

## Executive Summary

A sophisticated market structure underpins how ETFs operate under the hood, shaped by the interaction between primary and secondary markets and the coordinated roles of investors, exchanges, market makers, authorized participants and issuers. Together, these participants form an ecosystem that supports efficient trading, strong liquidity and pricing that closely tracks net asset value.

ETFs trade on exchanges in the secondary market, where most investor activity occurs through buying and selling existing ETF shares. When demand exceeds available trading volume, liquidity is supplemented through the primary market, where authorized participants can create or redeem ETF shares by exchanging them for the fund's underlying securities. This dual-market structure allows ETFs to accommodate large trades without materially disrupting prices, even when average daily trading volume appears low.

## Key Takeaways

- 1. ETF liquidity extends beyond trading volume:** An ETF's true liquidity comes from both its exchange trading activity and the liquidity of its underlying holdings, allowing large trades to be executed efficiently even when average daily volume appears low.
- 2. Primary market activity keeps prices fair:** Authorized participants and market makers use the creation and redemption process to arbitrage premiums and discounts, helping ETF prices stay closely aligned with net asset value.
- 3. Structural design supports tax efficiency:** In-kind creation and redemption transactions reduce taxable events inside the fund, making ETFs generally more tax-efficient than mutual funds and insulating investors from the activity of other



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