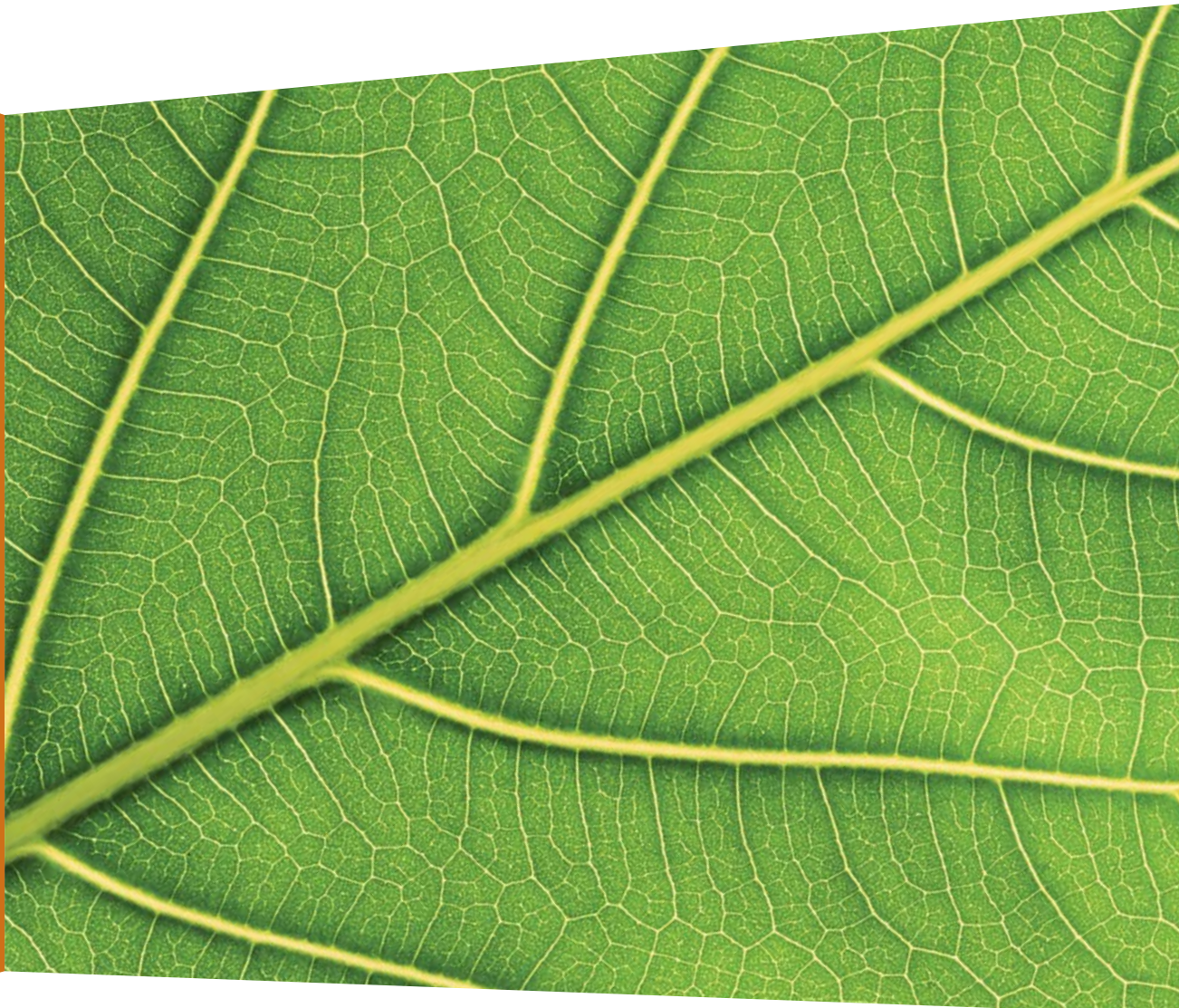


SIMPLE PRODUCTS, SOPHISTICATED STRATEGIES

ETF - Exchange Traded Funds





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ETF - Exchange Traded Funds

Introduction

Originating in the United States in the early 1990s, Exchange Traded Funds first became available to Italian investors in September 2002. Since then they have achieved impressive growth, demonstrated by increases in the volumes traded on exchange, the assets under management and the number of ETFs traded on the ETFplus market (the regulated market managed by Borsa Italiana that is dedicated to exchange traded products).

Simplicity

ETFs are passive instruments, exclusively aimed at replicating the performance of a benchmark index, which provide investors with a way to gain immediate exposure to an investment market (stocks, bonds, commodities, etc.) or to pursue an objective strategy in a market (through structured ETFs, eg. short and leveraged). In addition, ETFs trade throughout the day on the stock exchange and can be bought or sold like stocks, through a bank or broker.

Transparency

By replicating well-known market indices, ETFs allow investors to be perfectly aware of the risk/reward profile of their investment as well as the security portfolio to which they are exposed. Furthermore, the price of an ETF is updated constantly in response to the movements of components of the reference index, therefore the investors are always aware of the value of their investment in the ETF. This is supported also by daily publication of the official net asset value of the ETF (NAV).

Flexibility

ETFs do not expire and can be traded throughout the day on the stock exchange; investors can therefore control the length of the investment based on their specific objectives, from short term intraday trading to medium or long term investment planning. Considering that the minimum trading lot is only one share/unit, it is possible to take positions in a wide range of indices, even for reduced amounts.

Economy

The policy of passive management common to all ETFs combined with a stock exchange listing allows ETFs to operate without some of the typical costs of actively managed funds (eg. analyst teams and costs linked to distribution) providing investors low cost access to markets and investment strategies that otherwise would incur high management commissions.

Reducing issuer risk

ETFs are funds or SICAVs whose assets are, by law, the exclusive property of the holders of the ETF shares/units. As a consequence even in the case of insolvency of the ETF manager, administrator and promotion company, the assets of the ETF are protected.

Despite its simplicity and flexibility of use, the ETF remains a sophisticated and innovative instrument which is constantly developing (for example with the introduction of structured ETFs). The specific characteristics of these products needs to be understood in order to comprehend the potential ETFs offer and their limitations. To this end, the following pages describe the features of ETFs and structures ETFs, and methods of investment.

“ETFs have become successful over time for both institutional and retail investors because of their fundamental characteristics - simplicity, transparency, flexibility, low cost and low issuer risk”



Exchange Traded Funds

What they are

ETF is the acronym for Exchange Traded Fund, a term by which a particular type of mutual investment fund or Sicav is identified and whose main features are:

- it is traded on the stock exchange like a share
- it tracks a reference index (benchmark) through totally passive management

An ETF combines the typical features of a fund and a share, enabling investors to benefit from the strengths of both instruments:

- diversification and reduced risk - typical of funds
- flexibility, transparency of information and real time trading - typical of shares

Main features

ETFs allow investors:

- **to take a position in the target market with one transaction at any time during the trading session.** By purchasing an ETF it is possible to take a position in a market index (DAX, Nasdaq100, S&P500...) immediately, for a price that perfectly reflects the value of the index components at that time. As the minimum trading quantity is always just one unit/share, the investor may purchase ETFs by investing only a few hundred euros
- **to track the performance of the benchmark index.** The ETF allows investors to obtain a return equal to that of the reference benchmark through "totally passive management", i.e. by replicating exactly the composition and weight of the index to which it refers. However, if the reference currency of the index is different to the trading currency (which is always the euro), the return on the ETF may be different from that of the benchmark as a result of currency fluctuations
- **to achieve a price that is constantly aligned to the NAV.** Due to the creation/redemption process which enables the authorised participants to create and redeem ETF units by exchanging them for the underlying stock of the reference index (and vice-versa), the price on the stock exchange is constantly aligned to the official value of the ETF, the Net Asset Value (NAV). An ETF modifies its assets automatically in order to follow changes to the weighting and constituents of the reference index.



As a result the investor is never involved in re-balancing the assets

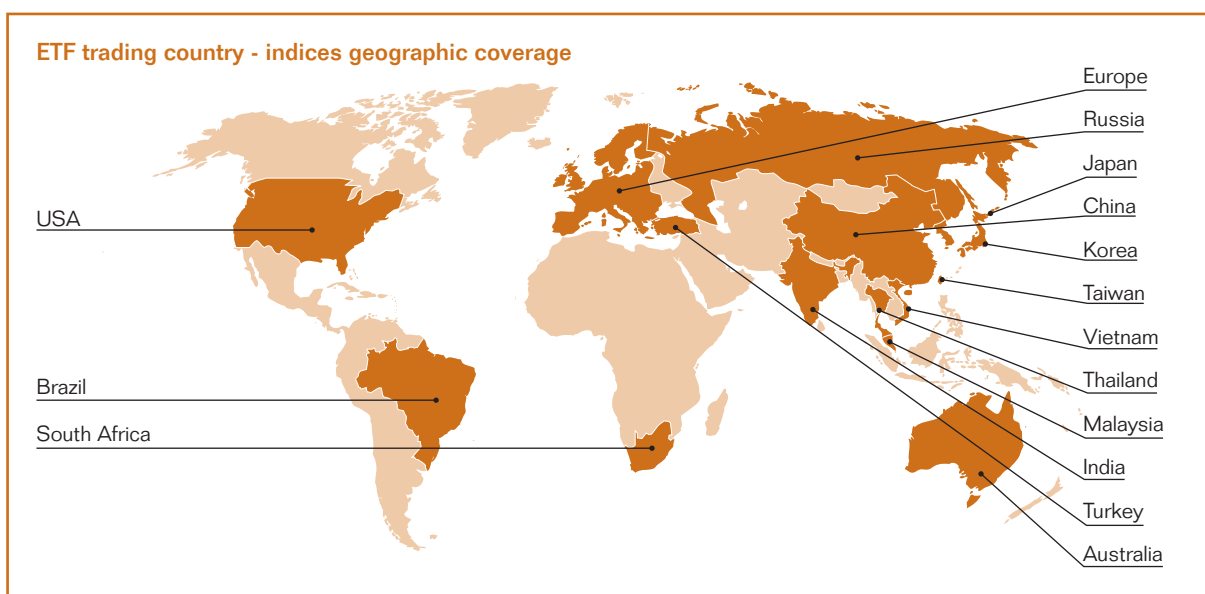
- **to obtain a broad diversification.** Investing in ETFs is an easy way to take a position on a whole market index which in general consists of a large basket of securities, thus diversifying and decreasing the investment risk. Consider the simplify of this compared to the transaction costs and the capital that would be required to purchase all the securities that make up the DJ EuroStoxx 50 index in the proportions stated by the operating rules of the index
- **to reduce the costs of one's own portfolio.** ETFs are subject to a low total annual commission (TER) applied automatically in proportion to the holding period and the investor is charged no "entry", "exit" or "performance" fees. The investors only need to consider the trading fees applied by their own bank/broker
- **to benefit from periodical proceeds.** The dividends or interests that an ETF collects in relation to the shares/bonds included in its assets (as well as the proceeds from the re-investment of these) may be re-distributed periodically to the investors or permanently capitalized in the assets of the ETF. In both cases, the only beneficiary is the investor
- **to reduce exposure to issuer risk.** The ETFs listed on ETFplus are, depending on the instrument, mutual investment funds or Sicav (UCITS). UCITS have segregated assets with respect to those of the companies which are involved in their creation, management, administration and marketing activities. Therefore ETFs are not subject to insolvency risk in the event of a default of an associated company

Investment modalities

ETFs make it possible for investors to access their desired market by tracking indices covering a wide range of investment categories:

- **bond and liquidity indices.** Eg. government bonds denominated in euro, USD, and sterling, segmented according to maturity. Corporate bonds from the euro and USD regions. Liquidity indices linked to euro, USD and sterling overnight interest rates, etc.
- **equity indices representing single markets and wider geographic areas.** Eg. Italy, UK, Germany, Switzerland, Japan, Europe, USA, Australia, etc.
- **equity indices from emerging markets.** Eg. China, India, Russia, Brazil, Turkey, Korea, Taiwan, Vietnam, Select frontier, etc.
- **equity indices relating to market sectors.** Eg. automotive, technological, telecommunications, utilities, banks, energy, financial services, etc.
- **style equity indices.** Eg mid cap, small cap, value, growth, select dividend, etc.
- **commodities indices**
- **indices relating to real estate companies or private equity**
- **fundamental and quantitative indices.** Indices composed of stocks selected using fundamental criteria (sales, cash flow, book value, dividends, etc.) and/or momentum criteria.
- **thematic indices.** Indices related to particular sectors such as water, clean energy, timber, etc.

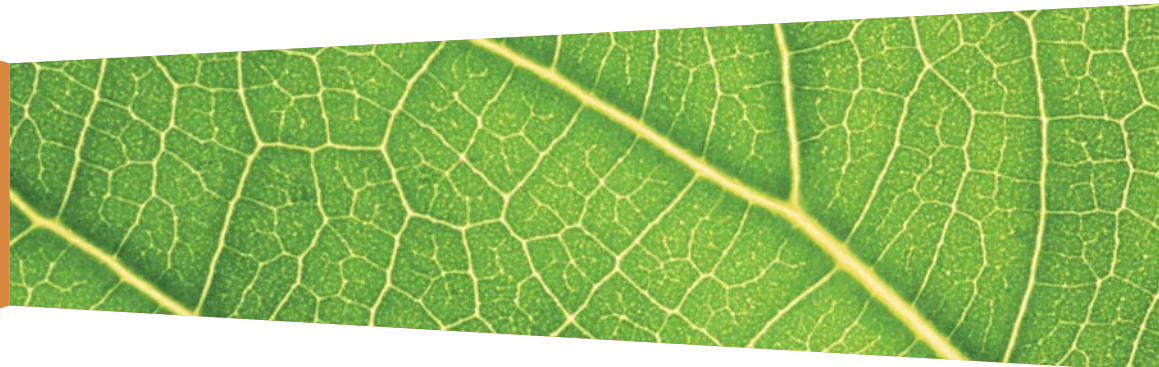
This wide range of ETFs available on ETFplus allows investors a great opportunity to diversify the composition of their own portfolio, thereby reducing overall risk whilst maintaining cost efficiency.



As ETFs are available to trade on the stock exchange, they are suitable for a range of investment strategies:

- **short-term trading (intra-day trading).** Due to the high liquidity of ETFs, they can be traded exactly like shares, allowing investors to exploit intra-day movements in the reference index
- **long-term investment.** As ETFs do not expire, it is possible to take a position in the target market over the long-term, as part of an investment strategy or within CAP (Capital Accumulation Plans)
- **short selling.** If a broker offers this service, it is possible through securities lending to profit from a decrease in the reference index for longer than one day.

“With structured ETFs the investor can access different strategies and risk profiles on the desired market through one transaction”



Structured ETFs

What they are

Structured ETFs are UCITS i.e. funds or Sicav that can be traded like shares and are aimed at generating returns related to the performance of the benchmark index, but which may also be aimed at:

- the protection of portfolio value, by participating only in any increases in the reference index (protection or protective put ETFs)
- participating in a more than proportional manner in the performance of an index (leveraged ETFs);
- inversely reflecting in the movements of the reference index (short ETFs with or without leverage)
- more complex investment strategies such as “buy-write” or “covered call” strategies, which consist of a long position on the benchmark index and a simultaneous sale of a call option on the index with an out of the money strike.

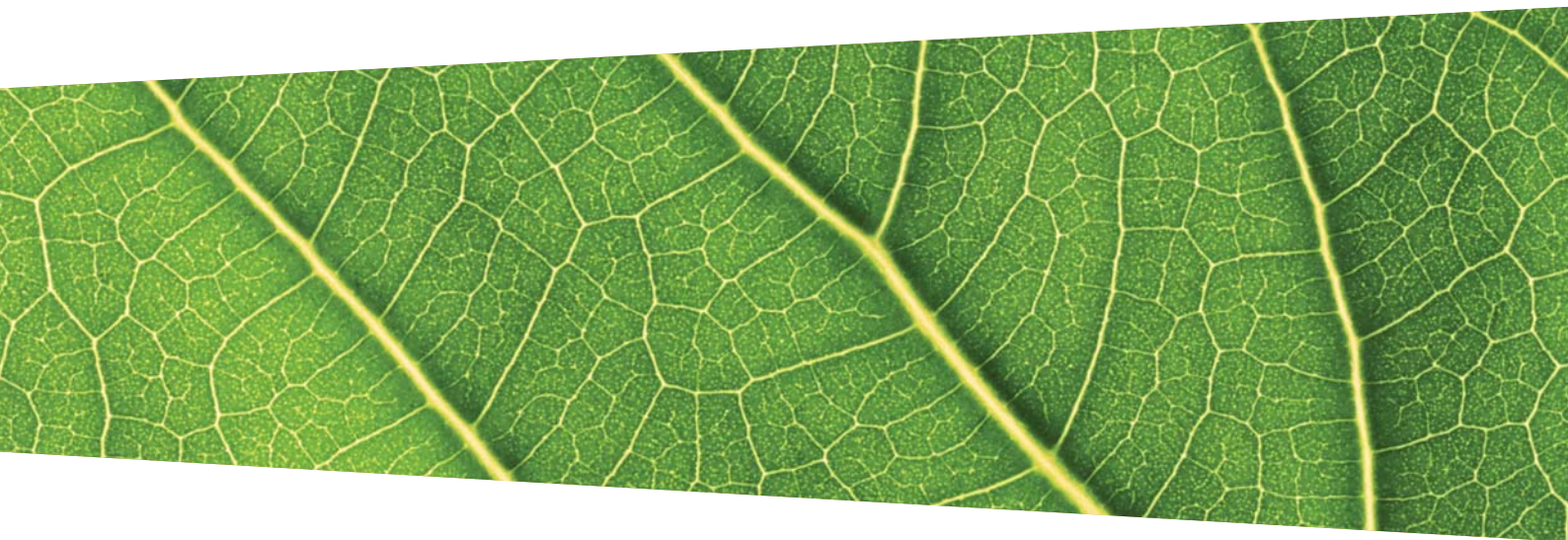
What structured ETFs and standard ETFs have in common is the ‘passive’ investment policy, that is to say the fact that once the mathematical model with which the assets will be managed is defined

the discretionary power left to the manager is limited. As with standard ETFs, the units may be created and redeemed continuously by authorised participants, and this ensures that the market price is always aligned to the NAV of the fund.

Main features

Structured ETFs allow investors:

- **to maximize the performance of each strategy.** Structured ETFs enable the investor to gain the typical benefits of an ETF investment (passive strategy) with those of dynamic management, thanks to the transparent method of allocation of the managed portfolio assets
- **to reduce the costs of managing the portfolio.** Structured ETFs provide low cost access to more complex investment strategies than simply tracking a benchmark index. They are subject to a low total annual commission (TER), which is applied automatically in proportion to the holding period and the investor is charged no “entry”, “exit” or “performance” fees. The investors only need to consider the trading fees applied by their own bank/broker



- **to benefit from periodical proceeds.** The dividends or interests that the structured ETF collects may be re-distributed periodically to the investors or permanently capitalized in the assets of the structured ETF. In both cases the only beneficiary is the investor
- **to reduce exposure to issuer risk.** Structured ETFs listed on ETFplus are, depending on the instrument, mutual investment funds or Sicav (UCITS) and therefore are not subject to insolvency risk in the event of issuer default.

Investment modality

Structured ETFs allow the investor to access different strategies and risk profiles on the desired market with one transaction. The transparency and liquidity provided by the ETFplus market make it easy for investors to invest:

- with leveraged effect, to increase exploitation of movements in the markets (both up and down)
- with an inverse relationship between the index performance and the performance of the ETF, through a "short" ETF
- with capital protection to provide lower risk than ETFs directly following the movement of the benchmark index through structured ETFs with protection.

ETFplus market

ETFplus is the regulated market of Borsa Italiana which is fully dedicated to the trading of ETFs and structured ETFs, diversified instruments which share the same trading mechanism.

To aid investors in selecting those instruments which best meet his risk-return profile and his expectations two segments are provided, which use the same trading modalities and are divided into distinctive classes:

- open-ended index funds segment, divided into the following classes:
 - class 1: ETFs with bond based reference indices
 - class 2: ETFs with equity based reference indices
- open-ended structured funds segment, divided into the following classes:
 - class 1: structured ETFs without a leverage effect
 - class 2: structured ETFs with a leverage effect

Microstructure

Liquidity

The liquidity of a financial instrument is directly linked to the availability of both bid and ask prices on the trading book, along with competitive spreads and high tradable quantities, i.e. provision of an adequate width and depth on the trading book.

As Borsa Italiana aims to guarantee the maximum liquidity for each ETF and structured ETF listed on the ETFplus market, Borsa Italiana requires the constant presence of:

- at least one specialist, who agrees to meet obligations both in terms of minimum bid/offer quantities and the maximum spread between bid and ask prices, and who is obliged to restore quotes in the event of a total or partial hit on the book. Borsa Italiana monitors the performance of these obligations on a continuous basis
- different liquidity providers that may also supply additional liquidity in these instruments by displaying their own prices, even though they have no quotation obligations.

Trading hours

Trading of ETFs and structured ETFs occurs continuously from 9.05 am to 5.25 pm (without an opening or closing auction). Contracts are executed through automatic matching of bid and ask orders according to price/time priority criteria.

During continuous trading, orders may be added to the book through an intermediary with or without a price limit and with various specifications on the duration, for example "good till cancelled" or "good till time".



To ensure proper operation of the market, as with shares, maximum limits are fixed for the movement of prices. A maximum price variation limit is established for orders inserted onto the order book compared to a control price, also a maximum variation limit for the execution price compared against the control price and, finally, a maximum limit to the movement of prices between two consecutive executions. The limits vary depending on the segment and the specific volatility of the instruments.

Clearing of contracts is managed by Monte Titoli (the company for the centralized administration, clearing and settlement of the Borsa Italiana – London Stock Exchange Group) on the third business day after the trade. Final settlement is guaranteed by the Central Counterparty (Cassa di Compensazione e Garanzia). The smallest quantity that can be traded is one share/unit so it is possible to purchase the instruments listed on ETFplus in very small amounts.

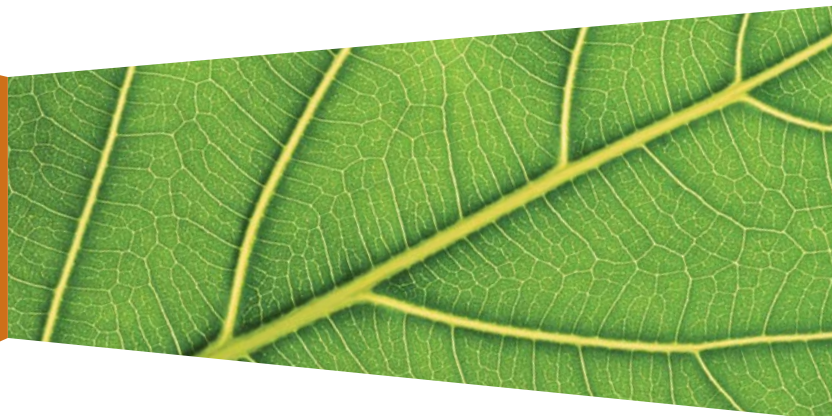
Transparency of Information

A continuing flow of up to date information is a fundamental requirement to guarantee the proper operation of the market, so Borsa Italiana requires that issuers make the following information available to the market:

- value of the NAV
- the creation basket (if applicable), i.e. the portfolio of securities in exchange of which the shares of the ETFs may be created and redeemed on the primary market
- the number of outstanding units or shares
- for structured ETFs, if applicable: the protection and guarantee levels, the value of the multiplier
- the dividends amount, ex date and the payment date.

In addition to the above information, statistics relating to the market, prospectuses and the issuers' brochures are available on the Borsa Italiana web site www.borsaitaliana.it/ETFplus.

It is also required that issuers make the instant net asset value (iNAV) available to investors, through information providers or their own web sites.



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