

# NYSE Informed Investor



## What You Should Know About Exchange Traded Notes

An Exchange Traded Note (ETN) is a relatively new type of investment vehicle that is unfamiliar to many investors. Before you decide to invest, there are some basic questions which you should consider in order to make an informed investment decision.

### What are Exchange Traded Notes?

An Exchange Traded Note (ETN) is a common name for a senior unsecured debt obligation designed to track the total return of an underlying market index or other benchmark, minus investor fees. The creditworthiness of an ETN is itself not rated, but instead is based on the creditworthiness of the issuer. Thus, the issuer's credit rating is an important consideration for ETN investors. Typically, ETNs have a repurchase feature, providing qualified investors the election to redeem notes of at least a specified minimum denomination or value with the issuer on a daily or weekly basis at a predetermined price. The details of this feature are in the ETN prospectus. Individual investors, not qualified for redemption election, can purchase or sell their ETNs in the secondary market, sell at a specified issuer call event, or allow them to mature.

ETNs can offer investment exposure to market sectors and asset classes that may be difficult to achieve in a cost-effective way with other types of investments. ETNs can also act as an effective hedging tool.

An ETN allows individual investors to buy an obligation, similar to a forward contract, which is traded on an Exchange. ETNs may be linked to a wide variety of assets. Today there are many types of ETNs linked to indexes and/or single reference assets based on a variety of products such as commodity futures (e.g., energy, grains, industrial metals, livestock, and petroleum), foreign currencies (e.g., Euro, yen), and equities (grouped by such categories as industry sector, strategy or geographic location).

ETNs are similar to Exchange Traded Funds (ETFs) in that they are listed on an Exchange and can be bought and sold throughout the trading day. The issuer of an ETN is obligated to deliver the index or asset performance (less fees) in cash upon early repurchase or maturity. Early repurchase of an ETN generally may be initiated by an investor, when tendering a sizeable minimum amount of securities as specified in the prospectus (either dollar value, such as two million dollars, or number of notes, such as 50,000 notes). Early repurchase may be elected on either a daily or weekly basis, as provided in the prospectus. It is also important to note that the early repurchase feature does not eliminate the credit risk associated with this type of investment. Early repurchase is not available to investors for less than the specified minimum. ETNs have a feature whereby notes that have been repurchased by the issuer can still be available as part of the continuous offering of the ETN. Continuous offering of each ETN is permitted but not required. It is important to review the relevant prospectus on this point, since this could have an impact on an ETN's liquidity.

As of mid-2008, there were 76 ETNs listed on NYSE Arca.

## Questions to Ask

Here are some of the questions you should ask yourself, your registered representative, and/or investment adviser to determine if an ETN is an appropriate investment for you. You should examine the risks and benefits of ETNs, and how they would fit into your portfolio (taking into account your total portfolio and how much you would invest in ETNs). As with any other investment, you should understand the operation of the financial instrument.

### Q. What are the fees associated with ETNs?

**A.** Fees associated with ETNs in the market today range anywhere from 0.30% to 1.25%. The issuer charges an annual fee that accrues through the term of the ETN. Fees may be described in the prospectus by such terms as an “investor fee”, “issuer fee”, “expense ratio” or “tracking fee”. As a result of this fee, the return of the ETN will be lower than that of the underlying index or exchange rate (for currency indexes). Refer to the prospectus of an ETN for details on how annual fees are calculated for individual ETNs, as calculation methods vary. Even if the value of an index or other asset at maturity or upon early repurchase exceeds the initial index or asset level, you may receive less than the principal amount of the securities due to fees. Because ETNs trade like stocks, brokerage commissions and/or transaction costs typically apply to ETN purchases and sales depending on your account type. Understanding the total cost of an investment in an ETN is important in order to make an informed decision.

### Q. How can I determine the value of an ETN on an intra-day basis?

**A.** ETNs are debt securities that do not trade at, nor have a net asset value (NAV). The sales price of the ETN may be higher or lower than the relationship of the ETN to the index or asset value underlying it. The sales price of the ETN is based on the supply and demand in the marketplace. Sales price take into account all factors relevant to the establishment of any price, including but not limited to the perceived value and direction of the underlying index or asset class, the ETN’s expected total return, the creditworthiness of the issuer, and liquidity in the marketplace. Generally, greater liquidity of the ETN and of the underlying index or asset class contributes to the narrowing of the spread between bids and offers in the marketplace and improves pricing. Many ETNs were created recently. We encourage you to examine the liquidity of the ETNs in which you have an interest.

### Q. How is the total return of the ETN calculated?

**A.** Many ETNs seek to track total return indexes or include an accumulation factor within the structure of the security. Total Return indexes and accumulation factors provide a method for dividends or collateral to be re-invested in the securities that do not distribute a periodic coupon.

The method and calculation of total return components will vary by ETN and will be different depending on the underlying asset class. This will be described in the calculation of payment section of the prospectus. For example, for equity-based ETNs, the index return is computed based on the dividend reinvestment. Cash dividends and special dividends are reinvested in all current index component stocks based on the weight in the index as of ex-date of the dividend. For currency-based ETNs, the total return or accumulation factor is a daily accrual of interest in the hypothetical notional amount of the underlying currency index. For commodity-based ETNs, the total return is the rate of interest that could be earned on cash collateral while holding futures positions.

### Q. Does my ETN provide current income?

**A.** Most ETNs do not provide for any periodic payments or cash distributions until sale or maturity. Those ETNs that do make periodic payments or cash distributions typically net out annual fees before making such payments. You should always consult the prospectus of your investment products to determine what types of payments are made, if any, and how they are calculated.

### Q. There are so many Exchange Traded Notes to choose from. How do I find the right ETN for me?

**A.** It is important to consult with your registered representative or investment adviser to select an ETN whose risks and exposure characteristics fit with your investment goals and portfolio. You should also read the prospectus or product description, and research the product (many issuers have a link to the ETN’s prospectus on their website). As with all investment decisions, you should think carefully about how much of your capital you should invest in this product and how ETNs compare to the alternative investment choices available to you.



## Q. What are the risks associated with investing in Exchange Traded Notes?

- A. There are several risks to evaluate when considering the purchase of an ETN. The risks are set forth in the prospectus for each ETN. You are encouraged to review these risks with great care. Some of the relatively unique risks of ETNs are outlined below.

ETNs are not funds and are not registered under the Investment Company Act of 1940. To date, ETNs are not secured debt and do not provide principal protection unless stated specifically in the prospectus. The repayment of the principal, interest (if any), and the payment of any returns at maturity or upon redemption are dependent on that issuer's ability to pay. In addition, the trading price of the ETN in the secondary market may be adversely impacted if the issuer's credit rating is downgraded.

The index or asset class for performance replication in an ETN may or may not be concentrated in a specific sector, asset class or country and may therefore carry specific risks.

Some ETNs seek to track the leveraged long or leveraged short performance of an index. The price of leveraged ETNs will be more volatile than the actual fluctuation of value in the underlying index or asset class. There is also, due to leverage, a greater potential for loss of principal. Each note with leverage is tied to a specific periodic return which is defined within the terms of the instrument. The formula for determining returns on a leveraged note requires an understanding of the base period from which the return is being calculated. It is therefore important to review the prospectus to understand how the issuer of the note performs these calculations. For example, a leveraged ETN that is designed to give double exposure may be constructed to offer two times the performance of the index over a specific time period.

An inverse leveraged ETN that aims to provide double short exposure, for example, may be constructed to provide two times the inverse performance of the index. For example, a double short ETN where the index goes down 50 percent would provide the investor with a return of 100 percent; similarly, if the index goes up 50 percent, the investment loss would be 100 percent. Losses will not exceed, however, the amount of your investment. The extent of leverage and time period will vary from instrument to instrument and are stated in the prospectus. The prospectus also provides details about how investment losses are capped.

In addition, ETNs containing components traded in foreign currencies are subject to foreign exchange risk, unless otherwise stated in the prospectus. Although the ETN may be denominated in U.S. dollars, the index components may be quoted in a foreign currency and therefore the return on the component will be affected by changes in the currency exchange rate.

Other ETNs may have call features that allow the issuer to call the ETN at the issuer's discretion due to the occurrence of certain market events. A call right by an issuer may adversely affect the value of the notes.

Investors should refer to the ETN's prospectus to obtain a complete discussion of the risks involved when investing.

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