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European Fund and Asset Management Association

EFAMA Reply to the Financial Stability Board's Note on Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)

EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 51 corporate members approximately EUR 13.5 trillion in assets under management, of which EUR 8 trillion was managed by approximately 53,000 funds at the end of 2010. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds.

EFAMA's membership includes a very large proportion of the European investment management industry, as well as nearly the entire European ETF industry. ETFs are a growing segment of the industry, and EFAMA fully supports initiatives to increase the understanding of ETFs, among them this Note by the Financial Stability Board.

First, we wish to highlight the key issues which we will address in detail in this reply:

1) ETFs in the European Union are already subject to one of the most respected and widely recognized frameworks for public investment funds – the UCITS (Undertakings for Collective Investment in Transferable Securities) Directive;
2) The areas of concern in the Note are not unique to ETFs;
3) A significant number of exchange-traded investment products are not ETFs – appropriate distinctions must be drawn and understanding among investors and the public must be improved;
4) The distinguishing features of ETFs are highly valued by investors;
5) The ETF segment is a very small percentage of the overall investment fund market.

We wish to highlight that EFAMA's comments apply only to European ETFs/UCITS ETFs, not to ETFs from other jurisdictions.

<u>ETFs as UCITS</u>

The vast majority of retail funds in the European Union are structured as UCITS, and a large majority of European ETFs are UCITS as well. The UCITS Directive provides a robust regulatory framework for investment funds which has evolved over time and provides the necessary flexibility together with strong risk mitigation provisions. Further enhancements to risk management and transparency to investors have been introduced by UCITS IV[1] in 2010, which will enter into force on 1 July 2011. The

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF

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high quality and strength of the UCITS framework are recognized and appreciated not just in Europe, but also in Asia and Latin America.

Summary of relevant UCITS regulation

All UCITS (including UCITS ETFs) are regulated and are subject to the same requirements and constraints. This robust product regulation is at the heart of the high level of investor protection UCITS provide. Key elements of the framework include: a fiduciary duty for the management company to act in the best interest of the fund and of investors; that the assets of the fund are held separately from the management company's balance sheet; that there is an independent depositary that oversees the activity of the manager and safeguards the assets; and that the manager is subject to detailed requirements relating to the management of conflicts of interest.

The universe and strategies of UCITS are evolving due to investor demand for risk reduction and return enhancement. This is true for all UCITS (including UCITS ETFs) and is a global trend. In relation to UCITS, however, all strategies must fit within the detailed UCITS requirements and constraints.

The key UCITS investment limits and requirements relevant to the FSB's stated concerns are:

- There are strict limits in relation to the global exposure of a UCITS; cover for investment in derivatives, and counterparty risk. There is a limit on absolute Value at Risk (VaR): a 99% confidence limit of 20%.
- Relative VaR: with the same confidence levels VaR has to be less than 2 times that of the benchmark.
- Benchmark Indices: where a UCITS aims to track a particular index, that index must be sufficiently diversified, an adequate benchmark for the market to which it refers and published in an appropriate manner.
- Liquidity: investor right to redeem and NAV publication at least twice a month. In practice, most UCITS are priced daily and UCITS ETFs provide investors with the ability to buy or sell shares at intra-day prices in the market.
- Collateral: there are strict requirements regarding liquidity and issuer credit quality in respect of collateral received for transactions in OTC derivatives. In addition, the collateral must be capable of being valued on at least a daily basis.
- Disclosure requirements: annual and semi-annual report, simplified prospectus (to be replaced by the key investor information document, the KIID, under UCITS IV) and a prospectus for the fund need to be published. In particular, the specificities and characteristics of the investment strategy of the UCITS and the relevant risks involved must be adequately explained. In practice, UCITS ETFs provide much more frequent disclosures relating to portfolio holdings, collateral compositions and counterparty exposures.

All these limits and restrictions are minimum requirements. In practice, UCITS managers (including UCITS ETF managers) operate against self-imposed tighter limits.

Also, the UCITS requirements impose detailed responsibilities on management companies in relation to risk management and risk measurement, in terms of both their organisation and procedures and in the way that funds are monitored. Management Companies are required to employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to meet redemptions. Senior management is responsible for approving and reviewing the risk management policy and arrangements, and the processes and techniques for implementing the risk management policy. UCITS management companies must establish a permanent risk management function, which must be functionally and hierarchically independent from other departments within the management company, and which is responsible for implementing the risk management policy and procedures. Managers are required to measure and manage at any time the risks to which the fund is or might be exposed, and must ensure compliance with the UCITS limits concerning global exposure and counterparty risk.

It should therefore be emphasised that risk management in UCITS is already state-of-the-art, and will be enhanced even further by the entry into force of the UCITS IV Directive on 1 July 2011. These new rules include many, even more detailed provisions on internal control mechanisms for the UCITS management company, including conflicts of interest management. The rules cover the risk management, compliance and internal audit functions, risk management policies, risk measurement, counterparty risk and issuer concentration risk calculation, as well as procedures to value OTC derivatives.

In addition, UCITS ETFs are subject to listing rules, to European-wide requirements relating to their prospectuses, and to national rules on securities lending. Furthermore, market makers in shares of UCITS ETFs are subject to European-wide rules on transaction reporting.

Concerns not unique to ETFs and effectively mitigated by the UCITS framework

We note the concerns raised by the FSB regarding potential conflicts of interest, synthetic exposure, securities lending and the use of collateral. We wish to stress that, whilst these types of issues and risks are common across the financial services industry, they are managed and mitigated to a large degree within the highly regulated framework of UCITS.

UCITS ETFs must comply with the same stringent requirements applicable to all UCITS. Some of the structures mentioned in the Note would not be possible under the UCITS Directive, and in other examples raised the UCITS rules deal with the concerns expressed. For example, the same legal entity cannot be the ETF provider and the derivative counterparty. Conflicts of interest rules (to be strengthened under UCITS IV) apply to the choice of counterparties, and the risk management process must be submitted to regulators for approval. Counterparty risk rules limit to 10% of AUM the exposure to any individual counterparty for OTC derivative transactions in case the counterparty is a credit institution with its registered office in a Member State of the European Union or is subject to equivalent prudential rules (5% in other cases)[2], and collateral for transactions in OTC derivatives is subject to strict liquidity and issuer credit quality criteria[3], thus mitigating collateral risk to a

[2] Art. 52 of the UCITS Directive.

[3] CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS
(http://www.esma.europa.eu/popup2.php?id=7000)

substantial degree. Further detailed collateral regulation can be found in national regulation implementing the UCITS Directive.

Synthetic ETFs – The counterparty risk limits and collateral rules in the UCITS framework ensure that at all times the exposure of the Fund to a single counterparty is managed to a very low level. The rules ensure that UCITS are at all times fully supported by own assets or collateral (unlike, for example, bank issued structured products).

Securities lending is a technique commonly used in the fund industry and is not specific to ETFs. Efficient portfolio management techniques like securities lending or repurchase transactions are taken into consideration in the determination of the global exposure and counterparty risk for UCITS. Detailed rules regarding collateral for securities lending are found in national implementing regulation.

EFAMA would welcome a dialogue on collateral rules with respect to collateral provided both for synthetic ETFs and for securities lending exposure, if deemed appropriate for market clarity and to reduce the risk of jurisdictional arbitrage.

We entirely agree with the need for transparency to investors regarding investment strategies, synthetic or physical replication, and collateral/fund assets composition. As mentioned above, there are extensive disclosure requirements in the UCITS Directive, and UCITS ETF providers already provide on a voluntary basis a higher level of transparency on fund assets and swap exposure via their websites. Enhanced transparency has been driven in particular by institutional client requirements.

ETFs and other Exchange-Traded Products

In order to address the concerns raised in the Note, we encourage the FSB not to limit the discussion exclusively to ETFs, as most issues are not unique to them. Furthermore, the concerns have already been addressed in some jurisdictions. We encourage the FSB as well as other regulators to carry out a comprehensive analysis of all Exchange-Traded Products (ETPs) and to make appropriate distinctions among them and their regulatory frameworks (both by product and by jurisdiction). It is very important that a level playing field be maintained (or established, as the case may be) among financial products, and that regulatory arbitrage among ETFs, ETNs, ETCs and other product structures be avoided.

Regrettably, ETFs are often confused in the public domain and in the press with other ETPs, and more investor education is required to correct some of the misperceptions. EFAMA members strongly believe that investors should understand that only ETFs have certain features, and that in Europe they are operating within the UCITS framework, which provides the highest level of investor protection.

ETFs: valuable features for investors

An ETF is – first and foremost – a conventional investment fund. To be regarded as an "exchange traded" fund it must (i) permit and respect secondary market transactions in fund units (i.e., allow investors to buy and sell from each other and not just with the fund) and (ii) provide a high degree of transparency regarding its assets and performance in order to allow for accurate intra-day pricing. As a consequence of these additional attributes, an ETF can be cleared, settled and held in custody like any other equity security.

ETF investors are attracted by the many advantages arising from these additional features, among them intra-day liquidity through exchange trading, multiple listings, availability of intra-day NAV, tight spreads, commitment by multiple market makers, low investment costs.

ETFs: fast growing, but a very small part of the overall investment fund market.

EFAMA largely agrees with the FSB analysis of ETF trends and growth factors. ETFs in Europe have indeed enjoyed fast growth, and statistics show that they regularly attract approximately 6% of European equity traded volumes (in spite of incomplete trade reporting due to the exclusion of off-exchange volumes).

Rapid growth has also been underpinned by strong innovation, but the ETF "phenomenon" is still very small in comparison to the overall fund market and its impact on secondary markets and their stability should be put into perspective: only 2.6% of all European funds are ETFs (3.5% of UCITS funds), and high growth rates are due to a low starting base.
In particular, new ETF types such as leveraged, inverse and leveraged-inverse ETFs are a tiny proportion of the ETF universe, as highlighted by the FSB Note.

Liquidity issues

Lastly, EFAMA wishes to offer some comments on a number of concerns articulated by the FSB relating to the liquidity of the product and the liquidity of banks and asset managers involved in exchange-traded products.

As noted above, all UCITS managers are required to employ an appropriate liquidity risk management process in order to ensure that the UCITS is able to meet redemptions. This overarching requirement is supported by a number of prescriptive rules as regards eligible assets and markets, diversification of fund investments, a tight counterparty exposure limit as described above, and quality of collateral. The NAV pricing mechanism for UCITS reflects market prices of the underlying assets in a transparent way. Furthermore, for UCITS ETFs, intra-day NAVs are regularly provided to the market, enabling all investors to track the value of their investment.

Investors in UCITS ETFs may, depending on the jurisdiction and on fund rules, receive redemption proceeds in the form of the fund's underlying assets rather than cash. For UCITS ETFs, there are already national requirements as regards the handling of potential fund suspensions, and IOSCO has recently issued draft principles for CIS suspensions.

As regards potential liquidity issues for the parties involved in the ETF market, we would first note that the assets of a UCITS ETF are held segregated from the balance sheets of the UCITS manager, portfolio manager or counterparty. Instead, they are held by the depositary under custody arrangements. We therefore do not understand the reference in the Note to "the liquidity of the large asset managers". Contrary to banks, asset managers do not issue balance sheet products.

EFAMA looks forward to a constructive dialogue regarding ETFs with the FSB and other regulatory bodies, and we remain at your disposal for any clarification you may require.

13 May 2011