios fail for one key reason: except in some very rare and unique circumstances, ETFs are created—and redeemed—in-kind. What does this mean? In short, an ETF itself will never participate in a “sell-off” or, on the other side, a bidding war, because ETFs generally do not buy and sell stocks. Rather, they exchange blocks of shares, usually 25,000 to 100,000 shares, to certain “authorized participants” (generally broker-dealers or other trading firms) for a proportional amount of the ETF’s underlying securities. Because of this process, an ETF would never need to sell securities in a falling market to provide a redeeming shareholder with cash. Rather, if an authorized participant wishes to redeem ETF shares, the fund takes in the shares and hands over a basket of securities. Because its obligations are limited to a proportional share of its securities, an ETF will always be able to meet them, even in a declining market.

Similarly, an ETF typically does not take in cash with an expectation of buying its component securities, but rather receives component securities in exchange for ETF shares. If the price of those securities is rising, an authorized participant may determine not to create ETF shares, but there is no risk that the value of existing shares will be diluted by an ETF being forced to buy in a rising market.

- Read ICI’s full response to the Kauffman report
- See ICI’s FAQs to learn more about ETFs
