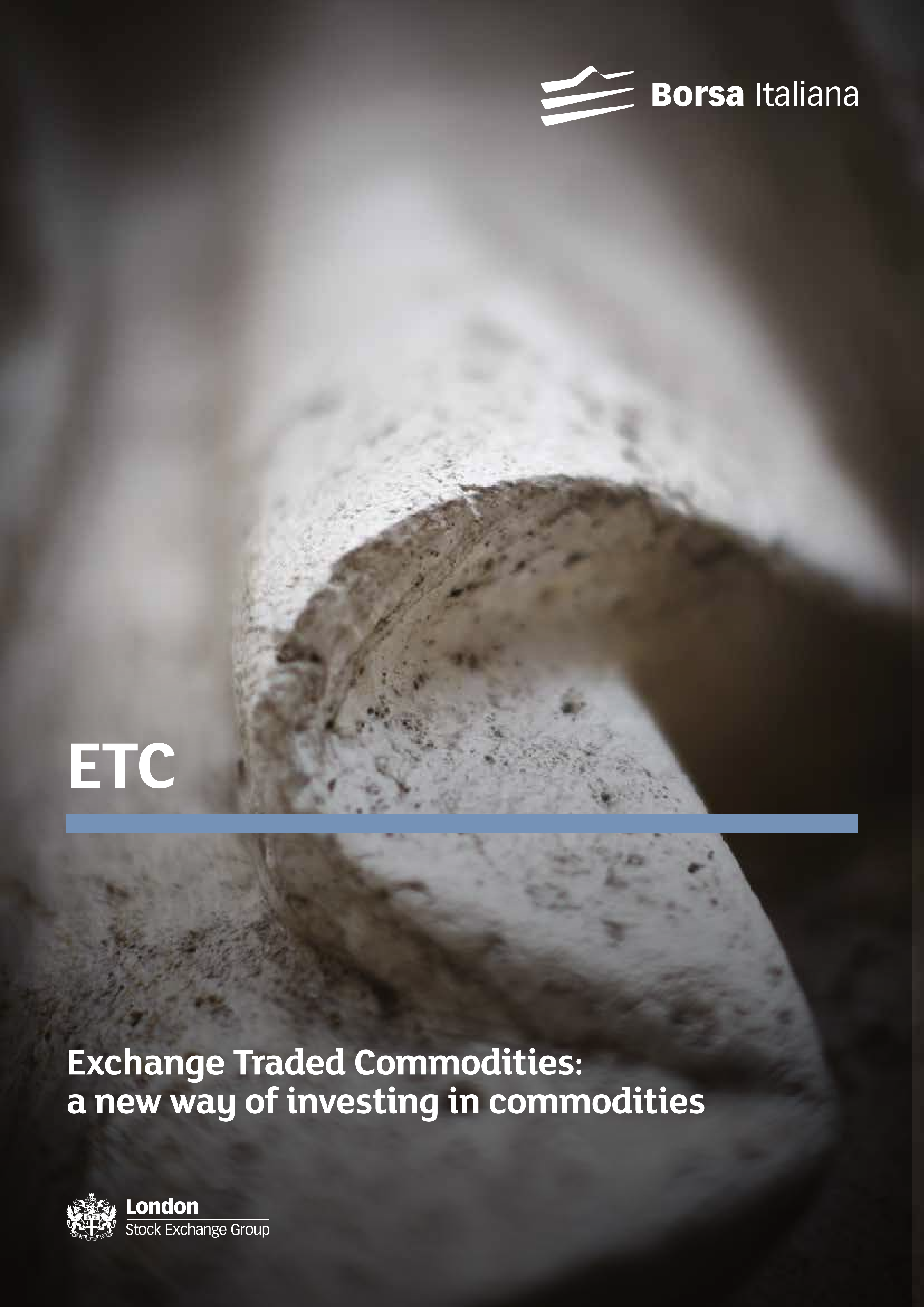

Borsa Italiana

ETC

Exchange Traded Commodities: a new way of investing in commodities

London Stock Exchange Group

“Traded on the stock exchange like a share, ETCs passively track the performance of the commodity or commodity index to which they refer.”

ETC
Exchange Traded Commodities

Introduction

Diversification and protection of capital from inflation represent two fundamental objectives in building a portfolio. From this standpoint, commodities have always been valued for their low correlation with traditional asset classes (typically equity and fixed income) and their structural revaluation in inflation periods.

Features of the commodities market

Thanks to these characteristics, commodities have represented and still represent an indispensable component of both institutional and retail investors’ portfolios. While material possession of precious metals – including gold, silver, platinum and palladium – is technically possible despite some operational risks (for example custody costs), other commodities such as energy, agricultural products and industrial metals present storage and perishability problems that don’t allow for direct physical investment. Exposure to these goods can be achieved only through standardised derivative financial instruments - futures -in which two parties contract to exchange, at a future date, a certain amount of a particular commodity for a defined price.

For these reasons, historically commodities were only accessible to institutional investors, since they were the only ones able to enter international derivative markets and manage positions in futures. This management required high minimum lots, maintenance of margins, and repositioning of consecutive futures contracts in order to maintain exposure to the relevant commodity (technically defined as ‘rolling’).

Access to the commodities market was therefore unavailable to retail investors until the introduction of instruments like Exchange Traded Commodities. Operating in a similar way to stocks, they allow investors to obtain the performance of a commodity or of commodity indices without the need for rolling, without any margin requirement and without the expense of managing expiring derivative contracts – as these activities are incorporated into the ETC itself.

ETCs are instruments that have only very recently been conceived and created. The first ETC was listed in March 2003, when Gold Bullion Securities began trading at the Australian Stock Exchange. Even more recent is the entry of ETCs into the Italian market: this first occurred in April 2007 with the opening of Borsa Italiana's ETFplus market in which a dedicated segment was provided for ETCs.

ETCs benefit from clearly defined investment objectives, low management commissions, no expiry date, a minimum lot of just one ETC and low–cost access to commodities that are otherwise difficult to obtain. These factors, together with the simplicity, flexibility and transparency characteristic of ETCs, combine to create a unique financial instrument. Although simple and flexible to use, ETCs are complex and innovative instruments whose characteristics must be understood in detail in order for their potential and limitations to be grasped.

The information on the following pages describes the features of ETCs and potential methods of investment. It may assist the making of informed investments in the world of commodities.

> "Access to the commodities market was unavailable to retail investors until the introduction of instruments like Exchange Traded Commodities."

Exchange Traded Commodities

ETCs are financial instruments fungible with the commodity or basket of commodities they refer to since, firstly, they are issued against a direct investment by the issuer in those commodities; and secondly, they can be created and redeemed on a continuous basis, and intermediaries can take advantage of arbitrage opportunities against the underlying commodities.

Main features of ETCs

What they are

Exchange Traded Commodities are financial instruments issued against a direct investment by the issuer in commodities or commodities derivative contracts. The price of an ETC is, therefore, directly or indirectly linked to the performance of the underlying.

ETCs:

- are traded on the stock exchange like shares
- passively track the performance of the commodity or commodity index to which they refer, and are thus fully entitled to be referred to as 'passive instruments'.

Using ETCs, the investor may take a position on one single commodity – for example gold, oil, natural gas, sugar, soybeans or zinc. This is something that ETFs can't offer because they must ensure a certain degree of diversification to comply with UCITS (the directive on Undertakings for Collective Investments of Savings).

ETCs are not funds; they are securities issued by an investment vehicle in relation to an investment in a commodity or in commodities derivative contracts entered into by the issuer with intermediaries operating in the commodities market.

ETCs are created in the primary market, accessible only to authorised participants, where the creation and redemption of the securities takes place on a daily basis at the price on the official reference market of the underlying commodity. It is also possible for certain ETCs to subscribe in kind, i.e. delivering the commodity directly to the issuer – for instance physically backed ETCs.

The secondary market is held on the stock exchange, where all other investors may trade the ETCs at a price determined by the best bid and ask orders on the trading book.

The creation and redemption process on the primary market allows authorised participants to take advantage of arbitrage opportunities, ensuring that the price of ETCs on the secondary market is always aligned to the market value of the underlying commodity. As a result the risk of buying (selling) an ETC with a higher (lower) price than the market value of the underlying commodity is reduced, although this risk can't be excluded.

02–03 ETC / Exchange Traded Commodities: a new way of investing in commodities

The range of commodities replicated by ETCs is very broad and is not limited to single commodities, but extends to their indices, sub-indices and forward indices. This allows investors, depending on their expectations and risk profile, to take a position on the performance of an individual commodity or maintain a well diversified position on a basket of commodities

Commodities represent an important asset class for both institutional and retail investors, and make it possible:

— to protect one's own investments against the risk of inflation

— to improve the risk-return ratio and therefore the efficiency of the portfolio, given the low historical correlation between commodities and the equity/fixed income markets.

ETCs can trade continuously throughout the day and the ETFplus market makes it possible for all investors to access a highly liquid commodities market in a simple and transparent manner.
Overall, an ETC permits investors:

— **To access the commodities market directly.** ETCs replicate the performance of a single commodity or a commodities index, as they are issued against a direct investment by the issuer in the relevant commodity or commodity derivative contracts. In the latter case, ETCs enable investors to gain an exposure similar to what would be obtained through a long position in a futures contract without leverage

— **To remain constantly aligned to the performance of commodities.** Unlike positions in futures, ETCs do not need to 'roll' from one futures contract to another, require no margin and do not entail the brokerage/replacement expenses of derivative contracts approaching maturity because these activities are already incorporated within the instrument. Finally, physically backed ETCs enable investors to avoid the charges and the risks linked to commodities storage

— **To obtain exposure to a total return.** ETCs linked to the price of commodity futures contracts provide the investor with access to a total return comprising three different components:

– spot return. This is the return derived from the fluctuation of the price of the underlying commodity

– roll return (positive or negative).This is the return associated with selling front month futures contracts prior to expiry and reinvesting the proceeds in next month futures contracts, in order to maintain the position on the underlying: it can be negative (contango) when the front month futures contract price is lower than the next month futures contract price, or positive (backwardation) in the opposite event

– return of the collateral. This is the interest obtained from the investment of the collateral (the purchase of a future does not require any investment other than the maintenance of a margin, which is also remunerated).

Finally, as a large proportion of commodities are handled in dollars, the value of an investment will be positively or negatively affected by the performance of the EUR/USD exchange rate.

— **To access the commodities market at a low cost.** The investor is charged no 'entry', 'exit' or 'performance' fees, while management fees are low and are applied in proportion to the time during which the ETC was held. Finally, as in the purchase of any other security, trading fees applied by one's own bank/broker must be considered.

Investment modalities

Types of ETC

The range of commodities replicated by ETCs is very broad and is not limited to single commodities, but extends to their indices, sub-indices and forward indices. This allows investors, depending on their expectations and risk profile, to take a position on the performance of an individual commodity or create a well diversified position on a basket of commodities by purchasing:

— ETCs on individual commodities (Aluminium, Coffee, Copper, Corn, Cotton, Gasoline, Gold, Heating Oil, Brent Oil, WTI Oil, Lean Pork, Live Cattle, Natural Gas, Nickel, Silver, Soybean Oil, Soybeans, Sugar, Platinum, Palladium, Wheat, Zinc, Lead and Cocoa)

— ETCs on indices linked to homogeneous baskets of goods (Agricultural Products, Energy, Cereals, Industrial Metals, Cattle, Oil, Precious Metals, etc.)

— ETCs on global commodities indices

— ETCs on forward commodities indices.

As they trade on the stock exchange, ETCs are flexible instruments suitable for taking advantage of expectations on the evolution of the markets as well as for other investment strategies. They may be used for short-term trading, for taking advantage of the movements of an individual session, or for long–term investments as ETCs have no maturity. In addition, it is possible to profit from a bearish trend by buying a short ETC, or to gain exposure in a more than proportional way to the performance of a commodity by purchasing a leveraged ETC.
Finally, if available through your bank/broker, ETCs may be short-sold in order to profit from a bearish trend, or can be bought with leveraged effect.

"ETCs make it possible for all investors to access the commodities market in a simple and transparent manner."

Focus on physically backed ETCs

Directly buying and keeping precious metals such as gold and silver for investment purposes is possible, but also costly and risky. Through physically backed ETCs, these critical factors can be eliminated.

Physically backed ETCs are guaranteed by raw materials deposited in the vault of a bank hired by the issuer. Therefore their value is directly linked to the spot price trend of the commodity, though it may need to be converted into EUR if that is not the trading currency of the underlying.

Physically backed ETCs allow investors to gain exposure that is similar to what they could achieve by buying and keeping the physical raw material, but with the advantage of avoiding risks and costs linked to their management (warehousing, custody, insurance, etc.).

Physically backed ETCs are the optimum technical choice if the underlying commodity has a high intrinsic value, is not perishable and proves to be easily stockable according to broadly recognised delivery standards.

Physically backed ETCs use the same primary market mechanism as ETFs, defined as creation and redemption in kind, in which authorised participants can request the creation or redemption of the physically-backed ETCs by exchanging with the custodian the exact quantity of raw material controlled by each ETC for a determined minimum lot (primary market).

This procedure ensures that physically backed ETCs are effectively fungible with their underlying commodities from the standpoint of both price and liquidity on the secondary market, where ETCs can be purchased by retail investors even in small amounts as the minimum trading lot is just one security.

Physically backed ETCs have a total annual commission contained in, and applied in proportion to the time of security possession through the reduction of the quantity of raw material that each ETC controls (the 'entitlement'), while the investor is not charged an 'entrance', 'exit' or 'performance' fee.

The fair price of a physically backed ETC can be easily controlled by any investor, since it is arrived at simply by multiplying the current price of the underlying commodity (for example, the spot price of 1/10 of a troy ounce of gold or 1 troy ounce of silver) by the entitlement (and any division by exchange rate).

ETFplus market

ETFplus is the regulated market managed by Borsa Italiana, that has a dedicated segment for the trading of ETCs. It is arranged with clear rules that aim to guarantee high liquidity, tight spreads and the greatest possible transparency in the price discovery process.

ETFplus: segmentation and microstructure

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 – in other words the provision of adequate width and depth. In order to guarantee the maximum liquidity for each ETC 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. The presence of the specialist is also mandatory during the closing auction. Borsa Italiana monitors the performance of these obligations on a continuous basis
- different liquidity providers who may also supply additional liquidity to these instruments by displaying their own prices, even though they have no quotation obligations.

Trading hours
The continuous trading of ETCs takes place non-stop from 9.00 am to 5.25 pm. Following the migration to the Millennium platform, a closing auction phase from 5:25 pm to 5:30 has been introduced, plus a variable interval of up to one minute. Contracts are executed through automatic matching of bid and ask orders according to price/time priority criteria. During trading, orders may be added to the book through an intermediary with or without a price limit (although orders without a price limit aren't allowed during the closing auction) and with various specifications on the duration – for example 'good till day' which allow orders with a maximum maturity of 30 days to be inserted.

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. These limits vary depending on the segment and the specific volatility of the instruments. Clearing of contracts is managed by Monte Titoli, the company responsible for the centralised administration, clearing and settlement at Borsa Italiana/ London Stock Exchange Group. Final settlement is guaranteed by the Central Counterparty (Cassa di Compensazione e Garanzia).

Transparency of information

A continuing flow of up to date information is a fundamental requirement for guaranteeing the proper operation of the market, so Borsa Italiana requires that issuers make available to investors the official value of ETCs and the number of them outstanding. It provides access through its web site www.borsaitaliana.it/ETC to a wide range of market statistics, prospectuses and issuers' brochures.

“The smallest quantity that can be traded is one ETC so it is possible to purchase the commodities market in very small amounts.”

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