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Exchange Traded Funds Discussion Paper (the "Discussion Paper")

Dear Sir/Madam

Introduction

We welcome the opportunity to contribute to the Discussion Paper.

William Fry is one of Ireland's largest law firms with a market leading asset management and investment funds practice. We represent over 80% by AUM of Irish domiciled ETFs and acted for over 50% of all Irish ETFs launched in 2016.

As the leading legal adviser to ETFs in the Irish market, we would like to congratulate the Central Bank on the publication of its Discussion Paper, which is informed and progressive.

While ETF providers and other market participants are best-placed to respond to the specific questions raised in the Discussion Paper, from our own perspective, we wish to share a number of general observations on matters raised in the Discussion Paper.

Investor Expectation

Much of the Discussion Paper is focused on the understanding that investors in an ETF have of the product they are purchasing. In our view, concerns around this can be addressed by proper disclosure. There are a number of aspects to the description of the product that are raised in the Discussion Paper which are discussed below.

Strategy

In our experience, the description of the investment strategy pursued by a UCITS ETF is subject to the same degree of review by the Central Bank as with any other UCITS. As such, the disclosure levels required pursuant to the Central Bank requirements are in no way less comprehensive than those of any non-ETF UCITS.

Structure

In relation to the dealing or structure elements of an ETF (i.e. those elements that distinguish an ETF from a mutual fund), the Discussion Paper raises the question as to whether secondary market investors in an ETF understand their position as beneficial owners of the ETF shares. We would note in this context that the Central Bank already requires significant disclosure/transparency around this position and that

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this disclosure has been developed considerably over time, particularly in conjunction with the implementation of the ICSD settlement model. It is also worth noting that the investors not being shareholders of record and holding beneficially through nominee arrangements is not a feature that is exclusive to ETFs.

Connectedness of parties

The interconnectedness of parties within an ETF structure is referenced in the Discussion Paper. This however is not an ETF-specific concern. There are many mutual funds that are serviced by related companies in a similar fashion, including for example non-ETF funds which offer synthetic exposures. In our opinion, concerns regarding such interconnectedness are currently and can continue to be effectively dealt with through appropriate disclosure of the positions of related entities within a fund structure and by requiring those participants to have appropriate conflicts of interest policies in place and to act in accordance with same.

If disclosure of specific parties like an ETF's current APs or OLPs is to be required, then careful consideration should be given as to where such disclosure would be made. In the event that the prospectus of the ETF is being considered, it should be noted that as APs and OLPs change, the prospectus disclosure would become out of date. It would not be in the interests of investors to have to update a prospectus purely to reflect a change of these parties.

Open-ended nature

The Central Bank notes and raises the question as to whether there is an impact on the open-ended nature of an ETF in the event of stressed market conditions. As a UCITS, the ETF is an open-ended fund and will remain an open-ended fund irrespective of conditions impacting on its ability to deal either in the primary or the secondary market. As an open-ended fund, an ETF has the same ability to deal with conditions that impact on the primary market as any other UCITS. In relation to the secondary market, the ETF will have obligations from its commercial arrangements and its ongoing exchange obligations. The ETF will need to take such appropriate steps as the circumstances warrant and will be best placed to understand the particularities of the circumstances facing it. We believe, therefore, that the steps to be taken in stressed market conditions should be a matter left to the discretion of the Board of the ETF, which will have full access to all of the relevant detail and options available and can make a decision that is in the best interests of the investors.

Should the Central Bank have concerns around the impact of market conditions on an ETF, these could be further addressed and made apparent to investors in the prospectus disclosure.

Right of Direct Redemption

The prospectus for an ETF is clear that purchasers on the secondary market are unlikely to become shareholders in a fund. Even if they do, redemption rights on the primary market will still be limited to APs. Direct rights will therefore only arise in situations contemplated by ESMA Guidelines dealing with secondary market redemptions. Our understanding is that ETFs have put in place mechanisms in conjunction with their administrator and TA to ensure that there is a process for such direct redemption rights. While it will require certain steps including verification of ownership by the legal holder and anti-money-laundering requirements, and it is anticipated that these steps will take some time, the process would be achievable. We would question, however, whether the right of direct redemption could in practice ever be invoked because the circumstances where the exchange price varies significantly from the NAV (which give rise to the direct redemption right in the first place) are also likely to result in the UCITS temporarily suspending dealing at the primary market level. It may therefore be the case that, in a market distress scenario, investors in ETF shares might be more likely to be able to monetise their investment by selling their ETF shares (albeit at a discount) on the exchange rather than directly to the ETF.

NAV and traded price variation

The Central Bank takes the view that there is no regulation requiring an ETF to take measures to ensure that the exchange traded price is close to the net asset value. We would submit that this is implicit in an ETF meeting the definition of a UCITS under the European Communities (undertakings for collective investment in transferable securities) regulations 2011. Regulation 4(4) does set such an obligation for an ETF. It has been noted in the Discussion Paper that many purchasers of ETF shares on the secondary

market (i.e., non-APs) will not become shareholders of record in the ETF. Some, however, will, for example those dealing through CREST. Even as a shareholder, however, an investor that is not an AP will not have a right to repurchase their shares directly with the Fund. To qualify as a UCITS, Regulation 4(3)(b) requires that its units "*are, at the request of holders, repurchased or redeemed, directly or indirectly, out of [the] undertakings' assets*". This condition will not be met for these non AP-shareholders. The ETF will only accept redemption requests from APs. On this basis, to comply as a UCITS, an ETF will rely on Regulation 4 (4) which states that "*action taken by a UCITS to ensure that the stock exchange value of its unit does not vary significantly from their net asset value shall be regarded as equivalent to repurchase or redemption referred to in paragraph (3)(b)*".

Therefore, we believe that there is an obligation to ensure that the stock exchange value does not significantly vary from the net asset value. You have noted that there is no current definition of what "significantly vary" would mean but historically that would have been taken to be a 5% variation and some exchanges to set other limits.

Portfolio transparency

It is useful that the Central Bank acknowledges that portfolio transparency is a matter governed by the rules (if any) imposed by the stock exchange on which the ETF is listed or admitted to trading and that the Central Bank does not have a rule on this. This is a welcome clarification.

The transparency, however, described to allow a tight secondary market is a transparency that is required to be given to the entities responsible for creating the secondary market price. This is not a transparency required for all investors in an ETF. Even the provision of full transparency to non-sophisticated investors would not allow them to benchmark the price on the secondary market to the NAV or to impact on the efficiency of the secondary market. Disclosure is required to ensure the trading price and the NAV do not significantly vary and it should be a matter for the ETF to make disclosure in such a way that meets its regulatory obligations without unnecessary disclosure. This position is very relevant in the context of the description and discussion of the disclosure that is warranted in relation to active ETFs and preventing the risks of front running.

Share Classes

In relation to the question of investors being treated fairly by having listed and unlisted share classes in the same fund, we would believe that treating investors of different classes fairly does not mean treating them the same. Investors are given a variety of options in terms of different share classes whether it be in terms of subscription amount, currency hedging or, with this possible new capacity, intraday trading. A number of ETF providers operate ETFs and index tracking funds based on the same index. Investors will choose whether the listed ETF or an index tracking mutual fund is the fund that best suits their needs. In terms of their investment, they will weigh up the risks and benefits of each option and purchase accordingly. The Bank has noted that securities regulation relies strongly on the capacity of investors to choose investments which align with their particular risk appetites. We believe that offering the choice of listed and unlisted share classes, aligned with full and proper disclosure, is a fair treatment of shareholders.

Active Funds

The Central Bank has considered the impact of new product development in relation to ETFs. Fundamentally, the question is asked as to whether investors can have a full appreciation of the actual exposure delivered and the risks associated with purchasing an ETF. In this regard, the ETF is, in all respects, a UCITS. The disclosure in relation to the exposure to be delivered and the risks associated would be addressed in the same manner as a non-ETF pursuing the same strategy. We believe that the suggestions in relation to disclosure to limited parties would satisfy the requirements without the risks of front-running, as discussed above. It is also possible to develop the disclosure around active ETFs to ensure that it is well understood that these funds are pursuing a discretionary management style rather than a passive one.

Final observations

In conclusion, we would echo the concluding remarks in the Irish Funds response by observing that a UCITS ETF is, above all, a UCITS and, accordingly, any regulatory proposals addressing ETF-specific issues must be mindful of maintaining a level playing field between ETF and non-ETF UCITS.

Yours faithfully

Sent by email and accordingly bears no signature

William Fry

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