THE
INVESTMENT
ASSOCIATION
INVESTMENT MATTERS

The Investment Association
Camomile Court, 23 Camomile Street,
London, EC3A 7LL

T +44 20 7831 0898
E enquiries@theia.org
W theinvestmentassociation.org
Twitter @InvAssoc

Date: 1 September 2018

To whom it may concern,

RE: Exchange Traded Funds, CBI Discussion Paper

The Investment Association ('the IA') represents UK investment managers and has over 200 members who manage more than £5.7 trillion of behalf of clients in the UK and around the world.

Since their development, ETFs have become an increasingly popular investment option, and the IA operates an ETF Committee whose membership covers more than 80% of the European ETF market.

We therefore welcome the opportunity to respond to the CBI's Discussion Paper on Exchange Traded Funds. We would like to use this opportunity to stress the advantages ETFs offer, as well as the need to avoid onerous and unnecessary additional regulation.

The IA considers that ETFs offer a number of benefits to investors.

- Transparency
    - Investors can generally see the composition of an ETF at any given time, and pricing is continuous through-out the day.
- Cost-effectiveness
    - ETFs offer a cost-effective route to diversified market exposure, in part because they do not require the additional operation costs, settlement and reporting infrastructure that other index products require. They also provide investors with the ability to estimate in advance the total cost of ownership.
- Diversification
    - ETFs offer immediate exposure to a basket or group of securities in a broad range of asset classes for diversification through a single trade.
- Flexibility
    - ETFs are listed on exchanges and can be traded on the secondary market at any time the market is open, and require no commitment or minimum fee. No notification of investment or withdrawal is needed. ETF shares can be created or redeemed in kind by authorised participants (APs), ensuring the shares in issue and the net asset value of the ETF are closely aligned.
- Additional liquidity
    - ETFs offer two sources of liquidity – traditional liquidity as measured by secondary trading volume, and the liquidity of the underlying assets via the

creation and redemption process. ETFs have proved an excellent source of liquidity in recent years, notably providing a method of price discovery when underlying markets aren't open, as occurred during the Greek economic crisis.

The ETF market in Europe is generally functioning very well, and has proved attractive to investors during stressed market periods, such as the aftermath of the Brexit referendum result in the UK. The European ETF market is currently subject to multiple strong regulatory frameworks, including the UCITS Directive, the Prospectus Directive and the MiFID Directive (to be replaced by the MiFID II framework from 3 January 2018). The extensive and rigorous analysis undertaken by the CBI demonstrates that while there are theoretical risks associated with the operation of ETFs, the existing regulatory framework addresses these risks and ensures these are properly disclosed to investors. There is little evidence that an additional framework would be beneficial, and the IA is concerned that unnecessary regulation could have unintended consequences and harm, rather than help, consumer outcomes.

In particular, the IA is concerned that the CBI should avoid:

- Over-regulation of APs.
    - APs are vital members of the ETF chain, and while counterparty risk is a factor as it would be in other structures, there are very few examples of AP arrangements breaking down. Even in these instances liquidity was uninterrupted, as different APs were able to step in to provide liquidity. There is therefore no obvious need for further regulation. The IA is concerned that overly onerous regulation of APs will, ultimately, result in a smaller number of liquidity providers and negatively impact the liquidity on which ETF markets rely.
- Over-regulation of ETFs compared to traditional fund structures.
    - It is important that ETFs not face undue regulatory restrictions when compared to other fund structures. ETFs may face different risk factors to traditional funds. However, the applicable regulations (including ESMA's Guidelines on ETFs and other UCITS Issues) already address these. What's more, the extra liquidity provided by ETFs can lend it an advantage when compared to traditional fund structures during stressed market situations. Likewise the transparency obligations of ETF structures mean that disclosure to investors is robust, timely and often superior to other types of funds, ensuring market participants have the information needed for the ETF market to function.

If the CBI does feel that changes to ETF requirements are necessary, these should be considered by way of amendments to listing rules rather than the creation of a separate set of regulations. The most preferable approach would be the creation of a harmonised approach to listing rules across the EU.

The IA remains committed to well-functioning markets that work for the benefit of end clients, and welcomes further discussion of any of the items raised in our response.

Yours sincerely,

Galina Dimitrova

Director – Investments and Capital Markets

ANNEX I

RESPONSES TO QUESTIONS

SECTION I: ETF DEALING

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?

The list of APs, OLPs and other market makers are already readily available in many cases from ETF providers and exchanges.

The IA's view is that it is not necessary for OLPs and ALPs to subject to additional requirements. Overly onerous regulation would discourage the participation of APs/OLPs in the ETF market, ultimately resulting in a smaller number of liquidity providers and negatively impact the liquidity on which ETF markets rely.

In addition, any new obligations would inevitably lead to an increase in compliance and operating costs for APs and OLPs, which would likely ultimately be passed on to end investors.

In particular, the IA rejects the disclosure of remuneration data or models for the following reasons:

- Remuneration is not a cost paid by the final investor, as listing costs are borne by the asset manager, who will appoint a market maker to list and provide bid/offer quotes for its products;
- Remuneration may change over time;
- Models may vary from one provider to the other; and

Remuneration models are private commercial arrangements, and transparency here seems neither useful nor appropriate given that there is no impact on the costs borne by final investors.

Any new requirements for ETFs should be considered by way of amendments to listing rules rather than the creation of a separate set of regulations. The most preferable approach would be the creation of a harmonised approach to listing rules across the EU.

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?

There is some merit in transparency with reference to the underlying securities held by the ETF and passive providers already provide details of fund holdings. Investors buying passive ETF investors must be sure the ETFs in which they are investing accurately replicate the relevant underlying index.

However, full transparency regarding ETF portfolio composition is not necessarily suitable, particularly for actively managed ETFs for whom this will be proprietary information.

The IA notes that market makers already have access to the fund investment portfolio, in order to ensure that they are able to properly assess the actualised value of the ETF assets and the value of the shares the ETF buys or sells on the market. This then allows them to provide fair and clear pricings of the ETF on the secondary markets.

It is important that ETFs not face undue regulatory restrictions when compared to other fund structures. ETFs are subject to UCITS, and should be treated no differently from traditional UCITS funds. If it becomes mandatory for ETFs to publish their portfolios on a daily basis, actively managed ETFs would be at a disadvantage to traditional actively-managed UCITS funds. This would have an inevitable negative impact on the actively-managed ETF market.

C. Is the idea of secondary market investors dealing directly with an ETF when the AP arrangements break down 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?

The concept of secondary market investors dealing directly with an ETF when AP arrangements break down is not workable in practice. This is because ETF providers often have no sight of the identity of end-investors, who typically hold their units via an intermediary whose name appears on the shareholder register on their behalf. As a result it is not currently possible for ETF issuers to accept direct redemption requests from end-investors, nor will it ever be possible without a structural change in the way securities are owned and traded across Europe.

What's more, even if were possible to identify end-investors, the number of end-investors is potentially very large. As a result, if it was possible for end-investors to redeem directly with ETF issuers, the administrative burden would be very significant.

Finally, even if it were possible for end-investors to deal directly with an ETF, this mechanism would not solve issues arising due to liquidity issues on the underlying securities of an ETF.

However, the possibility of AP arrangements breaking down is remote. By way of example, in August 2012 Knight Capital Group, who acted as a major AP counterparty, was forced to discontinue trading while it restructured. Liquidity was completely uninterrupted, as different APs stepped into provide liquidity.

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?

ETF managers will always allow dealing where possible and where this will not cause prejudice to investors, in line with the mostly open-ended nature of ETFs and their obligations under the UCITS regulations.

However, the nature of ETFs means they incorporate elements of open-ended and closed-ended funds. In the event that the basket of underlying securities is no longer tradable under stressed market conditions, it would be detrimental to existing investors that the fund remains open-ended, as the creation of new shares could no longer be covered by the purchase of underlying securities, and redemptions could no longer be covered by their sale. In such market conditions, ETFs would have to become closed-ended until conditions return to normal or the fund could be liquidated.

The IA agrees that it is important that investors be made aware that ETFs may become a closed-ended fund in certain market conditions.

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?

Such flexibility, as is currently permitted by ESMA's guidance on share classes, is welcomed. By creating arrangements that suit the specific needs of APs, the functioning of an ETF may be improved by increasing the number of market makers available. These arrangements would only be provided where there is no prejudice to secondary market investors.

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 between investors in the same investment fund and if so can these be mitigated or addressed?

ESMA's Guidelines on ETFs and other UCITS issues would appear to permit listed and unlisted share classes within the same investment fund.

There may be some disadvantages to this, as it may creation *perceptions* of unfairness in certain areas:

- Value – the pricing of unlisted share classes will depend solely on underlying assets, whereas the price of listed share classes will also depend on stock exchange demand. The resulting difference in value may result in a perception of unfairness.
- Liquidity – the liquidity of unlisted share classes is dependent on the liquidity of the underlying assets, whereas listed share classes tend to be more liquid as a result of their listing. As a result, scenarios may arise where listed share investors can sell their investment whereas unlisted shareholders cannot.
- Mis-selling risk – Investors might expect the asset they are buying to be listed, whereas the unlisted share class is not. This will need to be disclosed and carefully managed.

However, permitting listed and unlisted share classes within the same investment fund creates optionality for investors by providing a different entry point with the same investment objectives, but with different characteristics, liquidity profiles and risks. This optionality may serve to attract new investors and increase the size of the fund, which in turn creates economies of scale in terms of portfolio management costs.

The IA considers that offering both listed and unlisted share classes of a fund does not in itself create unfairness, despite the possibility for that perception to arise. Instead, the differences between the two share classes offer optionality that will benefit different investors with different approaches. 'Fair' treatment does not necessarily equate to 'equal' treatment, and it is possible to be fair to investors in both classes without treating them equally in all respects, provided there is adequate disclosure of the risks and consequences of opting for a particular investment.

SECTION II: DISTINCTIVE ETF RISK FACTORS

G. Are there conflict 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 worth of consideration?

While it is important for ETF providers to manage the potential for conflicts of interest, the existing regulatory frameworks are sufficiently effective to allow them to do so, including when group entities perform more than one role. ETFs, along with other types of funds, are subject to conflict of interest rules under UCITS, along with best execution requirements. There is no evidence to suggest that ETFs should be subject to more stringent conflict of interest rules than traditional types of fund.

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

Where there is a choice of suitable counterparties with favourable pricing investors may consider it a benefit to diversify counterparty risk. In particular, for synthetic and complex ETFs, multiple counterparties may be desirable where this is commercially viable.

However, if one counterparty is particularly well placed to offer competitive market access or favourable tracking error levels, it may be in the best interests of investors for the ETF to use a single provider.

The IA considers that the choice of counterparties should be determined on a case-by-case basis. In making their choice, managers will be guided by best execution requirements.

The IA further notes that the question of counterparty risk is not a subject limited to ETFs, but also applies to other UCITS-regulated funds. There is no evidence to suggest that ETFs should be subject to different requirements than traditional UCITS funds.

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 funding 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 both impractical and ineffective in terms of controlling for risk.

One of the benefits of synthetic ETF structures is that it can be more efficient to utilise a swap rather than directly investing in a given security or market. A collateral correlation requirement would limit the types of securities the fund could purchase or hold as collateral, even where there may be other appropriate securities that would meet quality and liquidity requirements. For example, Irish stamp duty would mean that investors would face a significantly higher cost if this was a requirement of the invested assets, while in certain restricted markets it is not possible to take certain securities due to local market, currency or security restrictions. In addition, it is not possible, under UCITS diversification rules, to have commodity collateral, which would make it impossible to correlate with commodity indices.

What's more, correlations can be unstable over time, particularly during times of market stress. For this reason, while correlation is one consideration in determining appropriate collateral baskets, greater importance is placed on collateral quality and liquidity. For example, while certain emerging market debt may show high levels of correlation to other emerging market debt issuances during normal market conditions, it times of market stress it could be considered inferior to higher quality and more liquid developed market government debt. Significantly, it should be noted that these conditions apply equally to physical UCITS funds.

We note that the idea of requiring correlation between collateral received and the index was originally floated in a September 2011 ESMA consultation paper, but was abandoned as there was little evidence such correlation would add additional security to the existing requirements. In fact the IA considers that such a requirement could inadvertently end up increasing the costs and risks faced.

Once again, collateral issues apply to UCITS funds generally and not just ETFs. There is no evidence to suggest that ETFs should be subject to different requirements than traditional UCITS funds.

SECTION III: PARTICULAR TYPES AND FEATURES OF ETFs

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)?

While the vast majority of ETFs are passive, there has been considerable growth in actively managed funds in recent years. These funds offer active investors the traditional benefits of ETFs, including a diversified portfolio at relatively low cost and intraday liquidity via trading on an exchange. ESMA's guidelines currently state that it is possible to create actively managed ETFs.

The IA takes the view that it is the role of the asset manager to determine whether or not a strategy can be implemented through an ETF structure.

K. Similar to the question posted in Section I, is portfolio transparency fundamental to the nature of an ETF or are there 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?

See answer to question B.

ETFs AND MARKET LIQUIDITY

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 allow? Are there other practices that might be appropriate for ETFs?

The IA considers existing liquidity rules under UCITS to be sufficient.

The base line liquidity of ETFs is normally reflective of the liquidity of the underlying assets (primary market liquidity), as APs will react to demand for an ETF by creating or redeeming shares as necessary, and buying or selling the underlying securities.

ETFs also offer greater secondary market liquidity than traditional open-ended structures, as they provide intraday liquidity. Secondary market trading in ETF shares does not require transaction activity in the underlying securities and as a result ETFs can provide additive liquidity beyond that of the underlying assets. This can be seen during a number of recent events, including the:

- Financial Crisis (2008)
- European Debt Crisis (2010)
- US Treasury Downgrade (2011)
- Taper Tantrum (2013)
- Oil Sell-Off (2014)
- High Yield Sell-Off (2015)
- Brexit Referendum Result (2016)

ETFs can also provide a method of price discovery even when underlying markets aren't open, as occurred during the Greek economic crisis.

With that said, while ETFs offer additive liquidity and have proved resilient in times of financial stress, in rare circumstances there may still be incidences where it becomes necessary to suspend subscriptions and redemptions until market conditions return to normal.

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?

While much debated, there is little hard evidence that indexing has significantly increased non-fundamental volatility or diminished price discovery. In any case, there is no evidence to suggest that ETFs are inherently more risky in this regard than other index-linked funds.

For example, there is no evidence to suggest that ETFs create an added disadvantage in terms of informational efficiency when compared to mutual funds or other index-tracking vehicles. In fact, ETFs provide an advantage in terms of price discovery. As brokers use real-time pricing of the underlying securities to accurately price the ETF, the price can be said to include informational efficiency.

Likewise, demand for index-tracking products ultimately represents investor demand for certain types of securities. For example, significant inflow into an index-tracking product implies significant demand for the exposure which that index provides. If ETFs did not exist, then an investor seeking exposure to an index would still have the option of direct investment into the underlying securities. There is therefore no evidence to suggest that the use of an ETF causes additional non-fundamental volatility of the underlying securities, as the securities would be traded either way.

In general, for indexing of any kind to cause prices to decouple from value, flows into index funds must have a significant permanent, rather than transitory, effect on prices. While there is evidence of some modest permanent price effects associated with index inclusion or exclusion, these may be explained by a greater focus by analysts or increased liquidity – this may in part be because hedging is less costly for index constituents. The charge that indexing significantly distorts pricing is not credible given that indexed assets represent only 10.3% of the total global equity and fixed income market, with ETFs in particular representing only 2.1% of this figure.

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 that 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?

Beyond the example of money market funds, there are few examples of sponsors providing support to funds or ETFs. Most mutual funds and ETFs do not entail a guaranteed price or NAV to investors upon exit, nor does it guarantee that investors will not face liquidity risk. In particular, as described in our answer to question D, in the event that the basket of underlying securities is no longer tradeable under stressed market conditions, it would be detrimental to existing investors that the fund remains open-ended, as the creation of new shares could no longer be covered by the purchase of underlying securities, and redemptions could no longer be covered by their sale. In such market conditions, ETFs would have to become closed-ended until conditions return to normal or the fund could be liquidated.

These risks, for which investors will look to be compensated by market returns, should be clearly disclosed in a fund's constituent documents.

Nonetheless, as noted in our response to question L, the IA considers that ETFs offer additive liquidity and notes that they have proved resilient in times of financial stress.

OTHER CONSIDERATIONS

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 issues?

While there are some differences between how US and European ETFs work, they share similar structures and trade using similar infrastructure. As a result, US-centric materials can provide a good basis of knowledge for risks associated with ETFs, even those authorised in Ireland and the EU.

In general, the existing MiFID and UCITS regulatory frameworks create a satisfying level of investor protection. Where there are concerns about the reporting and transparency of European ETFs, these should be addressed by MiFID II, which should help enhance reporting standards and bring European ETFs in line with their US counterparts.

Even post-MiFID II, obtaining a full picture of ETF liquidity will be a cumbersome process as trade data will not be consolidated. The IA would therefore welcome the development of a consolidated tape for European-domiciled ETFs under MiFID II.

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 do not consider that there are significant risks unique to ETFs which are not already addressed by the UCITS and MiFID regulatory frameworks.

However, the development of a more streamlined communication channel within custodians between nominee and beneficiary accounts would ensure that notification of fund closures, delistings and dividends would improve end investor access to this information. The CBI could look to encourage initiatives in this direction.