

Funds Policy
Central Bank of Ireland
New Wapping Street
North Wall Quay
Dublin 1

10 August 2017

Dear Sirs,

Responses to ETF Discussion Paper

We refer to your recently issued ETF Discussion Paper.

Please find attached our responses (in **blue**) to each of the questions raised therein.

Yours sincerely,

Sent by email and accordingly bears no signature.

Stuart Forbes
Legal counsel

Central Bank of Ireland Discussion Paper 2017
Exchange Traded Funds
ETF Securities response – 10 August 2017

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

ETFs Response: Our view is that APs/OLPs should not be subject to additional onerous requirements that will discourage their participation as APs/OLPs for ETF issuers. The activities of market makers and OLPs when dealing on stock exchanges is governed by the listing rules of each exchange. Accordingly, any new requirements should be considered by way of an amendment to listing rules primarily rather than through the creation of a separate set of regulations. However, the most preferable approach would be the creation of a harmonised approach to rules applicable to APs/OLPs across the EU.

It is worth noting that any new obligations imposed on APs/OLPs will necessarily lead to an increase in their compliance and operating costs which they will seek to pass on to ETF issuers. As the management fees charged to ETFs are relatively low compared with traditional UCITS funds, ETF issuers will not be inclined to absorb additional costs passed on by APs/OLPs. Accordingly, end-investors would likely see an increase in ETF management fees and/or transaction costs when dealing on exchange as a result of any new regulatory obligations imposed on APs/OLPs.

However, we do believe that ETF issuers should have in place an OLP for each fund that is contractually obliged to provide bid/offer prices for the ETF subject to the rules imposed by the relevant stock exchanges, or, ideally, by a new set of harmonised rules.

- 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? If ETFs are not transparent does this have unintended consequences?

ETFs Response: Our view is that ETFs are no different from traditional UCITS funds in terms of whether or not full transparency regarding the portfolio is needed. Any requirement attaching to ETFs should apply equally to traditional UCITS funds.

If it becomes mandatory for ETFs to publish their portfolios on a daily basis, then we will almost certainly see a premature end to the growth of actively-managed ETFs as they would have an unfair disadvantage versus traditional actively-managed UCITS funds that are not required to publish their portfolios (i.e. ETF investment managers would be publicising their proprietary day-to-day portfolio allocations which would enable others to simply copy them rather than invest in the ETFs that they manage).

All that is needed (in order for the secondary market to function properly) is transparency between the ETF issuer and market makers who provide two-way pricing on exchange. Accordingly, the issuers of actively-managed ETFs may prefer to disclose portfolio composition information solely to a single market maker pursuant to a market making agreement that obliges that market maker to support the relevant ETF as the OLP. Whilst this means that the arbitrage opportunity disappears as other market participants cannot see the fair value, it should not negatively impact the ETF or investor. This is because, if the sole market maker does not provide tight bid/offer pricing, there will be little demand, therefore commercial incentives will effectively police any lack of tight two-way pricing.

If the Central Bank is adamant that ETFs publish their portfolio holdings, then we believe the following would be a fair compromise:

- For passively-managed ETFs (i.e. which simply track/replicate an index), the requirement regarding frequency of publication of the portfolio should be that the ETF issuer mirrors the frequency of publication of the index constituents. As the constituents of an index are only required to be published after each rebalance (so long as prior to the next occurring rebalance) in order for them to be eligible for investment by UCITS funds, the requirement imposed on ETFs themselves should be the same.
- For actively-managed ETFs, the requirement to publish portfolio holdings should be infrequent (perhaps semi-annually) so as not to discourage managers from launching new ETFs. However, any requirement imposed on ETFs should be equally imposed on traditional actively-managed UCITS funds in order to ensure that there is a level playing field. Otherwise, you will simply discourage the growth of actively-managed ETFs. Notwithstanding the foregoing, ETF issuers would obviously need to provide market makers with daily portfolio composition files as stated above.

- 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?

ETFs Response: The current requirement that was introduced via the ESMA Guidelines was ill conceived and does not work in practice. As the Central Bank has correctly recognised in Schedule A of its discussion paper, Irish ETF issuers can only accept redemption applications from legal shareholders (i.e. persons/entities who appear on the relevant register of shareholders for the relevant share class).

In order to facilitate the stock exchange listing of ETF share classes, all ETF shares are admitted to one or more recognised clearing and settlement systems which enable the shares to be traded electronically. Generally, end-investors who purchase and sell their units on stock exchanges typically do not appear on the electronic shareholder register. This is because they typically hold their units via an intermediary (broker/nominee) which appears on the shareholder register on their behalf. By way of example, in the United Kingdom, Barclays Stockbrokers and Hargreaves Lansdown may appear on the electronic shareholder register in respect of thousands of underlying beneficial holders (i.e. end-investors). It is impossible for us to verify the identity of the end-investors as that information would be confidential to Barclays Stockbrokers and Hargreaves Lansdown.

For end-investors who purchase and sell their units on foreign exchanges which use alternative clearing and settlement systems (e.g. Deutsche Borse, Borsa Italiana, NYSE Euronext and the SIX Swiss Exchange), end-investors will be a further step removed from the electronic shareholder register (see simple examples below). This is because the relevant clearing and settlement system used by a particular stock exchange will usually appear on the electronic shareholder register as the relevant shareholder in respect of all investors who purchased their units on the relevant foreign exchange. The foreign settlement system will in turn have its own records as to the local intermediaries (brokers/nominees) who hold on behalf of end-investors.

Stock exchange on which ETF shares purchased	Shareholder (intermediary) appearing on CREST Share Register			
London Stock Exchange	Intermediary (i.e. broker / nominee)	→	End-investor	
Borsa Italiana	Monte Titoli SPA	→	Intermediary (i.e. broker / nominee)	→ End-investor
NYSE Euronext	Euroclear Nominees Limited	→	Intermediary (i.e. broker / nominee)	→ End-investor
Deutsche Borse	Vidacos Nominees Limited	→	Intermediary (i.e. broker / nominee)	→ End-investor
SIX Swiss Exchange	SIX SIS AG	→	Intermediary (i.e. broker / nominee)	→ End-investor

Accordingly, it is not possible under the current framework for ETF issuers to accept direct redemption requests from end-investors. Furthermore, a practical solution would not be possible without a structural change to the way that securities are owned and traded across Europe. Top-to-bottom transparency in a new harmonised system would be needed so that ETF issuers could identify legitimate beneficial holders seeking to redeem directly with it.

Additionally, given the secondary market nature of ETFs, the number of end-investors is potentially huge. Accordingly, if it was possible for end-investors to redeem directly with ETF issuers, the administrative burden would be huge. This is because anti-money laundering assessments as well as shareholder entitlement would need to be assessed for each redeeming investor and this would require a large number of administration and compliance personnel. Having to employ a full team of people to deal with such unlikely events would be totally disproportionate. It would be far more appropriate to simply oblige every ETF provider to have an appointed OLP for each product so that secondary market liquidity is, subject to sufficient liquidity in the underlying investments of the ETF, always available.

- 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?

ETFS Response: Again, our view is that this discussion applies equally to non-ETFs. Accordingly, our comments below relate to UCITS funds generally.

UCITS are only as liquid as their underlying investments. If a UCITS is not able to sell all of (or the majority of) the investments that it holds at any given time, then it would not be able to realise sufficient cash to satisfy redemption requests. If on any given day a UCITS is forced to permit redemptions in circumstances where a significant proportion of its holdings are not tradeable, then the UCITS would be forced to sell a

disproportionate amount of its liquid assets in order to satisfy the redemptions which would be unfair for investors who remain invested in the UCITS after such point (i.e. remaining investors would be stuck in an ETF that only holds the least liquid of the original suite of investments).

It is far more appropriate to regulate the type of investments that a UCITS can buy so as to ensure that UCITS are only investing in assets that are sufficiently liquid in normal market conditions. However, this is already legislated for in the CBI UCITS Regulations.

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

ETFs Response: We support taking into account the operational input of APs when constructing ETFs as APs are essential participants in ETF operating models. AP input is critical to the design of operational procedures that suit the particular underlying markets that ETFs invest in.

- 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?

ETFs Response: Other than the ability to deal directly with the Fund issuer, there are no differences between a listed and unlisted share class of an ETF.

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Creating unlisted share classes can be advantageous in terms of growing a fund and creating economies of scale in terms of portfolio management costs. For example, you can create an unlisted share class with a lower TER than the listed class. You could also set minimum investment subscription amounts and/or investor criteria for that unlisted share class to ensure that the administrative burden of running that share class does not become too great. The lower TER for the unlisted share class is justifiable on the basis that (i) the unlisted share class does not require an OLP to support its listing thereby reducing the management company's cost in running that share class; and (ii) you can attract large investments into the unlisted class which benefit the Fund as a whole due to the reduced overall costs in running the Fund (i.e. economies of scale with respect to portfolio management).

It is worth pointing out that many of the larger investors that invest in ETFs have the ability to invest directly in and manage their positions in the underlying assets themselves (i.e. equities, bonds, commodity futures and derivatives) without needing to invest in ETFs that provide exposure to those assets. Accordingly, by creating an unlisted share class at a lower TER, you incentivise such investors to invest using the unlisted share class of the Fund instead of investing directly in the underlying assets themselves.

An additional point around listed and unlisted classes is that certain Double Taxation Agreements between Ireland and other countries may have specific criteria that have to be met for a UCITS to avail of particular tax rates, which can include exchange traded turnover. Therefore, the creation of unlisted share classes within a UCITS sub-fund that also has listed share classes may cause the relevant UCITS sub-fund to lose the benefit of a more favourable tax rate. Furthermore, this may be assessed at the level of the UCITS umbrella rather than at the level of each sub-fund and therefore the proportion of assets in listed and unlisted share classes could determine the outcome for the umbrella (and all of its sub-funds) as a whole.

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?

ETFS Response: Again, our view is that this discussion applies equally to non-ETFs. Accordingly, our comments below relate to UCITS funds generally.

Our view is that where swap counterparties are part of the same financial group as an ETF issuer, conflicts of interest rules should be sufficiently robust to deal with conflicts in the context of charges and valuations.

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

ETFS Response: Again, our view is that this discussion applies equally to non-ETFs. Accordingly, our comments below relate to UCITS funds generally.

Our view is that, for synthetic UCITS, multiple counterparties are desirable where this is commercially viable. When launching new UCITS funds under an existing synthetic model, it should be straightforward to amend trading documentation with existing counterparties to include the new UCITS funds. This would mean that the investment manager can allocate swaps to the cheapest counterparty in the first instance but would have back-up counterparties ready to re-allocate to in the event that the counterparty with the current allocation becomes less creditworthy or seeks to increase the swap fees that it charges to the UCITS.

However, in terms of the actual allocation of swap balances to such counterparties, it would not make sense to always be forced to split the allocation across multiple counterparties as some counterparties may charge significantly higher swap fees than others (such swap fees are charged directly to the UCITS as portfolio transaction costs). You will note that, pursuant to best execution requirements, investment managers take into account the charges levied by swap counterparties in terms of how they decide to allocate swap balances so as to achieve the best financial result for investors in the UCITS. If UCITS funds are forced to allocate swap balances to multiple counterparties, this would negatively impact on their performance as they would be forced to allocate swaps to a mixture of cheap and expensive counterparties.

We think that it would be better if the best execution requirements imposed on UCITS management companies be updated if necessary to take into account counterparty concentration risk as one of the best execution criteria by reference to which UCITS management companies must make their allocation decisions rather than imposing a requirement on UCITS to use multiple counterparties in all cases.

For some more complex UCITS funds, it may not be commercially viable to appoint multiple counterparties for a single fund given the operational complexities faced by counterparties of hedging certain indices or strategies. For some indices or strategies, counterparties may not be willing to support the structuring and development process for new funds unless they are given the full swap allocation. Again, we think that counterparty concentration risk (i.e. whether or not multiple counterparties are required for a given fund) should be a matter of determination for the UCITS management company in the context of best execution principles.

- 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?

ETFS Response: Again, our view is that this discussion applies equally to non-ETFs. Accordingly, our comments below relate to UCITS funds generally.

Our view is that correlation between a UCITS fund's collateral and the constituents of the index that it tracks would not be a sensible means of determining the eligibility of collateral for a UCITS fund. UCITS funds will use a synthetic structure to track their indices for a variety of reasons. One is obviously cost as it may be cheaper for large investment bank counterparties to access certain markets using their existing infrastructure.

Additionally, collateral is not only applicable to *synthetically-replicating* UCITS. A huge proportion of *physically-replicating* UCITS engage in stock lending. Accordingly, to maintain a level playing field, any changes to collateral requirements should be consistent across all types of UCITS, whether they are *synthetically-replicating* (i.e. funds which use total return swap models to replicate their corresponding indices) or *physically-replicating* (i.e. funds which invest directly in the constituents of the corresponding indices but which also engage in stock lending).

Therefore, our view is that, if the Central Bank's aim is to limit deviation from an index in a counterparty default scenario, then any counterparty exposure requiring collateral (whether in a synthetically-replicating UCITS or a physically-replicating UCITS) should be captured, otherwise the rule would be biased.

It is worth pointing out that, if it was to become a requirement that collateral be correlated with the constituents of the tracked index, this would mean that a physically-replicating UCITS would need to receive similar securities to that which it has lent out, which would probably reduce the efficiencies (and therefore cost benefit) of the stocklending model.

It should also be considered why a fund might be synthetically replicated. For example, a UCITS tracking a commodity index would not be permitted to accept commodity futures or physical commodities as collateral. Furthermore, if the collateral effectively matches the index and therefore similar cost structures apply, there is effectively no point in being synthetically-replicated. UCITS that provide short (i.e. inverse) exposure would also not be able to satisfy this criteria.

It would be more appropriate to define the appropriateness of collateral by reference to actual liquid markets rather than by reference to the constituents of the index (for example, *equities* listed on major US, Canadian and EEA exchanges and *bonds* issued by governments and or supranationals with a minimum credit rating). Accordingly, we would support the imposition of more defined rules on types of collateral that should be permitted, however, detailed prescriptions of eligible collateral should be avoided as that would simply drive up the costs charged by counterparties. It is important that UCITS management companies retain a certain amount of flexibility in this regard in order to ensure that the cost of entering into swap and/or stock lending arrangements does not become unnecessarily expensive.

Finally, it is worth noting that, in the context of investor due diligence (which typically involves investors sending detailed RFP due diligence questionnaires to fund providers), collateral quality is one of the most heavily covered areas. Investors often require detailed responses regarding the collateral selection criteria and management processes employed by the investment manager and often review the actual collateral holdings of a fund as part of their due diligence. Accordingly, collateral quality is already subject to a significant amount of investor scrutiny.

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)?

ETFS Response: Our view is that actively-managed ETFs should be categorised according to how complex they are and how much discretion the investment manager has.

- 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?

ETFS Response: Please see our response at Section 1(B) above.

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

ETFS Response: Our view is that the existing liquidity rules applicable to UCITS are sufficient. Both the secondary market liquidity and the primary market liquidity of an ETF are consequent to the liquidity of the underlying assets of the ETF. If market makers and APs are able to hedge their exposures by trading the underlying assets of the ETF, then they will equally support the secondary and primary market trading of the ETF.

However, no instrument has infinite liquidity and certainly there are indices that are less liquid that are still suitable to be in an ETF format. It should be noted that an ETF issuer cannot control investor demand and assets may grow unexpectedly. In this scenario, it may be suitable in extreme circumstances to limit or suspend subscriptions (but not redemptions). Otherwise portfolio rebalances may be problematic.

- 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 Response: An increase in index-tracking products generally, rather than ETFs specifically is probably more appropriate for discussion. Any index-tracking product (whether an ETF, traditional UCITS fund or other type of collective investment scheme) will increase the behaviour discussed above. This type of question is not necessarily straightforward and papers can be written on this topic alone with varied interpretations of the results. We believe that, from a more simplistic view, it needs to be determined what percentage of transactions in an underlying security are related to index-tracking products. Firstly, if markets (and particularly individual stocks) are losing informational efficiency, that should naturally provide opportunities for active managers and stock pickers. Is it a risk or problem if an index-tracking product does start to impact stock prices and volatility?

Demand for index-tracking products ultimately represents investor demand for certain types of security (i.e. primarily equities and bonds) and, specifically, the broad exposure to such securities that an index seeks to represent. If a certain underlying security is included within an index, it seems that the purchase of that security is based ultimately on investor demand. The index selection criteria are scrutinised by sophisticated investors which adds more weight to the investor demand behind the individual trading of an index constituent. As such, not all trading in index-tracking products should be viewed as automatic and indifferent. Each index can be very different and an increased number of indices are utilising alternatively-weighted methodologies (i.e. not a traditional market-cap weighting methodology). For example, if there is significant inflow into an index-tracking product, it implies that there is a significant demand for the exposure which that index provides, and so, for the index-tracking product to then impact the underlying stocks is representative of investor sentiment towards the specific exposure. Informational efficiency should ultimately be realised when a security engages in any form of corporate activity where the specific demand in that company will be tested on the wider market rather than the index-tracking product. An index-tracking product will aim to keep its weighting constant during such an event.

- 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?

ETFS Response: Please see our response at Section 1(D) above. Again, our view is that this discussion applies equally to non-ETFs. Accordingly, our comments below relate to UCITS funds generally.

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?

ETFS Response: Our view is that existing literature pronouncing the so-called risks of ETFs should be treated with caution. ETFs are largely invested in common equities and bonds and therefore do not offer any

additional risks that are not already present in traditional UCITS funds which invest in the same types of assets.

However, one area that we would recommend that the Central Bank considers further is that of shareholder communications. As we have described in Section 1(C) above and as the Central Bank correctly points out in Schedule A of its discussion paper, end-investors do not appear on the shareholder register for ETF share classes. Accordingly, when an ETF issuer sends out shareholder notifications or invitations to vote at AGMs/EGMs, such notifications often do not reach the end-investor. Currently, there is no EU-wide rule that obliges each intermediary in the chain of ownership to pass shareholder communications to the beneficial holder beneath them in the chain of ownership. You will note from the table that we have included at Section 1(C) above, that with respect to end-investors trading on the Deutsche Borse, NYSE Euronext, Borsa Italiana or the SIX Swiss Exchange, there are at least two nominees/intermediaries interposed between them and the ETF issuer.

Germany has imposed a requirement on banks who act as intermediaries that forces them to forward shareholder notifications down to the beneficial holders beneath them in the chain of ownership. Pursuant to that rule, such banks are then permitted to charge the cost of posting those shareholder notices to the relevant ETF issuer that issued the shareholder notification.

A harmonised requirement needs to be considered for implementation across the EU as a whole such that all shareholder notifications (whether relating to an ETF or a normal equity) are passed down the chain of ownership by every intermediary. It is our view that it would be sufficient for each intermediary to send an electronic notification to underlying beneficial holders rather than sending hard copies by post. This would be more cost efficient and more likely to receive industry support.¹⁰

- 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?

ETFS Response: Please see response at Section V(O) above regarding shareholder communications for which we believe that a harmonised EU-wide obligation on forwarding shareholder communications should be considered.