CONSULTATION RESPONSE

Brussels, 30 June 2022

EFAMA REPLY TO IOSCO CONSULTATION ON GOOD PRACTICES FOR EXCHANGE TRADED FUNDS

Executive summary

EFAMA welcomes the opportunity to respond to this long-awaited IOSCO consultation report on *Good Practices* for ETFs and wishes to commend the IOSCO Secretariat and the Members of the Committee on Investment Management (Committee 5) for their work.

Our industry welcomes the fact that IOSCO's 2013 *Principles* remain relevant and appropriate and that no important gaps in the *Principles* have been identified. In the consultation report, we are pleased to see the resilience of the ETF structure be recognised, despite the severity of the March 2020 market correction and of more recent episodes, concluding that no ETF-specific structural issues have been identified as a cause for regulatory concern. We are also supportive of the effort that has gone into considering the broader ETF ecosystem, as one constituted by a host of critical sell-side institutions (notably APs, MMs and LPs), as well as exchanges. We greet the proposed *Good Practices* in that they finally acknowledge the validity of different supervisory approaches to the regulation of ETFs, avoiding a too prescriptive "one-size-fit-all" approach. We believe that the *Good Practices*, once finalised, will constitute a compendium of sensible principles poised to assist the future growth of the ETF industry to the benefit of markets and end-investors alike. Moreover, far from being prescriptive, their application should be adapted to the specificities of different markets and situations.

Our preliminary considerations on some of the core themes raised in the IOSCO consultation report are as follows:

- Regarding **effective product structuring**, we observe that ETFs bear indeed many commonalities with traditional open-end funds (OEFs), yet maintain unique specificities that prove critical for the commercial long-term success of the product. Among these, we stress the quality of the index provider, as well as that of the Authorised Participants (APs), liquidity providers(LPs) and market makers (MMs), all which remain central to an ETF's underlying arbitrage mechanism and secondary market liquidity provision. The importance of dedicated Capital Markets teams at the level of the ETF issuer/management company should also not be underestimated;

- From a close consideration of the European regulatory environment, most of the proposed *Good Practices* are already firmly rooted in the 1985 UCITS Directive (as revised) and its broader framework, characterised by several implementing measures, and more recently, by ESMA's 2014 *Guidelines*. Not surprisingly, the vast majority of ETFs in Europe are structured as UCITS, while also benefiting from a specific “UCITS ETF” label to aid investors and supervisors recognise the advantages of the brand and avoid confusion with other types of exchange-traded products (ETPs). Such advantages include clear asset eligibility requirements, portfolio diversification and global exposure limits, collateral requirements, index quality requirements, mandatory asset segregation rules upheld by an independent depositary institution, and the assurance of a deep secondary market;

- The above product structuring requirements have been complemented by comprehensive requirements defining detailed investor disclosures and product suitability rules, with the latter being represented by the EU MiFID regime’s “target market” requirements;

- In relation to the **disclosure of ETF basket and portfolio information**, it remains important for the final *Good Practices* to draw a clear distinction between the disclosures that are functional to estimate the ETF’s underlying fair value by the APs/MMs (for the purpose of maintaining an ETF’s price in line, or as close as possible, to the fair value of its constituents) and those that are more broadly intended to inform investors and the broader market. We argue that full portfolio disclosures are warranted only in the former case, as intended to support the arbitrage mechanism, narrower spreads for investors, as well as hedging options for AP/MM specialists;

- Concerning the **utility of the iNAV**, the consultation report accurately recognises some of the limitations behind iNAV calculations, including instances where the iNAV may no longer constitute a sufficiently reliable proxy for investors to derive the fair value of an ETF’s underlying holdings when looking to buy or sell ETF shares in the secondary market. Moreover, attempts to enhance the accuracy or usefulness of iNAV, as per some of the proposals mentioned in the consultation report, promise to not be cost-efficient for those entities in charge of the iNAV calculations. Lastly, as part of a global effort (as ETFs are listed on multiple venues) to harmonise criteria for the activation of circuit-breakers, we believe that better alternatives to the iNAV should be considered, especially in those jurisdictions where circuit-breakers are linked to it;

- Regarding **greater competition in the ETF AP/MM market**, we resolutely support, where possible, the presence of multiple providers offering their services in the interest of ETF investors through narrower bid-offer spreads and lower tracking error. Yet, it is important to appreciate that, in order to meet an ever-increasing investor demand for exposure to new asset classes, strategies or geographies, responsible entities seeking to meet this demand must often rely on a smaller group of specialist AP/MM firms, demonstrating unique capabilities in transacting the ETF’s underlying components across different currencies and time zones (e.g. emerging and frontier markets). It is therefore recognised that competition may be reduced to the extent that fewer APs/MMs are available to trade in the ETF’s underlying assets by either supporting the ETF’s creation/redemption mechanism and/or secondary market liquidity. As part of this inevitable trade-off, considerations around “best execution”, or in other terms, ensuring that firms obtain the best possible economic outcome for their client when executing an order, must also be considered and notwithstanding their belonging to the same financial group of the ETF issuer. Strong EU rules against conflicts of interest also apply in this latter instance;

- In relation to **investor disclosures around fees and costs**, we refer IOSCO to the existing pre-contractual disclosure obligations of the UCITS regulatory regime, comprising a key investor information document (KIID), as well as the prospectus and annual report. However, we observe that ETF issuers should not be held accountable for all types of fees and costs, especially in relation to those they cannot directly control, e.g. brokerage fees, exchange fees, and notably, transaction costs.

We elaborate on these aspects in greater detail in our responses to the consultation report's individual questions below.

1. Effective product structuring

> ***Measure 1:*** *Regulators and responsible entities are encouraged to consider the range of asset classes and investment strategies that may be appropriate for the ETF structure, taking into account their nature, novelty, and complexity, the effectiveness of the arbitrage mechanism for such assets and strategies and local circumstances.*

Q1. What additional considerations do regulators or responsible entities consider in determining the range of assets and strategies to be invested or implemented by an ETF and how are they different from those concerning OEFs

From an ETF issuer perspective, many are the considerations in a product's conception and pre-launch phase. In this regard, as the consultation report also correctly notes, there are generally few differences with non-exchange traded OEFs. As a first consideration, there naturally must be investor demand, or potential demand, where an issuer wishes to pioneer offering investors access to new assets classes, or industry sectors, based on their future earnings potential and contribution in terms of diversification. Concomitantly, responsible entities will also consider the availability of distribution networks in advance.

A second consideration would naturally involve the choice of the most appropriate regulatory structure able to deliver the chosen exposure, mindful of a jurisdiction's specific legal and regulatory requirements[1]. In this regard, we for instance refer to current EU rules under the UCITS Directive, introducing detailed portfolio diversification requirements, prohibiting direct exposure to certain asset classes (e.g. physical commodities), limiting the one to non-listed securities, and limiting the amount of leverage to not exceed the net value of the fund's portfolio.

Where the ETF structure is being considered, there are indeed additional – where not unique - considerations to be made. Critical are for instance:

1. The choice of a reliable index provider, factoring in *inter alia* its transparency, the objectivity of its index methodologies, their representativeness for the desired target market, the index type (e.g. capitalisation weighted or not, factor-based, ESG screened, etc.), rebalancing approach, etc.;

2. The choice of multiple Authorised Participants (APs), through thorough due diligence and risk control procedures, to deal creations/redemptions for the ETF's shares based on their experience in transacting the underlying securities. These institutions will verify that trading the index components will guarantee competitive bid-ask spreads on the secondary market, as well as test available hedging options;

3. The availability of other (non-AP) contracted liquidity providers able to exhibit competitive bid-ask spreads to support secondary market trading volumes;

[1] As an example, we refer to the asset eligibility, portfolio and index diversification requirements of the EU UCITS Directive (in part. Articles 50, 52-53), complemented by ESMA's 2014 *Guidelines on ETFs and other UCITS issues* (in part. Section XIII thereof, related to eligible financial indices).

4. Where index replication is swap-based, an ETF's swap counterparties are chosen through thorough due diligence and risk control procedures and on the basis of pre-defined legal and economic criteria[2]; and

5. A dedicated and reliable Capital Markets team at the level of the ETF issuer to guarantee efficient execution in the interest of ETF investors. More specifically, the team is at the core of the primary and secondary markets functioning and is generally responsible for three main functions, i.e. **investor trading services**, including execution guidance (pre and post-trade analysis), the facilitation of primary and secondary market transactions, and educational sessions on liquidity and execution for institutional end-clients; (ii) **liquidity management** aimed at increasing support from MMs to improve liquidity (e.g. tighter bid-offer spreads, larger tradable sizes both on-exchange and OTC), developing client execution channels and supporting efficient ETF trading (e.g. through disclosure of the trading calendar, creation/redemption fees, product updates etc.); and (iii) **liquidity monitoring**, consisting in the intraday communication with APs and MMs, monitoring their order books (e.g. bid-offer spreads, size and market depth), and comparing these with those for competing products.

Such choices are critical for the ETF to attract sufficient inflows and thereby achieve a minimum size above which economies of scale are expected to support the commercial success of the ETF post-launch. Moreover, we care to point out that the above choices involve several functions within asset management companies and are closely vetted and sanctioned by the highest degrees of management to ensure the quality of the product and that potential future compliance and reputational risks are avoided.

Whereas specific requirements or dedicated regulatory guidelines (as in the EU) may be warranted to account for some ETF specificities, at their core, ETFs remain OEFs and as such should continue to fall beneath the more comprehensive rules designed for the latter. In Europe, such rules correspond to the UCITS regime, stemming from the original 1985 Directive as the cornerstone of fund regulation in Europe, and are complemented by several technical implementing measures, along with ESMA's guidance. Today, the overwhelming majority of ETFs in Europe are launched as UCITS funds, taking advantage of the directive's robust requirements, as well as of its cross-border distribution passport with a retail focus[3]. Notwithstanding the possibility for ETFs to also be structured as non-UCITS products, UCITS ETFs share the success of the UCITS regime by having the following regulatory features in common with non-exchange traded OEFs:

1. <u>Portfolio diversification limits</u>: As a UCITS, apart from observing the related asset eligibility, portfolio and index diversification requirements of the UCITS Directive, the ETF must ensure that any index it intends to track is sufficiently diversified, where no investment in securities issued by the same body should exceed 20% of all index components. Exceptional circumstances, as in very volatile or concentrated market conditions, can stretch this limit up to 35%, with the ETF provider needing to make a corresponding disclosure in the prospectus. National supervisors are also obliged to ensure a chosen index is sufficiently diversified, that it represents a suitable benchmark for the market it references, and that its constituents are published in an appropriate manner[4]. These features are in contrast with those of non-fund ETPs, which are structured for the most part around single exposures or asset-backed securities (see *infra*). UCITS ETFs which do not track indices

[2] For instance, a key requirement will be for all swap counterparties to have an ISDA Master Agreement in place, setting the standard terms and mutual obligations governing the swap's performance and payoff. From an economic standpoint, the selection process for choosing the swap counterparties is a formal one, based on the most competitive swap spreads in the best interest of an ETF's investors and provided all other criteria are satisfied.
[3] Valuable to appreciate the advantages of the UCITS regulatory regime for ETFs in Europe is the AFG's 2019 Guide UCITS ETF: a unique European format; available at the following hyperlink.
[4] Please refer to Article 53 of the UCITS Directive, as well as to paragraphs 49-53 of the ESMA *Guidelines*.

must follow more exacting diversification requirements, most commonly referred to as the "5 / 10 / 40% rule"[5];

2. <u>Collateral requirements</u>: The 2014 ESMA *Guidelines* introduced several recommendations in terms of eligible collateral requirements. These apply to all UCITS structures, but affect ETFs particularly when these rely on OTC derivatives (as per derivative-based replication of an index via a total return swap contract), or engage in securities lending with eligible counterparts. We stress in this regard those provisions related to the collateral's degree of liquidity, correlation (i.e. independent of the counterparty's financial performance), diversification (within the broader UCITS single counterparty risk limits of 5% or 10%), a stress-testing policy (where collateral exceeds 30% of the UCITS' assets) and to disclosures in prospectuses and annual reports[6];

3. <u>Index quality</u>: The ESMA *Guidelines* contain several additional requirements for UCITS ETF providers to ascertain the "quality" of any index tracked prior to a product launch. These relate to the index's representativeness of the market it is intended to replicate, its independence in relation to the ETF provider, its rebalancing frequency, its disclosure, and its potential impacts on the product's costs. The transparency of the index's underlying methodology, its valuation and respective weightings should also be assessed. The ETF provider is also tasked to exercise documented due diligence of the quality of the index, including its independent audit and valuation[7];

4. <u>Asset segregation</u>: The 2014 amendments to the UCITS Directive ("UCITS V") considerably reinforced the UCITS requirements pertaining to asset segregation and oversight. Entrusted to an independent and eligible depositary institution (known alternatively as a custodian, or trustee, depending on the national legal regime), the latter is to primarily ensure that the ETF's assets (i.e. the basket of underlying securities) are segregated in the name of the ETF, thus making them bankruptcy-remote from the solvency of the ETF provider, as well as from the depositary's own solvency. Moreover, the latter is also entrusted to carry out oversight functions, including ensuring that the issue, repurchase and cancellation of shares is carried out in accordance with national law and the ETF's rules of incorporation; and

5. <u>A deep secondary market</u>: In terms of liquidity, UCITS funds must guarantee investors a fortnightly redemption dealing frequency as a minimum. UCITS ETFs are able to amply honour this commitment in light of their structural set-up involving a multitude of APs and MMs, especially for those ETFs tracking broad market indices. Numerous episodes of market stress have repeatedly tested the liquidity resilience of the ETF wrapper, where the secondary market has largely absorbed external shocks with no identifiable impact on the primary market.

Q2. What other good practices have been put in place to take into account the target investors at product design phase?

In addition to the product structuring requirements under the UCITS regime, an additional layer of EU rules on product suitability has been introduced through the original 2004 MiFID framework, requiring that in the provision of investment advice or of portfolio management to their clients, firms have to provide suitable personal recommendations. Suitability has to be assessed against clients' knowledge and experience, financial situation and investment objectives. To achieve this, investment firms have to obtain the necessary information from clients. More recently, the 2014 review of MiFID ("MiFID II") has added that firms must always ensure the compatibility between products they offer/recommend and a corresponding "target

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[5] Accordingly, a UCITS may not invest more than 5% of its assets in securities of a single issuer, although this limit can be increased to 10% per single body and as long as the total value of all holdings exceeding 5% does not exceed 40% of the net assets of the fund.

[6] Respectively, for each of these five features, please refer to paragraphs 43 (letters a., d. and e.), 45, 47 and 48 of the ESMA *Guidelines*.

[7] Please refer to paragraphs 54-62 of the ESMA *Guidelines*.

market" for end-clients. Such target market is to be identified in the product design phase and further defined by the financial adviser/distributor. Despite these common standards, there are numerous instances of EU jurisdictions applying additional national requirements (i.e. so-called "gold-plating") in the definition of a target market, thereby hindering the full potential of the UCITS cross-border fund distribution passport. While IOSCO's consultation is targeting *Good Practices*, we would nevertheless appreciate a reference to such "bad" practices, mindful of the regional European fund distribution context.

Worth referencing are also ESMA's July 2020 *Guidelines on liquidity stress testing in UCITS and AIFs*, whereby liquidity stress testing policies and procedures should be adapted to the specific structure of ETFs (as these in Europe are for the most part authorised as UCITS) by accounting for the role of APs, the type of replication chosen ("physical" vs. "swap-based") and redemption models ("in cash" vs. "in-kind")[8].

Measure 2: *Regulators are encouraged to consider requirements regarding the transparency of an ETF's portfolio and/or other appropriate information provided to market participants so as to facilitate effective arbitrage.*

Q.3 Do the merits and other considerations as set out above accurately reflect the issues for different portfolio and basket information disclosure approaches?

The consultation report accurately recognises the importance of full and timely disclosures of an ETF's creation or redemption basket – through the so-called "portfolio composition file" (PCF) which is shared with APs/MMs before the opening of the trading session in the relevant market. Such disclosures are exclusive and are intended to facilitate APs/MMs in their underlying arbitrage and related hedging activities, thereby *de facto* contributing to maintain an ETF's price in line, or as close as possible, to the fair value of its constituents. Important, however, is to draw a clear distinction between such disclosures and those directed at investors and to the broader market for information purposes only. In other words, whereas the initial PCF (or the near real-time information on a custom in-kind basket, in the context of an "in-kind" creation/redemption with an AP during the trading day) serve the critical purpose of enabling the efficient arbitrage for APs/MMs to quote narrower bid-ask spreads (thereby indirectly also benefitting end-investors), the disclosure of the same information on full portfolio holdings and at the same frequency to the broader market and end-investors will be of little use, if valuable at all.

Moreover, full portfolio disclosure on an intra-day basis – other than to designated APs/MMs - could be detrimental to the ETF and its shareholders by offering professional trading firms sensitive information from which these could for instance anticipate the amount of a particular security to be bought or sold, thereby profiting by "front-running" the ETF's transactions and harming the ETF (and ultimately its shareholders) by causing it to pay more, or receive less, for the securities. In the same way, an actively-managed ETF may experience the erosion of its performance where its proprietary information in terms of portfolio composition and trading techniques is discovered through the intraday disclosure of its full portfolio composition by the broader market. For information purposes, end-investors are therefore better served by accessing the information related to an ETF's holdings either via the regulatory disclosure documents (where usually only the top portfolio components, or a representative sample, are given), or preferably through the ETF issuers' own website where all holdings are commonly disclosed on a daily (end of day/lagged) basis.

In sum, it is important for supervisors to consider the breadth and frequency of portfolio disclosure requirements in the interest of guaranteeing an efficient arbitrage mechanism, with the resulting better execution, lower tracking difference and lower costs for investors overall.

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[8] Please refer to the July 2020 *Guidelines on liquidity stress testing in UCITS and AIFs* (Section V.1.7), available at the following hyperlink.

4. Other than the examples of portfolio and basket information disclosure approaches as listed above, are there any additional portfolio-related disclosures that have been used to support the functioning of the ETF arbitrage mechanism?

From an ETF issuer perspective, there are no additional portfolio-related disclosures besides the ones listed in our answers above. It is important to recognise, however, that APs/MMs will not exclusively use the portfolio-specific information provided by the ETF issuer. As their respective balance sheets are put at risk throughout their arbitrage activity, such actors will have recourse to proprietary or other third-party sources of price information around the components of the ETF basket. The integration of such data further contributes to achieve a better approximation of the underlying components' fair value, affecting in turn the quality of the index replication.

> ***Measure 3:*** *For jurisdictions that mandate the provision of iNAV, regulators and/or trading venues are encouraged to consider means to enhance the accuracy and usefulness of iNAV.*

Q.5 What additional means or disclosures have been put in place to address issues relating to iNAV?

The consultation report accurately recognises some of the limitations behind iNAV calculations, including those stemming from time zone differences and stale prices when APs/MMs attempt to derive the fair value of the ETFs underlying basket. Such calculations are only rendered more difficult, where not impossible, during volatile market conditions, or even in instances where several of the underlying basket components are not trading at all (e.g. as also recently demonstrated by events following the Russian military invasion of the Ukraine in February 2022). We therefore concur with the finding that APs/MMs do not consider the iNAV calculation to be sufficiently accurate, opting to derive the fair value of the ETF's basket through internal proprietary methods, including external and alternative sources of price information.

Similarly, the need for the iNAV as a source of end-investor information/protection has also become less relevant, as a result of the growth of ETFs tracking less "plain vanilla" benchmarks, including factor-based, thematic, ESG or even fixed income indices, among others. In such cases, where proxies are not available to price the underlying market during the ETF's trading hours, the iNAV itself no longer serves as a sufficiently accurate proxy of the ETF's fair value for end-investors to refer to. Alternatively, to the extent there is at least one MM that is committed to quote a two-way bid-offer within the official spread required (where the latter is intended *inter alia* to also protect end-investors) by an exchange, we believe such outcome may be preferable to the mandatory publication of an iNAV in those few jurisdictions where it is still required. Moreover, attempts to enhance the accuracy or usefulness of iNAV, as per some of the proposals mentioned in the consultation report, promise to not be cost-efficient for those entities in charge of the iNAV calculations. We refer in particular to suggestions made for using a real-time fair value for the inputs of the iNAV, increasing the frequency of dissemination of iNAV information, as well as verifying the iNAV calculation against live quotations on secondary markets. In fact, calculating the iNAV on these grounds will entail additional costs for the relevant financial entities which are notably those of the iNAV calculation *per se*, compounded by the cost of data (e.g. index and data licenses). Such costs, which the ETF issuer already bears as the product manufacturer, risk being passed back to the ETF issuer and to the detriment of investors choosing ETFs also for their low cost proposition. Moreover, the exchanges concerned may also become less attractive and competitive to list ETF products as a result.

Lastly, as part of an global effort (as ETFs are listed on multiple venues) to harmonise criteria for the activation of circuit-breakers, we believe that better alternatives (as the last traded price, for instance) to the iNAV should be considered, especially in those jurisdictions where circuit-breakers are linked to the iNAV.

Measure 4: *Responsible entities are encouraged to:*

(i) conduct due diligence on APs and MMs when onboarding them to the ETF, with a view towards having those that are capable of facilitating an effective arbitrage mechanism and providing liquidity;

(ii) conduct ongoing monitoring on APs and MMs for the ETF regarding, amongst others, the functioning of the arbitrage mechanism and liquidity provision; and

(iii)avoid exclusive arrangements with APs and MMs if they may unduly affect the effectiveness of the arbitrage mechanism.

Q.6 Have the examples of considerations above captured the key considerations relating to selection and due diligence of APs, and where relevant, MMs, by responsible entities?

EFAMA concurs with the proposed Measure 4, as well as with the consultation report's related considerations.

Q.7 Do you agree with the proposed good practice to promote competition in ETF arbitrage and market making? Are there any justifiable circumstances where exclusive arrangements with APs or MMs would bring net benefits to ETF investors as a whole?

In principle, EFAMA supports fair competition to avoid an excessive concentration in the AP/MM market, while realising a more efficient arbitrage mechanism through tighter bid-offer spreads and ensuring that ETF issuers can sufficiently diversify counterparty risks. In general, we would therefore agree that exclusive arrangements between ETF issuers and single APs or MMs should be avoided in the interest of end-investors. Yet, considering the ever-expanding investor interest in new asset classes, strategies or geographies, responsible entities seeking to meet this demand must often rely on a smaller group of specialist AP/MM firms, demonstrating unique capabilities in transacting the ETF's underlying components across different currencies and time zones. One could in this respect for instance consider those of a narrow thematic index or those of an ETF tracking a unique frontier market index. Besides these considerations, there may also be additional factors leading ETF issuers to appoint fewer APs[9], or for secondary market liquidity to rely on fewer MMs. One of these is the need to ensure "best execution", as per a requirement at the heart of the EU MiFID II regime and which consists in demonstrating that a firm has taken sufficient steps to ensure the best possible economic outcome for its client(s) when executing an order[10]. Compliance with such principle translates into a rigorous selection process with respect to the appointment of one or more APs able to more efficiently execute creation/redemption orders in the interest of ETF shareholders. For swap-based ETFs, the principle applies *mutatis mutandis* to the selection of its swap counterparties, especially in the manner these are able to price the swap.

Where an AP's geographical presence, infrastructure and technological capabilities prevail over those of a competitor when needing to execute a creation/redemption in the most cost-efficient manner, as well as those of an MM in providing liquidity to the secondary market, or of a swap counterparty when offering better terms for the swap agreement, choices may naturally become restricted. Therefore, it is important for IOSCO to consider that, in certain cases, exclusive arrangements are not concluded for their own sake,

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[9] As an example, ETF issuers in France rely on a "main AP" model set-up, whereby one or a limited number of APs are appointed by the ETF issuer to centralise primary market orders, while also interfacing with the ETF's registrar and transfer agent. A number of "secondary APs" – acting as *de facto* market makers - will rely exclusively on the main AP to "make" a market for the ETF's shares.

[10] Please refer in this regard to Article 27(1) of MiFID II (Directive 2014/65/EU) in conjunction with Article 64 of the Delegated Regulation (EU) 2017/565 listing the "best execution criteria". Key factors on which "best execution" is to be assessed are its price, costs, speed, likelihood of execution and settlement, size, nature, or any other consideration relevant to the execution of the order.

but to meet growing client demand in situations where the offer of APs/MMs (or reliable counterparties of swap-based replication) is limited, or predicated upon complying with the EU “best execution” principle.

> ***Measure 5:*** *Responsible entities are encouraged to put in place appropriate arrangements to facilitate an effective arbitrage mechanism, including contingency plans to address the circumstances where the arbitrage mechanism of the ETF is impaired.*

Q.8 Do you agree with the proposed good practices and jurisdictional examples as set out above? What additional good practices related to primary market arrangements have been put in place to promote effective arbitrage?

We generally support the proposed *Good Practices*, noting that these are already practically being followed by many ETF issuers. In addition, we recall that an effective arbitrage mechanism also depends on elements which are beyond the direct control of the ETF issuer, and depend notably on the specific preferences of an AP/MM when determining which ETF structure to partner with.

However, we are less convinced about whether an obligation for an AP to transact with other market participants on an agency basis (as per the example of the Hong Kong market) can be considered as a good practice. Whereas an AP’s ability to accept and process creation or redemption requests from third parties remains valuable, this should be done on a voluntary basis so as to not interfere with the AP’s own incentives to partner with an ETF structure.

Q.9 To what extent should responsible entities be encouraged to provide more frequent disclosure of portfolio information to the public to facilitate the arbitrage mechanism? Does it depend on the information APs/MMs receive on a daily basis and the ETF’s arrangements with APs/MMs?

As described in our answer to Q.3 above, full daily portfolio disclosures to the APs/MMs are critical to the efficiency of the arbitrage mechanism, and in turn for the quality of an ETF’s index-tracking feature and low cost to end-investors. Conversely, we believe the same type of information and its frequency is neither suitable, nor warranted, to be disclosed to the broader public. In this regard, we believe several ETF issuers have adopted a reasonable approach, i.e. that of either partially or fully disclosing the underlying basket components on a lagged basis, usually through their own website.

Q.10 Have the examples above captured the key operational risks that may lead to disruption in achieving the ETF’s investment objective? What additional good practices have been put in place to mitigate such risk?

EFAMA concurs with the proposed measure, as well as with the examples presented in the consultation report to highlight operational risks. Nonetheless, it is important to bear in mind that, while the diversity of service providers contributes positively to risk mitigation, the ultimate degree of diversity will inevitably depend on product type and on whether there are attractive commercial opportunities for APs, MMs, swap counterparties, etc. to partner with an ETF issuer. Always in this regard, another important consideration relates to the natural due diligence process conducted by investors on the ETF structure. Institutional investors, in particular, will expect more APs/MMs around a broad-based, developed market index comprising hundreds of single line items, while accepting a far narrower ecosystem for ETFs tracking less diversified indices (e.g. single commodities, frontier markets, thematic, etc.).

As an example of a good practice applying to all UCITS funds (including ETFs) in Europe, we care to highlight the importance of the ESMA recommendations in terms of managing collateral from OTC derivatives and from securities lending transactions. More specifically, paragraph 43 of ESMA’s above cited *Guidelines on ETFs and other UCITS issues* lists key criteria for collateral quality, including *inter alia*, liquidity, valuation, issuer credit quality, correlation (with the counterparty) and diversification. In practical terms, the above collateral requirements for example ensure that no counterparty to the ETF, whether through a swap or a securities loan, is free to post the collateral securities it wishes to the ETF. Rather, these are dictated by the risk management team of the ETF sponsor and undergo considerable scrutiny based on the pre-set, multi-dimensional ESMA criteria under paragraph 43 of the *Guidelines*. The team reserves for the ETF the right to decline any security, especially those issued by the same counterparty. Where the above practices are adhered to and monitored constantly as part of an ETFs ordinary risk management, dealing the collateral of a defaulting counterparty under a rare and extreme scenario, proves frictionless. Furthermore, to ensure that an ETF's received collateral withstands a sudden shock or a market correction leading to the (highly improbable) default of a counterparty, its composition should preferably not mirror that of the underlying index an ETF is tracking. It is important to note in this regard that the primary quality of collateral is for it to be liquid and readily disposable to secure a claim. It should not replace a portfolio's assets.

In addition, we wish to stress regulatory requirements in terms of swap exposure collateralisation for trades that are not subject to a clearing obligation through a central counterparty (CCP), as per the European Market Infrastructure Regulation (EMIR)[11]. Recognised as "financial counterparties" under the EMIR definitions, UCITS ETFs and their counterparties are obliged under the Delegated Regulation 2016/2251 – effective since February 2017 - to implement appropriate procedures and arrangements to measure, monitor and mitigate operational and counterparty credit risks. Central to such measures is the need to ensure a timely, accurate and appropriately segregated exchange of collateral (i.e. initial and variation margin) by way of title transfer or by way of pledge, depending on the terms of the agreement between the counterparties, as well as collateral eligibility requirements.

Finally, in relation to the opportunity of offering end-investors the direct redemption of their ETF shares with the ETF issuer (as per the example under Box 5 of the consultation report), we agree these would confront significant operational challenges. Since the application of the ESMA *Guidelines* in this regard[12] and contingent on a disrupted secondary market where investors are no longer able to trade the shares of a given ETF, ETF issuers in Europe may consider opening the ETF for direct redemptions. There are nevertheless some impracticalities behind this option, as generally highlighted in ETF prospectuses and also acknowledged in the consultation report. In a stylised example, the ETF issuer will typically issue a communication (a "non-AP buy-back notice") to the market confirming that the relevant Board of Directors has decided to allow investors direct access to the ETF's underlying holdings over a specified period. Willing investors would consequently need to instruct their agent bank to complete the relevant documentation and submit a redemption request directly to the Transfer Agent (TA) for the specified ETF. The TA in turn will need to conduct and complete its due diligence checks on the agent bank, open an account in its name and instruct the redemption. Cash proceeds are subsequently delivered to the investor's agent bank for onward payment to the investor. Such cumbersome process would often allow only institutional investors to redeem directly with the ETF issuer. Moreover, as demonstrated by the recent experience of some ETFs exposed to Russian securities following the February 2022 Russian invasion of the Ukraine, direct redemptions remain prohibitive where the primary market is not able to function as a result of the indefinite and full suspension in the trading of these ETFs' underlying securities. We consider it of critical importance that investors – and retail ones in particular - are educated about these rare and more extreme possibilities, enabling them to improve their knowledge on the functioning of financial markets, especially under exceptional circumstances.

[11] Please refer to Regulation 648/2012 of 4 July 2012.
[12] See paragraphs 23 and 24 thereof, including a description of the process to be followed by investors in the ETF's prospectus, as well as of the related costs involved.

Measure 6: *Regulators are encouraged to consider whether the securities laws and applicable rules of securities exchanges within their remit and jurisdictions appropriately address potential conflicts of interests raised by ETFs.*

Q.11 Do you agree that the examples above are the key considerations related to potential conflicts of interest? In addition to the above, are there any other potential conflicts of interests associated with ETFs that warrant careful considerations?

EFAMA observes that the examples provided in the consultation report are sufficiently comprehensive in helping regulators identify potential conflicts of interests between an ETF issuer and other relevant parties, including index providers. References to EU standards, as the 2014 ESMA *Guidelines*, remain relevant, as do the broader UCITS requirements addressing conflicts of interest. As to the latter, Article 23 of the Delegated Regulation 2016/438, specifying the "operating conditions" requirements of the UCITS Directive with regard to conflicts of interest, would oblige the UCITS ETF issuer as the management/investment company to adopt policies identifying potential conflicts of interest arising from group links, as well as to take reasonable steps to avoid such conflicts. Where such conflicts cannot be avoided, the management/investment company needs to manage, monitor and disclose its intra-group dealings to investors in the UCITS ETF for these to make informed decisions. Noteworthy is that these EU standards have been implemented with greater detail in individual EU jurisdictions, offering valuable examples of *Good Practices* reflected in the consultation report.

The risks associated with group entities acting in multiple capacities can also be mitigated, especially by relying on multiple APs or counterparties outside the group, thereby also increasing competition. Ultimately, however, it should be up to the ETF issuer to manage the benefits versus the costs of having multiple non-affiliated APs and counterparties in view of an efficient balance. In the presence of intra-group affiliations of an ETF issuer, one should compare the potential for conflict of interest risks against a couple of important factors, including those cited in our response to Q.7 related to "best execution", a provider's geographical presence, trading infrastructure, technological and asset ss expertise, to name only a few.

We therefore believe that, as long potential conflicts of interests are well disclosed and stand to offer greater benefits to ETF end-investors, intra-group affiliations should not be overplayed. Lastly, we also recall that specific conflict of interest rules apply to APs, other counterparties and index providers under EU regulation (e.g. the MiFID regime and the Benchmarks Regulation), thereby reinforcing those cited above and specific to asset management entities.

Q.12 What additional good practices have been put in place to mitigate conflict of interests between the ETF manager and other stakeholders?

Please refer to our response to the question above.

2. Disclosure

Measure 7: *For ETFs, in particular those that invest in more complex or novel asset classes, or use more complex investment strategies, regulators are encouraged to consider appropriate requirements for the adequacy and appropriateness of the disclosures regarding ETF-specific aspects, including whether certain disclosures are presented in an understandable manner and whether they address the nature of risks associated with the ETFs' strategies.*

Measure 8: *Regulators are encouraged to consider appropriate requirements for the disclosures of fees and expenses for investing in ETFs (including secondary market trading costs) in a way that allows* *investors to make informed decisions about whether they wish to invest in an ETF and thereby accept a particular level of costs.*

Q.13 What additional good practices in disclosure have been put in place to help investors better understand (i) the risks and vulnerabilities of an ETF's arbitrage mechanism; and (ii) the specificities of ETF investment strategies?

As ETFs in Europe are predominantly structured as retail-focused UCITS funds, ETF investors benefit from all the ample disclosure requirements which are proper of the UCITS framework. By definition, under the EU MiFID framework, products with the "UCITS" label are "non-complex" and may consequently be bought by end-investors without needing financial advice. In other terms, ETFs in Europe can be bought on a variety of brokerage platforms "execution only", with investors confirming they have read the related precontractual information documents. The latter are the key investor information document (KIID), accompanied by the fund prospectus and the annual report, offering ample information on the functioning of the arbitrage mechanism, its related risks, as well as on the risks specific to the underlying asset class exposure and to the index provider[13]. Additional information is also typically made available on the ETF issuers' websites, with descriptions of how specific risks arising from the specific ETF structure are managed. We consider such disclosures – especially the more detailed ones of the prospectus – to offer adequate information for all end-investors, beginning with those having only a basic level of financial literacy. For other types of (non-UCITS) exchange traded products (ETPs), the EU MiFID II requirements around the identification of a target market further ensure that disclosures related to risks in the arbitrage mechanism, or specific to the investment strategy, are appropriately calibrated to the specific investor type for which the product is intended.

Q.14 Have the examples above captured the fees and costs associated with ETFs that are important considerations to investors?

In relation to fees and costs, we certainly support the proposed Measure 8, as well as the examples of *Good Practices* provided. As ETFs are for the most part structured as UCITS funds in Europe, their degree of transparency over fees and costs is already aligned with the extensive disclosure standards supervisors expect under the UCITS Directive, whereby all cost and charges – beginning with the fund's total expense ratio (TER) - need to be disclosed in the fund's key investor information document (KIID)[14], as well as in the prospectus. Moreover, the latter contains additional details on the fees and costs arising from so-called "efficient portfolio management" techniques, or securities financing transactions (e.g. securities lending, repo and reverse repo agreements). ESMA's 2014 *Guidelines* complement such requirements by expressly foreseeing that all the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS (including ETFs, if structured as such). The annual report moreover provides for the revenues arising from efficient portfolio management techniques for the entire reporting period to be disclosed, together with the direct and indirect operational costs and fees incurred. We are expecting potential additional changes to EU-wide practices in terms of cost disclosures for UCITS, as a result of ESMA's publication in June 2020 of a *Supervisory Briefing* on the supervision of costs in UCITS (and in alternative investment funds, AIFs), followed by a *Common Supervisory Action* (CSA) *vis-à-vis* EU national supervisors in January 2021, intended to guide the latter in supervising how costs and fees are charged in UCITS and Alternative Investment Funds (AIFs). Such guidance will articulate a set of harmonised regulatory expectations for EU supervisors authorised asset management companies and their funds will have to adhere to, ETFs included.

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[13] In this regard, please refer to the ESMA's 2014 *Guidelines on ETFs and other UCITS issues* (in part. Sections X-XIII thereof.

[14] As from 1 January 2023 such disclosures are set to migrate into a new key information document (KID) template under the EU Packaged Retail Investment and Insurance Products (PRIIPs) Regulation.

ETF investors should nevertheless be mindful that there are additional costs to investing in ETFs that the ETF issuer (as the product manufacturer) should not be held accountable for; e.g. brokerage fees, exchange fees, secondary market transaction costs, capital gains taxes, et al. Whereas some of these charges will be known at the point of sale, others – like transaction costs – will largely depend on prevailing market/liquidity conditions at the time ETF shares are bought or sold on the relevant exchange.

Q.15 What additional good practices in disclosure have been put in place to help investors better understand the cost of investing in the ETF?

We consider that the mandatory regulatory disclosures of the UCITS regime, as described above, are broadly sufficient for investors to understand the main cost components when investing in ETF. Naturally, investors will have to consider additional charges which are typically levied by the chosen distributor, brokerage platform, or exchange, along with tax considerations (e.g. related to capital gains). Such charges are not set at the ETF issuer/product manufacturer level, yet they must be appropriately disclosed by such distributors in a clear and transparent manner just as well, while accounting also for potential differences between retail and institutional investors. Disclosures on intraday pricing information are also outside the control of the ETF issuer and stand to vary significantly depending on market conditions, average daily volumes being traded, availability of LPs and MMs to "make markets" for a given ETF, among other factors. We therefore believe that any quantitative determination of such costs by the ETF issuer, even if merely indicative and beyond a simple qualitative description in the disclosure documents, risks being misleading.

Over the longer term, what promises to contribute significantly to greater cost ETF transparency for investors is the introduction of a near real-time consolidated tape in Europe, both for equity, equity-like (as ETFs), and fixed income instruments. In this respect, EFAMA is significantly engaged in the context of the ongoing review of the EU MiFIR framework[15].

Measure 9: *Regulators and responsible entities are encouraged to consider appropriate disclosure requirements or disclosures to help investors clearly differentiate ETFs from other ETPs / CIS, as well as appropriate disclosure for index-based and non-index-based ETFs.*

Q.16 What additional good practices in disclosure have been put in place to help investors differentiate (i) ETFs from other ETPs / CIS; and (ii) conventional ETFs from other more complex ETFs?

In terms of differentiating ETFs from other ETPs or CIS, the 2014 ESMA *Guidelines* have unequivocally introduced a "UCITS ETF" identifier which expressly identifies it as an exchange-traded fund. Such identifier, as referenced also in the consultation report, must be used when naming the ETF, as well as throughout its fund rules or instrument of incorporation, its prospectus, its KIID, as well as in all related marketing communications. Such an identifier should also be used in all EU languages. Consequently, a UCITS which is not a "UCITS ETF" (as defined in the ESMA *Guidelines*) should not use the identifier, nor refer to itself as an "ETF", or as an "exchange-traded fund"[16]. EFAMA welcomes such a categorical approach for a clear product nomenclature, able to inform and better protect investors. Our experience, and even recently in the beginning of the 2020 Covid pandemic, sees that ETFs are all too often grossly confused with products that from a structural set-up, risk management and applicable regulation standpoint vary sometimes considerably. As a result, in November 2020, EFAMA authored an investor guide for the purpose of bringing greater clarity around ETPs to a less-sophisticated investor public. We believe that

[15] Please refer to our November 2021 paper on *Buy-side use cases for a real-time consolidated tape*; available at the following hyperlink, as well as EFAMA position paper on the EU MiFIR Review, *A buy-side view on consolidated tape and market structure reforms*; available at the following hyperlink.
[16] Please refer to paragraphs 15-16 of the ESMA *Guidelines*.

industry-led initiatives of this sort could be a valuable contribution to investor education, especially where the share of retail investors into ETPs (and ETFs in particular) is only destined to grow[17].

In relation to disclosures intended to mark a clearer distinction between broad, market capitalisation-weighted ETFs (alias "conventional" in the language of the consultation report) and a newer category of products (e.g. factor-weighted ETFs, active ETFs, ESG, etc. and which are not necessarily "complex" unlike the consultation report infers), we consider that these should more appropriately be made in the relevant sections of the disclosure documents as mandated by the EU UCITS framework. Alternative approaches, such as for instance adding the designation of "complex", or similar, to the existing "UCITS ETF" product identifier, would only risk creating confusion and splitting up an otherwise very clear label in Europe.

3. Liquidity Provision

> ***Measure 10:*** *Regulators and/or trading venues, where applicable, are encouraged to monitor secondary market trading and market making activities of ETFs and have rules governing the orderly trading of ETF shares.*

Q.17 Please describe how ETFs' trading or market making activity is monitored by regulators and trading venues. Does monitoring enhance the secondary market liquidity of ETFs? What are the key metrics that should be monitored and what are the appropriate follow-up actions?

With respect to monitoring and supervising ETFs' trading and market making activities, and besides the functions performed by an ETF issuer's dedicated capital markets team (as per our answer to Q.1 above) we prefer to defer the details to other market participants. However, what could nevertheless certainly improve the monitoring of trading activities, and not only related to ETFs, is the introduction of a consolidated tape in Europe.

Q.18 What rules are there to govern the cessation of liquidity provision by a MM? Do they minimize the impact to the secondary market liquidity of an ETF? What additional good practices have been considered in this regard?

We would defer this question to the relevant actors, however noting that it is generally mandatory for ETF providers to ensure that a least one main MM is operating on the exchange at any one point in time. This MM is required to sign an agreement with the exchange and commit to offer two-way pricing for the ETF within a predefined range. The MM has to uphold such obligation, or alternatively, be replaced after a relevant notice period.

4. Volatility control mechanisms (VCMs)

> ***Measure 11:*** *Regulators and/or trading venues, where applicable, are encouraged to appropriately calibrate volatility control mechanisms applicable to ETFs, considering factors including their liquidity profile and volatility profile. Where an ETF is listed or traded on a number of trading venues, those trading venues are encouraged to consider communicating with one another as appropriate when VCMs are triggered.*

[17] Please refer to EFAMA investor guide entitled *Demystifying ETPs: A simple guide for the European investor*; available at the following hyperlink.

Q.19 What are the key parameters that regulators and/or trading venues should take into account in calibrating the format of VCMs and the relevant thresholds applicable to different types of ETFs?

EFAMA believes that greater harmonisation and standardisation in the definition and activation of VCMs, based on reliable and transparent metrics, as well as on processes (e.g. auctions) is warranted across global exchanges. Please also refer to our considerations in the response to Q.5 above, insofar as the iNAV where used as a reference for circuit-breakers is concerned.

Q.20 What additional good practices related to design or implementation of VCMs have been put in place?

We would defer this question to the relevant actors.

ABOUT EFAMA

EFAMA, the voice of the European investment management industry, represents 27 member associations, 58 corporate members and 26 associate members. At end Q4 2021, total net assets of European investment funds reached EUR 21.9 trillion. These assets were managed by more than 35,000 UCITS (Undertakings for Collective Investments in Transferable Securities) and more than 30,000 AIFs (Alternative Investment Funds). At the end of Q3 2021, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 31.3 trillion.

More information is available at www.efama.org

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