

Date: 11 August 2017

Central Bank of Ireland  
New Wapping Street  
North Wall  
Dublin 1

**Re: Response to CBI Discussion Paper on Exchange Traded Funds**

Dear Sir/Madam,

The Passive Investment business is one of the core units of Deutsche Asset Management and has asset under management of over EUR 100 billion globally across a range of passive products. In Europe, through the Xtrackers ETF and Xtrackers ETC platform, Deutsche Asset Management is one of the largest and most established providers of Exchange Traded Products (ETPs) with over 200 UCITS ETFs.

Deutsche Asset Management welcomes the opportunity to respond to the Central Bank of Ireland's Discussion paper on Exchange Traded Funds. Whilst we provide our answers to the specific questions, we wish to highlight how encouraged we are by the quality of the discussion paper.

**Section I Questions**

**A. Is public disclosure of the identity of APs and OLPs of an ETF of benefit and should regulators have a clearer view of the interconnectedness of the AP / OLP ecosystem?**

Both the identity of APs and OLPs is readily available from issuers and the exchanges.

Xtrackers discloses the number of and names of our APs to clients and other interested parties.

OLPs for each ETF are already disclosed by the various exchanges. OLPs can sign up to market make an ETF on exchange without any approval or verification from the ETF issuer and the ETF issuer is not always notified if another market maker signs up. OLPs have different trading approaches and not all OLPs will access the primary market in order to be able to provide liquidity on exchange.

**Should remuneration models of OLPs (and if relevant APs) be disclosed?**

We do not believe this is necessary, though issuers should make all efforts to ensure there is sufficient support for their products in secondary market. Every exchange has a mandatory requirement to have a market maker registered to provide liquidity throughout the day for each ETF.

**B. Transparency is described as the feature which enables a tight secondary market price (by comparison to net asset value) to be maintained. It also provides certainty to investors in terms of exposure achieved through the ETF. It might be the case that there are other mechanisms which achieve the same goal as transparency?**

We publish full fund holdings on to our website each day which provides complete transparency to investors, and publish the PCF each day (portfolio composition file) to assist brokers and AP's with pricing our ETFs.

In addition, the Capital Markets and Sales teams at Deutsche Asset Management are available to address transparency related queries from market participants.

**C. Is the idea of secondary market investors dealing directly with an ETF when the AP arrangements breakdown unworkable in practice or unnecessary? Is there a better way of enabling secondary market investors to dispose of their ETF shares at a price close to the next calculated net asset value when secondary market liquidity is impaired?**

We believe the existing trading mechanisms of ETFs – at risk and NAV are effective for secondary market investors.

ETFs are wrappers that reflect the liquidity of the underlying. If the secondary market liquidity is impaired, then it will generally be due to some underlying market dislocation or event. ETF liquidity and pricing will reflect the liquidity of the underlying vs greater transactions costs to reflect this uncertainty. If individual investors could transact directly with the ETF to redeem their shares, they would still be exposed to the same underlying markets

and any market conditions there. One of the great benefits of an ETF is that they can be traded at risk, and the price to the end investor is known immediately. If a market is falling and the investor wishes to get out, they can trade immediately rather than waiting for the NAV price to be available which can be over a day later in the case of Asian or world underlyings. Xtrackers has close to thirty APs who trade in ETFs and the underlyings and have developed expertise in pricing and trading even in stressed market scenarios.

- D. Should ETFs warn investors that the ETF may temporarily become a closed-ended fund in certain market conditions? Would requiring an ETF to remain open-ended in a stressed market be disadvantageous to existing investors or have other unintended consequences?**

There are disclaimers and provisions in the Prospectus which allow the fund to be closed in exceptional circumstances so investors should already be informed of this fact. For example, if an ETF's quotas to access a restricted market was exhausted e.g. QFII quotas to access China in the past, which would have required the fund to be closed for subscriptions due to local authority restrictions.

- E. Is it correct to permit share classes to be structured having regard to the operational concerns of APs and the impact this may have on secondary market pricing?**

Yes

**Are there factors (other than those noted above) that could be relevant to ETF structuring?**

Yes, including but not limited to index provider, transfer agency, portfolio management requirements, and operational set up.

- F. What are the benefits or disadvantages of permitting listed and unlisted share classes within the same investment fund? Do listed and unlisted share classes create unfairness as between investors in the same investment fund and if so, can these be mitigated or addressed?**

We do not believe listed and unlisted share classes create unfairness. As long as the existing investors and investors entering/leaving either of the share classes are treated fairly and equally.

## **Section II Questions**

- G. Are conflicts of interest rules effective for dealing with concentrations of activities within an ETF provider's financial group (e.g. group entities could act as promoter, investment manager, AP and swap counterparty or SFT counterparty)? Are other approaches worthy of consideration?**

We do not see any issue with existing conflict of interest rules as UCITS provides a framework for managing these effectively, including when group entities may do more than one role.

- H. Are multiple counterparties necessary, or appropriate for ETFs? Could they expose ETFs to unintended risks and consequences?**

No. We believe it can be appropriate for an ETF to utilise either the multiple swap or the single swap counterparty structure. Where there is a choice of suitable swap counterparties with favourable swap pricing investors may consider it a benefit to diversify any counterparty risk.

Alternatively, if one counterparty is particularly well placed to offer competitive market access or favourable tracking error levels, it may be in the best interest of investors for the ETF promoter to work with that single swap counterparty. Similar situation may also exist where an ETF has a low level of AUM and it would not be economical to have more than one swap counterparty.

Deutsche Asset Management is therefore of the view that it can be appropriate to determine on a case-by-case basis whether an ETF should have a single or multiple swap counterparties. In each instance the counterparty or counterparties need to meet the required standards in terms of being an eligible first class institution.

Deutsche Asset Management believes that transparency with regards to counterparties is important and it should be clear to investors which swap counterparties the ETF is facing.

- I. Some academic research suggests that if a synthetic ETF experiences counterparty default, the synthetic ETF is more likely to be able to deliver the performance of its underlying index if the collateral received is correlated to that index. Should collateral received (where a funded model is used) or securities purchased (where an unfunded model is used) be correlated to the index being tracked? Is this practical, particularly for example where the index tracked by an ETF is comprised of securities which may be relatively expensive to access? Is collateral quality sufficiently regulated and disclosed?**

Imposing collateral correlation requirements may be an ineffective way of controlling for risk. While we do consider correlation in determining appropriate collateral baskets, we place a greater importance on collateral quality and liquidity in judging the potential effectiveness of a collateral basket.

It is worth noting correlations can be unstable over time, particularly during times of market stress, and an overreliance on statistical correlation figures in determining risk can be inappropriate. We place an importance on collateral quality and liquidity as we believe these metrics are critical in anticipating the effectiveness of collateral in times of market stress. These conditions equally apply to securities lending transactions for physical funds, as they do to funds in general.

For example, while certain emerging market debt may show high levels of correlation to other emerging market debt issuances during normal market conditions it could be considered inferior to high quality developed market government debt collateral in times of market stress as the higher quality and more liquid securities are more likely to achieve a realizable value in the market, if required.

Imposing a strict correlation requirement can also introduce an inefficiency in the structure. One of the benefits of the synthetic ETF structure is that it can be more efficient to utilise a swap rather than directly investing in certain securities or markets. Imposing a requirement for the fund to hold highly correlated securities could remove some of this benefit as it would limit the types of securities the fund could purchase or hold as collateral, despite the fact that there might be a good availability of appropriate securities which meet quality and liquidity requirements. For example, Irish stamp duty would mean that investors would directly or indirectly face a significantly higher cost if this was a requirement of the invested assets. In certain restricted markets it is practically not possible to take certain securities due to local market, currency or security restrictions.

We are generally of the view that collateral quality is already sufficiently regulated and disclosed.

### **Section III Questions**

- J. Are active strategies appropriate for “housing” in an ETF structure and if so, is there a limit to the type of strategy that would be appropriate? If the ETF structure provides opportunities for managers to achieve scale is there a downside to this where the strategy is active (or, if scale is achieved, its potential impact is not otherwise capable of being ascertained)?**

As the paper recognises there are a number of reasons for the recent growth in ETFs. While increasing interest in passive strategies has contributed to demand for ETFs, it is important to recognise that additional benefits from the ETF structure exist. Our view is that if some of these benefits can be made available to investors, for example the intrinsic benefits of the ETF structure (such as secondary market trading), then we do not see why these should be withheld.

It would therefore follow that the availability of the ETF wrapper for some active strategies could be a benefit to investors.

- K. Similar to the question posed in Section I, is portfolio transparency fundamental to the nature of an ETF or are there are other mechanisms which achieve the same goal as transparency? In the context of an active ETF, is transparency essential in order to achieve a liquid market and to facilitate efficiency in pricing?**

While transparency is a desirable quality we do not see it as fundamental to the nature of the ETFs. If a market participant can price an illiquid bond of a company then pricing a basket of securities that the ETF tracks can certainly be possible. Methods such as those discussed in the paper are indeed worth considering as viable routes.

#### Section IV Questions

- L. **Some commentators are concerned that ETFs are tracking indices of underlying stocks which are not sufficiently liquid to match the intra-day liquidity on the secondary market which the ETF offers. This statement is quite simplistic and does not, for example, reflect that there may be much secondary market activity but very little primary market activity. UCITS, including UCITS ETFs, are subject to general liquidity management rules which should ensure that ETFs track indices of underlying stocks that are sufficiently liquid to allow the ETF to meet creation and redemption requests. Is this sufficient?**

Yes, the following UCITS eligibility rules are adequate to ensure the ETF can sufficiently meet creation and redemption requests:

- Eligible assets requirements ensure potentially illiquid assets are not permitted such as private equity, hedge funds and non-financial indices
- Eligible markets requirements adequately ensure that UCITS can only invest in regulated markets which are recognised and open to the public
- Liquidity rules ensure a UCITS fund must re-purchase or redeem its shares / units at the request of any unit holder.
- Diversification rules (unlisted securities, 5/10/40, control and borrowing rules..) ensure risk is controlled and spread across multiple securities

The existence of the secondary trading market for ETFs provides an additional buffer of liquidity where buying and selling activity can be netted of between clients and brokers and a residual amount (not all individual trades) flow through to the primary market where new units are created to satisfy demand, or existing units are redeemed when there is excess inventory

#### **What liquidity practices do ETFs follow? Are there other practices that might be appropriate for ETFs?**

At Deutsche Asset Management, liquidity is at the centre of the planning process when selecting a potential index for a new ETF product. Our Portfolio Managers performing liquidity screening on an existing index and if required will request a customised index to ensure liquidity profile are appropriate and enable the portfolio managers to track the benchmark within tolerance and allow for market makers to provide adequate liquidity and pricing in the secondary market.

- M. **One of the potential impacts from greater investment in index-tracking ETFs is decreased informational efficiency of underlying securities as well as increased non-fundamental volatility of underlying securities. However, these may not be risks *per se* or, at any rate, may not be risks that ETF providers or regulators can mitigate, manage or eliminate. Is this assessment correct or could measures be taken to address this impact?**

ETFs create no added disadvantage compared to mutual funds or other index tracking vehicles, but have the advantage of price discovery. The price of an ETF can be considered to include informational efficiency as brokers use real time pricing of the underlying securities in the ETF to derive a fair value from which they price the ETF to clients.

With regards to an increase in non-fundamental volatility of underlying securities; if ETF's did not exist, then an investor seeking exposure to an index would still have the option of direct investment into the underlying securities. As such, the use of an ETF does not cause additional non-fundamental volatility of the underlying securities as the securities would be traded either way.

For example: The perceived "decreased informational efficiency" of underlying securities as well as "increased non-fundamental volatility" of underlying securities would also be caused by any delta one vehicle such as futures and swaps so ETFs should not be singled out as the only investment product.

- N. **One of the key issues in the context of support by ETF providers is investor expectation. Investors' views about purchasing ETFs and their ability to sell may be informed by whether or not the ETF provider will support the ETF in the face of stress events. There are, however, divergent views amongst ETF providers as to whether they would support their ETFs. Is provider support a desirable objective?**

It is not feasible to allow all investors to redeem shares directly with the provider. It would need for every single end investor to complete onboarding / KYC in order for the client to "potentially" one day approach the provider for a redemption.

Furthermore, what scenario or scenarios would be considered as a trigger for when an investor could skip the secondary market and directly approach the provider for a redemption also is a challenge.

Example 1; if a client couldn't sell Vodafone shares on exchange due to volatile markets then Vodafone is not required to buy back the shares directly from the client.

Example 2; We do assist periodically for clients to sell their shares when there is secondary market disruption: a Swedish client who held a position in a delisted ETF to move their shares from the Swedish depository holding to German depository holding from where they could sell the German listing and receive sale proceeds.

### **Section V Questions**

- O. The Central Bank is primarily interested in risks associated with Irish authorised ETFs and European ETFs more generally yet much of the available academic literature, analysis and data relates to US ETFs. The concern is that any analysis of Irish authorised and European ETFs may be adversely affected by our reliance on US-centric materials. Is this valid? Are Stakeholders aware of EU ETF specific information that might lead to different conclusions? Will MIFID II resolve these data issues?**

US and European ETFs share similar structures and trade using similar infrastructure (exchanges, RFQs, MTFs) so US centric materials can provide a good foundation of knowledge for risks associated with Irish authorised ETFs and European ETFs. Certain parts of MiFID II, such as the mandatory trade reporting requirement of all OTC trades, will bring the reporting and transparency of European ETFs in line with the US ETF market.

- P. Does the nature of an ETF have peculiarities (and therefore risks) that neither the UCITS nor MiFID regulatory frameworks, either in isolation or in conjunction, address and which has not been examined here?**

We consider UCITS and MiFID regulatory framework addresses ETFs. An area where there could be more transparency is knowing who the end investor is of an ETF. In the US, there is a quarterly requirement for investors to disclose their ETF position, this information is also published on Bloomberg.

An enhancement which would also benefit the transparency of European ETFs would be the creation of a EBBO (European best bid offer) which could show clients a consolidated overview of which of the many exchanges an ETF can be listed on has the best bid offer at that point in time. Also, a more streamlined communication channel within custodians between nominee and beneficiary accounts would ensure that notifications of fund closures, delisting's and dividends would definitely reach end investors which isn't always the case.