Principles for the Regulation of Exchange Traded Funds

Final Report

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Relevant Definitions

Exchange-traded fund (ETF)	ETFs are open ended collective investment schemes (CIS) that trade throughout the day like a stock on the secondary market (i.e., through an exchange). Generally, ETFs seek to replicate the performance of a target index and are structured and operate in a similar way. Like operating companies, ETFs register offerings and sales of ETF shares and list their shares for trading. As with any listed security (including some closed-end investment companies), investors may trade ETF shares continuously at market prices, but ETF shares purchased in secondary market transactions usually are not redeemable from the ETF except in large blocks called *creation units*.[1] As noted in the definitions below, ETFs may be index-based or actively managed, and may pursue their investment objectives using a physical or synthetic investment strategy.
Authorized Participant (AP)	Unlike other open ended CIS, ETFs generally do not sell or redeem their individual shares (ETF shares) to and from retail investors directly at net asset value (NAV). Instead, certain financial institutions (known as authorized participants or APs) purchase and redeem ETF shares directly from the ETF, but only in creation units. Most often, an AP that purchases a creation unit of ETF shares first deposits with the ETF a *purchase basket* of certain securities and cash and/or other assets identified by the ETF that day, and then receives the creation unit in return for those assets. The basket generally reflects a pro rata portion of the ETF's underlying holdings. After purchasing a creation unit, the AP may hold the ETF shares, or sell some or all of the ETF shares in secondary market transactions. The redemption process is the reverse of the purchase process. The AP acquires (through purchases on national securities exchanges, principal transactions, or private transactions) the number of ETF shares that compose a creation unit, and redeems the unit from the ETF in exchange for a *redemption basket* of securities and/or cash and other assets (or all cash).
Exchange-traded products (ETPs)	ETPs include a wide variety of different investment products that share the feature of being traded on an exchange. They include ETFs that are organized as CIS, exchange-traded commodities (ETCs), exchange-traded notes (ETNs), exchange-traded instruments (ETIs), and exchange-traded vehicles (ETVs).

[1] A creation unit may be defined as the block of ETF shares (the number of which the ETF specifies) that an authorized participant can acquire or redeem, typically for a specified basket of securities or other assets.

Index-based ETFs	Index-based ETFs typically seek to replicate the performance that corresponds to that of an underlying index or benchmark. Index-based ETFs may seek to obtain this performance either by holding physical securities and other assets, or entering into one or more derivative contracts with a counterparty, as defined further below.
Physical ETFs	Physical ETFs seek to meet their investment objective by holding physical securities and other assets. Physical ETFs that are index-based obtain returns that correspond typically to those of an underlying index or benchmark by replicating or sampling the component securities of the index or benchmark. A physical index-based ETF that uses this replicating strategy generally invests in the component securities of the underlying index or benchmark in the same approximate proportions as in the underlying index or benchmark. The transparency of the underlying index typically results in a high degree of transparency in the ETF's underlying holdings. In certain cases, it may not be possible for an ETF to own every stock of an index (e.g., due to transactions costs, because the index is too large, or some of its components are very illiquid, or where an index's market capitalization weighting would result in the ETF violating regulatory requirements for fund diversification). Where owning every stock of an index is not possible, a physical index-based ETF may rely on sampling techniques. The physical index-based ETF implements the sampling strategy by acquiring a subset of the component securities of the underlying index, and possibly some securities that are not included in the corresponding index designed to improve the ETF's index-tracking. Some physical ETFs, however, may be non-indexed based (or actively-managed). i.e., with a portfolio selected at the discretion of the investment manager.
Synthetic ETFs	Synthetic ETFs seek to meet their investment objective by entering into a derivative contract (typically through a total return swap) with a selected counterparty. The swap contracts can take two forms: (i) a so-called *unfunded structure*; and (ii) a so-called *funded* or *prepaid* swap structure. Synthetic ETFs tend to be concentrated in Europe and in some parts of Canada and Asia.[2]
Synthetic ETF *unfunded* structure	In this type of synthetic ETF structure, the ETF provider/manager invests the cash proceeds from investors in a so-called *substitute* or *reference basket* of securities (which is typically bought from a bank). The basket's return

2 According to data elaborated by ETFGI, as of January 2013, 60% of the European ETF offer is synthetic, compared to 20% of the offer in the Asia/Pacific region including Japan. Hybrid ETFs (accounting for roughly 1% of ETF-managed assets globally according to ETFGI) are structures that utilize both replication techniques purely as a mean to mitigate e.g., the occasional impact of market closings (i.e., long public holiday periods in certain jurisdictions) or the temporary unavailability of certain securities.

	is swapped via a derivative contract with an eligible counterparty (frequently, the derivatives desk of the same bank) in exchange for the return of the index referenced in the ETF's investment objective.
Synthetic ETF *funded* structure	In the funded model type, a synthetic ETF seeks to obtain a return in line with the performance of its reference index by engaging in a swap in exchange for cash (or for the entire ETF portfolio) without the creation of a substitute basket. In both models, derivative exposure is collateralized or reduced through a collateral or portfolio management process that may involve the services of a third party as collateral agent (in the *funded* model) or is covered by the substitute basket as assets of the ETF (in the *unfunded* model).[3]
Actively managed ETFs	ETFs where the manager typically exercises discretion over the composition of the invested portfolio in an attempt to outperform a chosen benchmark. The key difference compared to passive ETF products is therefore a manager's ability to adjust the portfolio without being subject to the set rules of an index.
Leveraged & inverse ETFs	Leveraged ETFs seek to deliver multiples of the performance of an index or benchmark over a specified time frame. Inverse ETFs (also called short funds) seek to deliver the opposite of the performance of the index or benchmark over a specified time frame. Like other ETFs, some leveraged and inverse ETFs reference broad indices, some are sector-specific, and others are linked to commodities, currencies, or some other benchmark. Use of leverage may alternatively be embedded in an index itself, whereby the index provider attempts to replicate the payoff to leveraged investment strategies. Inverse ETFs often are marketed as a way for investors to seek to profit from, or at least hedge their exposure to, downward moving markets. Leveraged inverse ETFs (also known as ultra short funds) seek to achieve a return that is a multiple of the inverse performance of the underlying index over a specified time frame. An inverse ETF that references a particular index, for example, seeks to deliver the inverse of the performance of that index, while a 2x (two times) leveraged inverse ETF seeks to deliver double the opposite of that index’s performance. To accomplish their objectives, leveraged and inverse ETFs pursue a range of investment strategies through the use of

3 For further information on the differences between the two synthetic replication models, see *Synthetics under a Microscope*, published by Morningstar ETF Research in July 2011; available at: http://news.morningstareurope.com/news/im/msuk/PDFs/Morningstar%20ETF%20Research%20-%20Synthetic%20ETFs%20Under%20the%20Microscope.pdf

	swaps, futures contracts, and other derivative instruments. Most leveraged and inverse ETFs *reset* daily, meaning they are designed to achieve their stated objectives on a daily basis. In general, the daily return of this type of ETF will be a multiple, or inverse (multiple), of the daily return of the stated index or benchmark. However, the weekly, monthly, and annual returns of this type of ETF will generally not be equal to the corresponding multiple, or inverse (multiple), of the weekly, monthly, or annual returns of the stated index or benchmark. This effect can be magnified in volatile markets.
Tracking Error	Tracking error measures how consistently an index-based ETF follows its benchmark underlying reference index. Tracking error is defined by the industry as the volatility (as measured by standard deviation) of the differences in returns between a fund and its underlying reference index. The tracking error helps measure the quality of the replication.
Tracking Difference	Tracking difference measures the actual under- or outperformance of the fund compared to the underlying reference index. Tracking difference is defined as the total return difference between a fund and its underlying reference index over a certain period of time.

Chapter 1 - Introduction

There is increasing interest in ETFs worldwide as evidenced by the significant amount of money invested in these types of products. The dynamic growth of ETFs has also drawn the attention of regulators around the world who are concerned about the potential impact of ETFs on investors and the marketplace.

The IOSCO Committee on Investment Management (C5), in the course of 2008-2009, decided to carry out preliminary work into the ETF industry. Responses to a questionnaire sent to member jurisdictions and subsequent hearings with industry representatives confirmed the value of further policy work to assist national regulators in addressing potential issues. In 2010, C5 sought the endorsement of the former IOSCO Technical Committee (TC) – now the IOSCO Board – for a policy initiative to establish a common set of principles of value for regulators, industry participants, and investors alike. The C5 proposal was adopted by the TC in June 2010 and outlined a three-fold mandate:

1. Highlight the experience and key regulatory aspects regarding ETFs and related issues across C5 members;
2. Identify the common issues of concern; and
3. If appropriate, develop a set of principles or best practices on ETF regulation.

In order to carry out its mandate, C5 established an *ad hoc* working group, co-Chaired by the French AMF and the US SEC, and comprising the following C5 Members: the AMF of Québec, the Ontario Securities Commission, the Swiss FINMA, the German BaFin, the Hong Kong SFC, the Italian CONSOB, the CSSF of Luxembourg, the Central Bank of Ireland (CBI), the Spanish CNMV and the UK FSA.

Consistent with the mandate of C5, these principles address only ETFs that are organized as CIS and are not meant to encompass other Exchange Traded Products[4] (ETPs) that are not organized as CIS in a particular C5 Member jurisdiction. Accordingly, unless otherwise noted, when used in this paper, the term ETF refers only to an ETP organized as CIS.[5]

As ETFs are CIS, C5 notes that work done by IOSCO with respect to other areas of CIS regulation are also applicable to the management and operations of ETFs.[6] Therefore, in this paper, C5 chiefly identifies principles that distinguish ETFs from other CIS, reviews existing IOSCO principles for CIS, and adapts those principles to the specificities of an ETF structure where relevant. More general recommendations are made where concerns are not exclusive to ETFs or to securities markets regulation.

4 Please refer to the definition in the above Relevant Definitions section.

5 In particular, we note that an entity that may be deemed to be an ETF organized as a CIS in one C5 member jurisdiction may be deemed a non-CIS ETP in another. For example, some synthetic products regulated as CIS in Europe may not be regulated as CIS in the U.S. For the purposes of the principles in this report, ETFs are understood in the U.S. to be those ETFs that are regulated under the Investment Company Act of 1940 (*Investment Company Act*). *See* Appendix IV.

6 See *Principles for the Supervision of the Operators of Collective Investment Schemes*, IOSCO Report, September 1997; available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD69.pdf.

The aim of this report is to outline principles against which both the industry and regulators can assess the quality of regulation and industry practices concerning ETFs. Generally, these principles reflect a common approach and are a practical guide for regulators and industry practitioners. Implementation of the principles may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances.

Box 1: ETF industry overview and emerging trends

As mentioned above, the global ETF industry is characterised by a rapid evolution and strong growth. Below are a few of the more noticeable trends that may be relevant to understand the context of the present policy work.

- In terms of size, according to industry estimates released at the end of January 2013, the assets managed under ETF structures amount to USD 1.9 trillion[7], representing roughly 7% of the global mutual fund market, which is estimated to manage approximately USD 26.8 trillion;[8]
- Investor appetite expressed in terms of net new asset flows into ETFs has reached USD 243 billion by year-end 2012, compared to the corresponding year-end 2011 figure of USD 161 billion. At year-end 2012, the lion's share in terms of the sought after exposure was occupied by equity indices (USD 165 billion), followed by fixed income (USD 63 billion) and by commodities (USD 7 billion);[9]
- Although traditionally the largest ETFs have been those based on broad market, cap-weighted indices, over the last three to four years, index providers have begun offering indices that are no longer cap-weighted. Instead, as a response to a low-yield environment, providers have turned to offer alternatively-weighted indices, e.g., equal-weighted indices, risk-weighted indices, sector-weighted indices, etc. that seek to deliver higher positive returns;[10]
- The industry is consolidated and dominated by a few large players.

Other market trends are a reflection of the increased regulatory scrutiny that has gone into ETF products, particularly in Europe:

- The large ETF providers in some jurisdictions have substantially increased the disclosure to investors regarding the collateral held and the use of securities lending, as well as the management of counterparty risk;
- Synthetic ETF providers have taken significant steps to increase transparency, minimize counterparty risk, including over-collateralization and the implementation of safeguards guaranteeing the minimum quality and liquidity of collateral;
- In Europe, this latter trend was spurred by the action of ESMA, which in January 2012 outlined the contours of a future regulatory framework for European (UCITS) ETFs via a

7 Source: ETFGI: Global ETF and ETP industry insights (January 2013).

8 Source: ICI Worldwide Mutual Fund Assets and Flows (Fourth Quarter 2012).

9 Source: ETFGI: Global ETF and ETP industry insights (January 2013).

10 See *Innovation drives next generation of indices*, by Peter Davy in *Financial News*, Issue 842; available at: http://www.efinancialnews.com/story/2013-03-18/innovation-drives-next-generation-indices

consultation that ultimately has led to a final set of *Guidelines on ETFs and other UCITS issues* published in December 2012.[11] As the *Guidelines* have introduced a series of recommendations for (UCITS) ETFs to reduce their counterparty risk – regardless of the replication model that is used – there is also evidence that certain providers have begun reviewing their practices in terms of limiting the portion of an ETF's portfolio they agree to lend out.[12] The debate around the merits of physical as opposed to synthetic ETFs has settled and there is evidence that market players have begun competing actively on fees in a way that proves advantageous for investors through the offer of more transparent and cheaper products;

- With regard to index replication techniques, physical ETFs occupy the largest market share worldwide, with approximately 90% of all global ETF managed assets. A recent trend in Europe has nevertheless seen established synthetic ETF providers make a gradual shift to the physical replication model, either by converting their existing synthetic ETF inventory or via new launches). These moves have been justified by the relevant providers as a response to investors' demand.[13]

For an update on the regulatory changes in Europe or in the U.S., see Appendix IV.

11 See ESMA *Guidelines on ETFs and other UCITS issues*, published on 18 December 2012; available at: http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf (for a summary, please see Appendix IV).

12 For instance, already in June 2012, one significant industry player introduced a 50% limit on the amount of assets that one of its European ETFs can lend out to a third party, i.e., well below the maximum permitted by current European regulations (i.e., 100%). In parallel, this company also decided to provide an indemnity, so that investors will not face financial losses in the case of a default by a counterparty to a securities lending transaction involving one of its ETFs. In the U.S., ETFs generally may not lend more than one-third of total assets. In calculating this limit, the SEC's staff has taken the view that the collateral (i.e., the cash or securities required to be returned to the borrower) may be included as part of the lending fund's total assets. Thus, an ETF could lend up to 50% of its asset value before the securities loan.

13 See statements by Thorsten_Michalik, global head of db X-trackers and Alain Dubois, chairman of Lyxor in the FTfm article *Deutsche and Lyxor switch tactics* dated 18 November 2012 where they said respectively that "Some clients have shown a preference for direct (physical) replication and we aim to meet that demand", and "Lyxor is diversifying its offering to include physically replicated ETFs to fully address investors' needs."

Chapter 2 - Principles Related to ETF Classification and Disclosure

1. Disclosure regarding ETF classification

ETFs offer public investors an interest in a pool of securities and other assets as do other CIS (such as Undertakings for Collective Investment in Transferable Securities - UCITS - or mutual funds), except that shares in an ETF can be bought and sold throughout the day like stocks on an exchange through an intermediary.

Disclosure standards for ETFs generally should be consistent with those required for other CIS, but may require additional disclosures when justified by the specificity of funds' exchange traded nature, for instance, disclosures explaining the peculiarities of the unit creation/redemption mechanism, or explanations with regard to the numerous factors that affect an ETF's intraday liquidity. In particular, appropriate disclosure is needed in order to help investors understand and identify ETFs. Disclosure regarding classification that helps investors distinguish ETFs from non-CIS ETPs and from other CIS, and understanding the risks and benefits of each also would be helpful.

Principle 1: ***Regulators should encourage disclosure that helps investors to clearly differentiate ETFs from other ETPs.***

Principle 2: ***Regulators should seek to ensure a clear differentiation between ETFs and other CIS, as well as appropriate disclosure for index-based and non index-based ETFs.***[14]

Means of implementation:

ETFs have to comply with applicable CIS regulation, but other kinds of ETPs generally are not subject to such requirements. In particular, despite the fact that, like ETFs, these are also products that trade intra-day on an exchange platform, non-CIS ETPs are usually index-tracking listed debt products that are characterised by very different diversification and risk management requirements. Thus, in terms of seeking to help investors understand the differences between ETFs and non-CIS ETPs, regulators should consider requiring ETFs to describe the distinguishing characteristics and regulatory requirements applicable to ETFs in a particular jurisdiction that are not applicable to other ETPs, including any requirements related to diversification, underlying asset liquidity, or risk management.[15] Investors could then compare the ETF's disclosure with disclosure by other products to understand the different characteristics and regulatory requirements. The adoption by regulators of a classification scheme, accompanied by the use of a common *ETF identifier* as already adopted in certain jurisdictions, may represent a useful tool.[16]

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[14] Index-based ETFs seek to obtain returns that correspond to those of an underlying index. Non index-based ETFs represent a small category of ETFs that are generally actively managed.

[15] Implementation of these principles is directed at disclosure by ETF providers.

[16] See for instance the ESMA *Guidelines on ETFs and other UCITS issues*, published in December 2012, introducing a specific *UCITS ETF* identifier for use across all EU Member States.

Regulators should seek to ensure that disclosures describe the specific ways in which an ETF may be similar to and different from other CIS (i.e., an open-end CIS or mutual fund). In particular, disclosure (including, where appropriate, sales literature) could make clear to investors whether an ETF may sell or redeem individual shares to or from retail investors. Whereas ETFs usually do not provide for direct redemptions, regulators may require that retail investors be given the right to redeem their shares directly from the ETF provider in exceptional circumstances (e.g., stressed market conditions) provided appropriate safeguards are in place. In addition, disclosure should help investors understand an ETF's investment strategy, such as if it is index-based.

2. Disclosure regarding ETF portfolios

Principle 3: ***Regulators should require appropriate disclosure with respect to the manner in which an index-based ETF will track the index it references.***

Principle 4: ***Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio and/or other appropriate measures in order to provide adequate information concerning:***

i) any index referenced and its composition; and

ii) the operation of performance tracking.

Means of implementation:

The disclosures recommended by the above principles should be viewed in the broader context of existing CIS regulation in Member jurisdictions and particularly of index-based CIS. With regard to index-based ETFs, regulators could require an index-based ETF to include disclosures in the prospectus, in offering documents, or in other disclosure documents, with respect to how the performance of an index is tracked and to risks associated with this method.

With regard to transparency of an index-based ETF's portfolio, one way in which regulators might address these issues is to require that an ETF publish daily the identities of the securities in the purchase and redemption baskets which are representative of the ETF's portfolio.[17] Arbitrage activity in ETF shares is facilitated by the transparency of the ETF's portfolio because it enables market participants to realize profits from any premiums or discounts between the intraday price of the ETF and the NAV of the fund. Arbitrageurs seeking to realize such profits apply opposing buy and sell pressure to the ETF in comparison

[17] For example, in the United States, each day, the ETF publishes the identities of the securities in the purchase and redemption baskets, which are representative of the ETF's portfolio. To be listed and trading on an exchange, the ETF is required to widely disclose an approximation of the current value of the basket on a per share basis (often referred to as the Intraday Indicative Value or IIV) at 15 second intervals throughout the day and, for index-based ETFs, disseminates the current value of the relevant index. In addition, the NAV is typically calculated and disseminated at or shortly after the close of regular trading of the exchange on which the ETF is listed and trading. The NAV is required to be disseminated to all market participants at the same time. If any of the aforementioned values is interrupted for longer than a trading day or is otherwise no longer being disseminated, or if the NAV is unevenly disseminated, the exchange listing and trading such ETF is required to halt trading in such ETF until such values are disseminated as required.

to its underlying components that helps to reduce intraday premiums or discounts.[18] An efficient arbitrage mechanism is therefore designed to ensure that the intraday value of the ETF's shares is closely aligned (i.e., minimizes wide premiums and discounts) with the ETF's intraday NAV per share.[19]

In addition, index-based ETFs in certain jurisdictions may lack common standards for assessing their performance. Noticeable differences have been noted by regulators in some jurisdictions regarding the quality and consistency of performance reporting and tracking error measurements. Regulators might therefore consider requirements regarding disclosure in order to help provide adequate information to investors concerning the index and performance tracking. Such disclosure might include:

i) Information on the index composition, its methodology and relative weightings (index providers also may publicly announce the components and/or value of their indices, which could assist investors in understanding any tracking error and permit investors to reference the units' intra-day performance). Such information should be provided in an appropriate time frame. [20]

ii) The past performance of the ETF measured through its realised tracking difference and tracking error;

iii) The methodology used to measure tracking error as published in the investor disclosure documents, as well as a policy to minimize tracking error, including what level of tracking error may be reasonably expected; and

iv) A description of issues which will affect the ETF's ability to fully replicate its target index (e.g., transaction costs of illiquid components).

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18 For example, in France, specific rules fix continuous limits to the maximum possible discrepancy between the intraday value of underlying index ("iNAV") and the ETF share price. When the limits are reached, a trading interruption (reservation) sets in leading to a subsequent auction. Thus, according to section 4.1.2.3 of the Trading Manual for the Universal Trading Platform, and according to the Euronext Rule Book, Book 1 of the Trading Manual, the French stock exchange stipulates that: "Reservation thresholds consist of applying a range above or below an estimate of the net asset value ("indicative net asset value", referred to as "iNAV") for ETFs or a reference price contributed by the selected Liquidity provider for ETNs and ETVs, as updated during the Trading Day according to the movements of the underlying index or asset. The level of this range is set at 1.5% for ETFs, ETNs and ETVs based on developed European equity, government bonds and money market indices and 3% for all others. For products providing a cap or a floor-value, the trading thresholds resulting from the above-mentioned rules shall not break the said cap or floor-value."

19 Trading activity in ETFs, including OTC trading, should be subject to regulation with respect to reporting of securities transactions. In the U.S., for example, all trades (subject to some very minor exceptions), on or off exchange, must be reported to the consolidated tape.

20 In this regard, IOSCO stresses the importance of disclosing information on the index composition and weightings to market participants, although it is cognizant of the concerns expressed by certain stakeholders as to the protection of proprietary information. Regulators should therefore consider the appropriate level of disclosure relating to index composition and weightings that addresses these concerns, while also accounting for the sophistication of concerned investors, local conditions, as well as the overall efficiency of arbitrage activities. In terms of index transparency and quality, please also refer to the IOSCO Principles for Financial Benchmarks, especially with regard to the recommended disclosures around the contents of a benchmark's methodology. For further information on this initiative, please consult the IOSCO website when the final document becomes available.

3. Disclosure regarding ETF costs, expenses and offsets

ETF shareholders currently may pay a number of costs or bear expenses, some of which may be more transparent than others. One type of ETF trading cost incurred directly by investors is reflected in bid/ask spreads.[21] Another relevant factor may be changes in discounts and premiums between the ETF's shares and the ETF's NAV.[22] As with other CIS, ETF shareholders also incur fund expenses while holding ETF shares. There may also be indirect costs borne by an ETF and its shareholders (e.g., trading costs incurred when a physical ETF purchases its underlying securities). In some jurisdictions, indirect costs borne by synthetic ETFs may be balanced by cost savings on the underlying assets, due to the fact that synthetic ETFs do not need to buy all of the instruments in the underlying index. Moreover, an investor's particular portfolio strategy (i.e., buy-and-hold vs. active investing) also may impact the total cost of investing in such a product, particularly with respect to commissions and other trading costs.

Similar to other CIS, ETFs also may engage in securities lending activities. In the case of index-based ETFs, such activities may result in returns that can partly offset the ETF's management fee, helping the ETF to more closely achieve the performance of its reference index and may, subject to the split of revenues from such activities with the securities lending agent, which could be the same entity as or an affiliated entity of the ETF operator and the ETF, therefore improve the ETF's performance.

Principle 5: ***Regulators should encourage the disclosure of fees and expenses for investing in ETFs 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.***[23]

Principle 6: ***Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities (e.g,. on related costs).***

Means of implementation:

The fee information disclosed by ETFs should be aimed at enabling investors to understand the impact of fees and expenses on the performance of the product and describe the ETF's cost structure (e.g., the management fee; operational costs; where relevant, swap costs; etc.). If appropriate, regulators also may require disclosure on other types of fee and cost information, such as disclosure regarding brokerage commissions, tax structure, and additional information on revenues (including a breakdown) derived from assets held by the ETFs that are likely to have an impact on performance. These disclosures may include

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[21] The *bid* is the market price at which an ETF may be sold and the *ask* is the market price at which an ETF can be bought.

[22] An ETF is said to be trading at a *premium* when its market price per share is higher than its NAV per share and to be trading at a *discount* when its market price per share is lower than its NAV per share.

[23] For more on best practices standards, see *Elements of International Regulatory Standards on Fees and Expenses of Investment Funds*, Final Report, Report of the Technical Committee of IOSCO, October 2004; available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD178.pdf.

additional information on rebalancing costs, on revenues derived from fund assets, and on the way these are distributed between an ETF operator and the ETF's shareholders (e.g., such as dividends of equity shares or coupon payments of fixed income securities).

Similar to other CIS, physical ETFs also may lend securities to other financial institutions in exchange for a fee paid by the borrower. Securities lending can in some cases provide relatively significant additional revenues to ETFs, particularly ETFs with comparatively lower fees. The scope and scale of ETF securities lending activity differs across jurisdictions and even among ETFs within the same jurisdiction. In some jurisdictions, there are restrictions on the amount of securities that may be loaned.[24] In other jurisdictions, where a significant amount of securities may be loaned, regulators could require specific disclosure, for example, to help inform investors about conflicts of interest that could arise when such revenues accrue (at least in part) to the ETF's operator.[25]

In this sense, in those jurisdictions where there are not restrictions on the amount of securities that may be loaned, such disclosure should be designed to help investors understand whether revenues are received by parties other than the ETF or its investors (e.g., a lending agent).[26] Such disclosure arguably becomes even more significant where ETFs are marketed to retail investors as having low (or no) management fees. If securities lending revenues represent a significant source of return, another option, would be to require disclosure of gross returns from securities lending from other sources of fund income.[27] This would allow investors to assess how such revenues have contributed to the performance of the ETF and to assess the efficiency of the ETF's operator in distributing such revenues to other service providers involved (e.g., securities lending-agents).[28] Such disclosures would allow the ETF's operator to inform investors about the major trade-offs the ETF may have to balance when handling such revenues or how such revenues might be shared between the ETF and its operator. Such additional disclosure might also be desirable when dividend management leads to specific tax treatment and/or to risk-return trade-offs that may materially impact the ETF's performance

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24 As stated previously, in the U.S., ETFs generally may not lend more than one-third of total assets. In calculating this limit, the SEC's staff has taken the view that the collateral (i.e., the cash or securities required to be returned to the borrower) may be included as part of the lending fund's total assets. Thus, an ETF could lend up to 50% of its asset value before the securities loan.

25 In the U.S., if lending income is paid to the CIS operator as part of the advisory contract, such compensation would be considered by the CIS board of directors as part of its process of approving the advisory contract. Moreover, the CIS's board approves any and all compensation paid to the lending agent. Fees may be paid in connection with securities lending only for services rendered.

26 The amount of fees paid to a lending agent may not be the most important factor in assessing whether to hire a lending agent. The least expensive lending agent may not have the best performance or be the best match for a lender. In addition, for a discussion of issues relating to use of an affiliated lending agent, see *infra* in Chapter 4.

27 In Europe, the *ESMA Guidelines on ETFs and other UCITS issues* of December 2012 for instance foresee that a UCITS (as the majority of ETF structures in Europe are labelled) should disclose in the prospectus the policy regarding direct and indirect operational costs/fees arising from efficient portfolio management techniques that may be deducted from the revenue delivered to the fund. These costs and fees should not include hidden revenues. The fund should disclose the identity of the entity(ies) to which the direct and indirect costs and fees are paid and indicate if these are related parties to the management company or the depositary.

28 This disclosure could be particularly helpful where, for example, the ETF's underlying equity index is a price index (i.e., namely an index that, unlike total return indices, does not take into account dividend reinvestment).

(e.g., when the ETF's operator manages dividends actively by using, for instance, dividend options). In addition, it could help investors to assess counterparty risks to which they may be exposed, especially when an ETF lends its assets in order to optimize its returns.

4. Disclosure regarding ETF strategies

Since they were first developed in the early 1990s, ETFs have evolved. The first ETFs (such as the SPDR in the U.S.) held a basket of securities that replicated the component securities of broad-based stock market indices, such as the S&P 500. In Europe, most ETFs also initially replicated broad market indices but were structured as synthetic ETFs where exposure is obtained through the use of a total return swap. Many of the newer ETFs are based on more specialized indices, including sector/regional indices, indices based on less liquid asset classes (e.g., bonds, commodities), and indices designed specifically for a particular ETF. The investment objectives and techniques of index-based ETFs have also become more diverse and complex, leading to the creation of a new generation of ETFs, such as those that are leveraged through the use of futures contracts and other types of derivative instruments, or that reference the inverse of an index's performance. With respect to the use of derivatives, ETFs could consider making appropriate disclosure to provide investors with meaningful information about the fund's anticipated use of derivatives in light of the ETF's actual or anticipated operations.

Principle 7: ***Regulators should encourage all ETFs, in particular those that use or intend to use more complex investment strategies to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with the ETFs' strategies.***

Means of implementation:

Regulations should encourage adequate disclosure of the specificities of ETF investment strategies and replication techniques, including any specific risk associated therewith. Regulators might address this concern by, for example, requiring an ETF to provide disclosure in its prospectus, in offering documents, or in other disclosure documents, that reflects its material operations, particularly its use of complex investment strategies, use of derivatives, or securities lending agreements. Regulation could also require that an ETF, when updating its disclosure documents review its investment strategies, investments in derivatives, and provide timely disclosures in reports to its shareholders in the event of material changes identified *ex-ante* (e.g., organizational change).

Where ETFs engage in significant use of derivatives, the identification of a counterparty (accompanied by further disclosures as appropriate) may be an important component for the disclosure's completeness. In addition, regulators could require an ETF provider to explain the nature and extent of its counterparty exposure, including information on the collateral agreements to mitigate such exposure.[29] It should be kept in mind that many other CIS also use complex investment strategies, derivatives and securities lending agreements and that ETFs may not present unique risks.

[29] See *infra* in Chapter 4.

Chapter 3 - Principles Related to the Structuring of ETFs

1. Conflicts of interest

Due to the nature and structure of CIS, conflicts of interest may arise between the CIS operator and the CIS shareholder. ETFs share many of the general CIS conflict of interests, but also may be subject to specific conflicts arising from the ETF structure.

As noted above, recent innovations include ETFs that are based on indices designed specifically for a particular ETF. A few of the index providers that compile and revise indices that are designed specifically for a particular ETF are affiliated with the sponsor of that ETF. These affiliated index ETFs raise the risk of the communication of material non-public information between the ETF and the affiliated index provider.

In some jurisdictions, intra-group affiliations in respect of authorised participants (APs) also can lead to conflicts of interest; especially when there is a small number of APs.[30] The affiliated AP, if it has the ability to exercise power over the ETF provider through the group parent, has the ability to *channel business* through in-house trading desks, in order to gain an order flow benefit. Moreover, the group parent may also have the ability to instruct the ETF provider to *authorize* and *de-authorize* competitor APs. This conflict may have consequences for the fair pricing of the ETF shares on the secondary market and the ability for investors to redeem ETF shares.

Synthetic ETFs also may raise potential conflicts of interests where affiliates are involved, for example as the swap counterparty.[31]

Principle 8: ***Regulators should assess whether the securities laws and applicable rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interests raised by ETFs.***

Means of implementation:

Where a custom index is created by an affiliate, regulators should appropriately address the conflicts that could arise. For example, when an index is created by an affiliate of the ETF, ways to address the conflicts that could arise might include:

a) Making publicly available all of the rules that govern the composition, inclusion and weighting of securities in each index *in an appropriate time frame*;

b) Limiting the ability to change the rules for index compilation and requiring public notice before any changes are made; and

c) Where appropriate, by establishing firewalls between the staff responsible for the

30 In the U.S., CIS are generally prohibited from conducting affiliated transactions and those prohibitions would apply to an AP affiliated with an ETF provider.

31 As noted above, U.S. prohibitions on affiliated transactions generally would apply to a swap transaction where an affiliate is the counterparty.

creation, development and modification of the index compilation rules; and the portfolio management staff.

In the case of a synthetic ETF that obtains its return through entering into an asset swap with an affiliated counterparty such as a bank affiliated with the management company of the ETF, regulators also should consider requirements designed to address the potential conflicts of interest raised by this type of arrangement, e.g., their disclosure and ensuring that both entities are hierarchically separate.

Other measures could include fostering greater market transparency on the terms and conditions for the services offered to an ETF, e.g., regarding fee structures. The harmonization of ETF listing rules (e.g., particularly in terms of maximum spreads, offer sizes, minimum time presence, etc.) could usefully complement these alternatives.

2. Managing counterparty risks

Physical ETFs accomplish their investment objective either by purchasing the component securities directly, or by indirectly selecting a sample of the index's component securities. Synthetic ETFs that seek to track the returns of an underlying index do so through the use of derivatives, typically through a swap.[32] Leveraged or inverse ETFs rely on a range of investment strategies typically involving swaps, futures, and other derivative instruments to magnify investment returns. In addition, ETFs may also engage in securities lending. The use of derivative instruments for index replication purposes, or engaging in securities lending, entails counterparty credit risk for the ETF and its shareholders. Counterparty credit risk is the risk attributable to the downgrading and/or insolvency of a counterparty either in an OTC transaction or in a securities lending arrangement.

Principle 9: ***Regulators should consider imposing requirements to ensure that ETFs appropriately address risks raised by counterparty exposure and collateral management.***

Means of implementation:

Although counterparty exposure and collateral management are not exclusive to ETFs and may concern all CIS, they may be better appreciated in the light of the two main ETF-specific replication strategies.

a) Synthetic and other derivative-based ETFs

As described above, synthetic ETFs pursue a range of investment strategies partially or wholly through the use of swaps, futures contracts, and other derivative instruments. Thus, synthetic ETFs obtain their desired return, in whole or in part, by entering into derivative transactions with one or more eligible counterparties. Overall, this strategy may reduce high rebalancing costs and may help diminish tracking error generally associated with physical replication. Despite the exchange of collateral, synthetic ETFs expose themselves to the risk of a default of the swap counterparty. This issue is nevertheless not specific or inherent to

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[32] As explained in the Relevant Definition section, synthetic ETFs may be *funded* or *unfunded* structures, with a consequence on how the collateral is held and who owns it. For example, the selected structure may affect the timing of a potential liquidation of the assets.

synthetic ETFs, but to a broader scope of products embedding a swap derivative.

Concerns also have been raised that, with regard to these synthetic ETFs, in some jurisdictions, there is no requirement for collateral to be of the same nature and quality of the securities making up the referenced index. As the collateral, or the direct investments belonging to the ETF in the *unfunded* model, together with any additional financial guarantees that the ETF may receive, are intended to cover the counterparty risk borne by ETF shareholders, they should be prudently valued (i.e., at least daily, independently, and allowing for haircuts and discount rates to mitigate valuation uncertainties) and be sufficiently liquid and of high quality. By satisfying these conditions, in the event of the counterparty's default, the ETF may more easily find either a new counterparty to the swap contract, or turn to physical replication, or liquidate the basket of collateral to return monies back to investors at a limited discount.[33] Moreover, high standards for collateral partially address potential risks consisting in the incentive that banks would have to post less liquid securities to the ETF as collateral.[34] Additionally, periodic publication of ETFs' counterparties, the exposure, along with the amount and composition of the ETF's collateral may also be required.

Regulators should appropriately address risks raised by synthetic ETFs in their jurisdictions. In assessing alternatives, regulators should consider the ETF risk exposure from derivatives investment and develop requirements – to the extent that they do not already exist - proportionate to the risks raised by the scope and scale of such activity and the structure of each ETF. For example, ETFs that invest largely in futures may not be exposed to the same counterparty risk as those that invest in OTC swaps.[35] As another example, in some jurisdictions, ETFs may become subject to liquidity requirements, designed to ensure that they are able to meet obligations resulting from exposure to leveraged derivative investments, while continuing to satisfy redemption requests).[36]

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33 In Europe, when the synthetic ETF receives collateral to reduce exposure to the counterparty, this collateral must comply with the relevant criteria in ESMA *Guidelines on ETFs and other UCITS issues* as published in December 2012. Of the multiple criteria, the most relevant consist in requiring that collateral other than cash be highly liquid and traded on a regulated market (or multilateral trading facility), that it be valued at least on a daily basis and conservative haircuts applied where it exhibits high price volatility, that it not be issued by the counterparty or exhibit a high correlation with it, that it be diversified across markets, country and issuer with an exposure to a given issuer no larger than 20% of the (UCITS) ETF's NAV, that it be capable of being fully enforced at any time, that non-cash collateral not be sold, re-invested or pledged, that cash collateral be invested according to certain strict conditions, and that stress tests be carried out under normal and exceptional liquidity conditions when a (UCITS) ETF receives collateral for at least 30% of its assets. For more details, see paragraphs 41-47 of the *Guidelines*; available at: http://www.esma.europa.eu/system/files/2012-832en_guidelines_on_etfs_and_other_ucits_issues.pdf .

34 The Bank for International Settlements (BIS) has exposed a potential risk consisting in the incentive that banks could have to avoid the more stringent liquidity standards of Basel III by posting their riskier and more illiquid assets as collateral to third counterparties, including to ETFs. In its view, a large investment bank, that is at the same time authorised participant (AP) and swap counterparty to the ETF, would be in a position to upgrade its asset inventory for the purpose of funding itself at better terms on the repo market, whilst transferring lower quality assets off its balance sheet and into the ETF. See S. Ramaswamy, *Market structures and systemic risks of exchange-traded funds*, BIS Working Papers (No. 343), April 2011; available at: http://www.bis.org/publ/work343.pdf

35 Though, in many jurisdictions, regulatory reform requiring central clearing of certain OTC swaps may mitigate this risk.

36 This is the case in the U.S. with regard to leveraged ETFs (the types of synthetic encountered in Europe, Canada or in Asia generally do not exist as a CIS in the U.S.). In addition, funds and their

b) Physical ETFs

Physical ETFs also may invest in derivatives as part of their investment strategy, and regulators should consider requirements to address counterparty and collateral risks that are implied by such activity. In assessing alternatives, regulators should consider the amount of derivatives investment in which an ETF engages and develop requirements proportionate to the potential risks raised by the scope and scale of such activity.

Further, physical ETFs may be exposed to counterparty credit risk to the extent that they engage in securities lending. While the FSB noted concerns with regard to ETF securities lending, this issue is not specific or inherent to ETFs, but to a much broader scope of products and/or activities.[37] Moreover, as mentioned earlier, the scope and scale of ETF securities lending activity differs across jurisdictions and even among ETFs within the same jurisdiction. Such activities may raise potential counterparty risk if the default of the borrowing counterparty results in that party's inability to return the loaned securities to the ETF. Regulators should consider requirements to address such counterparty risks accordingly. For example, they could limit the extent to which an ETF can lend securities and require that loans be fully or over-collateralized,[38] with collateral requirements similar to those for synthetic ETFs. Additionally, in jurisdictions where the amount of securities that can be loaned is significant, regulators might consider requiring appropriate disclosure of ETFs risk management policies with regard to securities lending, as well as of their lending

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counterparties typically agree under master swap agreements to both post collateral equal to their daily marked-to-market exposure under a swap, netted across all of the swaps between the two parties and additionally agree on acceptable forms of collateral; usually cash and U.S. treasury and agency securities, but other securities such as equities are sometimes permitted – as well as an agreed-upon haircut representing the negotiated relative risk associated with a particular type of collateral. See 16 May 2011 Letter to Secretariat of the FSB from the Investment Company Institute regarding *Potential Financial Stability Issues Arising from Recent Trends in Exchange Traded Funds* (ICI Comment); available at: http://www.ici.org/pdf/25189.pdf.

37 The European Central Bank expressed this view: "it is worthwhile mentioning that the risks and transparency issues raised [recently by financial authorities in connection with securities lending by ETFs] are not ETF-specific and might also be relevant for certain types of mutual funds or the underlying building blocks (i.e., swaps, securities lending) more generally." See Chapter III – The Euro Area Financial System at n. 5, *Financial Stability Review June 2011,* European Central Bank June 2011; available at: http://www.ecb.eu/pub/pdf/other/financialstabilityreview201106en.pdf?dd351cc552a0033e8f96e09533e3c85d.

See also comment letter of the Investment Company Institute on the FSB note, "Many types of collective investment vehicles, including mutual funds, hedge funds, pension plans, and collective investment trusts, as well as other market participants, engage in securities lending. Thus, to the extent there is concern about the impact of securities lending activities on the broader markets, it should not be approached as an ETF-specific issue", 16 May 2011.

38 This is the case in the U.S. where ETFs may not lend out more than 33% of total assets, including the collateral, or 50% of assets, excluding collateral. *Fully collateralized* in the context of securities lending, means that the ETF must receive approved collateral equal to 100% of the market value of the loaned securities, and the collateral must be marked-to-market daily. In practice, securities loans often are over-collateralized – up to 105% of the market value of the loaned securities (or more under certain market conditions). Collateral generally is limited to cash, U.S. government or agency securities, or bank *standby letters of credit.* In Europe, ESMA issued its *Guidelines on ETFs and other UCITS issues* in December 2012, laying out strict collateral standards for collateral received from OTC and securities lending/repo transactions.

agent(s). To promote compliance with such policies, they may also request the periodic publication of the ETFs' largest lending counterparties, the amounts of securities on loan, along with the amount and composition of the ETF's collateral. In assessing alternatives, regulators should consider the amount of securities lending activity in which an ETF engages and develop requirements proportionate to the potential risks raised by the scope and scale of such activity, including steps to mitigate possible operational risks.

c) General counterparty risk

Finally, regardless of the chosen replication method, if an ETF is exposed to counterparty risk through significant use of derivatives, or the loan of a significant portion of its portfolio securities, regulators could require ETFs to adopt additional measures to the extent relevant and appropriate. Ways of addressing risk might include:

i) Appropriate risk management procedures[39] regarding use of derivatives for which the risk of counterparty default is not covered by a clearing agency;[40]

ii) Limits with respect to an ETF's net exposure to counterparty risk posed by a specific issuer;[41]

iii) Additional limits on assets accepted as collateral;

iv) Diversification rules for the collateral basket (e.g., to limit concentrated exposure to an issuer, sector or country); or

v) Other safeguards to mitigate potential operational and legal risks arising from collateral management (e.g., conditions governing the re-investment of cash collateral, restrictions designed to ensure that non-cash collateral not be sold, re-invested or pledged, etc.).

Regulators could finally consider requiring the periodic reassessments of the value of any collateral and require

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39 In jurisdictions authorising synthetic ETFs, regulatory frameworks have been devised to that end. One may refer here in particular to the ESMA *Guidelines on ETFs and other UCITS issues* published in December 2012; and to article 8.8 of the Section II of the Code on Unit Trusts and Mutual Funds of the Hong Kong SFC; available at: http://www.sfc.hk/sfc/doc/EN/intermediaries/products/handBooks/Eng_UT.pdf.

40 As an example of appropriate risk management procedure, the ESMA *Guidelines on ETFs and other UCITS issues* have introduced the requirement for managers to carry out a stress-testing policy where the level of collateral received exceeds a certain percentage of a fund's NAV. This requirement applies notwithstanding the type of transaction that is at the origin of the collateral exchange (i.e., no matter if to cover OTC or securities lending risks).

41 It may be appropriate for such limits to account for the credit quality of the counterparty and, if appropriate, the possibility of *haircuts* for counterparties with lower credit worthiness. Procedural requirements also might address the liquidity of collateral posted in order to be possible in the event of default for an ETF to sell collateral securities over a short period and at prices reflecting an independent, pre-sale valuation based on frequent marked-to-market, reliable and verifiable valuation of assets.

appropriate segregation with a third party custodian to protect against counterparty bankruptcy or default.

Chapter 4 – ETFs in a broader market context

The present report has focused primarily on aspects specific to the ETF product. Where appropriate, aspects not exclusive to ETFs have been duly pointed out as well. This concluding chapter touches upon a number of aspects that ETFs share with other financial products and indicates useful references for regulators to bear in mind.

Concerning the marketing and sale of ETF shares, as for other CIS, regulators should consider the importance of intermediaries' disclosure obligations, conduct requirements, including applicable suitability requirements vis-à-vis their clients.[42] The latter are defined here as any requirement that a financial firm, when recommending a retail client to purchase a particular financial instrument, make a determination of whether that investment is *suitable* or appropriate for that particular client. IOSCO encourages regulators and the industry to consider ETFs in connection with the guidance on the applicability of suitability obligations to market intermediaries in the context of complex financial products set out in IOSCO's recent report on *Suitability Requirements with Respect to the Distribution of Complex Financial Products*[43].

As other financial instruments that trade on an exchange, ETFs have been cited in a number of reports focussing on issues of market stability, particularly with regard to their potential effects on the overall liquidity and their vulnerability as means of alleged market abuse. Although the evidence gathered at this stage remains inconclusive, ETFs would be subject to the same preventive controls (e.g., trading halts) as myriads of other financial instruments. In this regard, IOSCO encourages regulators and industry practitioners to consider ETFs in connection with recommendations developed in the IOSCO 2011 *Market Integrity and Efficiency Report*.

In addition, as discussed above, for the purpose of informing investors regarding the different characteristics of ETFs and non-CIS ETPs, regulators are encouraged to consider requiring ETFs to describe the features, risks and regulatory requirements applicable to ETFs that are not applicable to these ETPs. Moreover, in relation to the comments received regarding disclosure of non-CIS ETPs, IOSCO notes that, although beyond the scope of this report, disclosure of non-CIS ETPs is encompassed by other IOSCO work that global regulators or regional standard setters may consider when evaluating non-CIS ETP disclosure within their respective legal framework.

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[42] As stated in the IOSCO *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* of October 2011, "Market intermediaries generally include those who are in the business of managing individual portfolios, executing orders and dealing in, or distributing, securities." According to the methodology, a jurisdiction may also choose to regulate as a market intermediary an entity that simply provides advice regarding the value of securities or the advisability of investing in, purchasing or selling securities. However, for purposes of this report, the term intermediary in the U.S. securities sector refers to broker-dealers, not investment advisers.

[43] See FR01/13 *Suitability Requirements with Respect to the Distribution of Complex Financial Products*, Final Report, Report of the Board of IOSCO, January 2013; available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD400.pdf.

<u>Appendix I</u> – List of Principles

Principle 1	*Regulators should encourage disclosure that helps investors to clearly differentiate ETFs from other ETPs.*
Principle 2	*Regulators should seek to ensure a clear differentiation between ETFs and other CIS, as well as appropriate disclosure for index-based and non index-based ETFs.*
Principle 3	*Regulators should require appropriate disclosure with respect to the manner in which an index-based ETF will track the index it references.*
Principle 4	*Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio and/or other appropriate measures in order to provide adequate information concerning:* *i) any index referenced and its composition; and* *ii) the operation of performance tracking.*
Principle 5	*Regulators should encourage the disclosure of fees and expenses for investing in ETFs 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.*
Principle 6	*Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities (e.g., on related costs).*
Principle 7	*Regulators should encourage all ETFs, in particular those that use or intend to use more complex investment strategies to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with the ETFs' strategies.*
Principle 8	*Regulators should assess whether the securities laws and applicable rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interests raised by ETFs.*
Principle 9	*Regulators should consider imposing requirements to ensure that ETFs appropriately address risks raised by counterparty exposure and collateral management.*

<u>Appendix II</u> - Feedback Statement on the Public Comments received to the Consultation Report – Principles for the Regulation of Exchange Traded Funds

Feedback Statement on the Public Comments received by the Technical Committee on the Consultation Report – *Principles for the Regulation of Exchange Traded Funds*

Twenty-seven responses have been received in relation to the consultation report *Principles for the Regulation of Exchange Traded Funds,* published by the Technical Committee (TC) of the International Organization of Securities Commissions (IOSCO) on 14 March 2012. The consultation closed on 27 June 2012. The majority of replies came from the asset management industry and its numerous associations, followed by two main stock exchanges, an index provider, a research institute, a foreign regulator and a private citizen. All responses were of a non-confidential nature. In particular, comments have been submitted by the following respondents:

1. International Securities Lending Association (ISLA)
2. Index Industry Association (IIA)
3. Amundi
4. Intendencia de Mercado de Valores – Ecuador
5. Investment Company Institute (ICI)
6. Blackrock
7. State Street
8. Deutsche Bank
9. Canadian ETF Association (CEFTA)
10. Association of the Luxembourg Fund Industry (ALFI)
11. German investment and asset management association (BVI)
12. Union Bank of Switzerland (UBS)
13. Investment Management Association (IMA)
14. National Association of German Cooperative Banks (BVR)
15. Chris Barnard
16. Hermes Equity Ownership Services
17. NYSE Euronext
18. London Stock Exchange Group (LSE)
19. EDHEC-Risk Institute
20. French Asset Management Association (AFG)
21. Irish Funds Industry Association (IFIA)
22. European Fund and Asset Management Association (EFAMA)
23. Alternative Investment Management Association (AIMA)
24. Lyxor
25. Cicero Group (on behalf of ETF Securities)
26. Stoxx
27. International Banking Federation (IBFed)

General comments and high-level summary of the responses received

Respondents welcomed the objectives of the consultation and stressed the importance of adopting a consistent approach for the regulation of ETFs compared to other investment products. A large majority of replies underscored the fact that ETFs should be viewed as a sub-category of collective investment schemes (CIS). According to these respondents, only a few of the proposed principles would be specific to ETFs, thus raising the question of whether the scope of the consultation should be broadened to CIS, or alternatively, whether the scope should be narrowed to those few principles that are only specific to ETFs. One respondent (EDHEC) opined that the proposed regulation of ETFs through *ad hoc* policy principles would do little to promote a more level playing field across the fund or investment management industry, despite the good intentions of regulators to address potential ETF risks early on.

Concerning principles (1-8) and their related recommendations presented in Chapter 2 of the consultation report - *Principles Related to ETF Classification and Disclosure* – all respondents welcomed the intention of regulators to establish a clear demarcation between ETFs and other exchange-traded products (ETPs). The distinction, however, between *traditional* and *non-traditional* ETFs met considerable reservations on behalf of some industry members. On the other hand, the suggested principles to enhance investor disclosures by explaining complex strategies, replication methods, portfolio and performance tracking measures, fees and operating expenses, as well as securities lending programs, were all positively received by industry players and their representatives. Some respondents outlined minor exemptions that they believe ought to be taken into account for the fine-tuning of selected principles and to reflect certain industry practices.

Principles (9-12) as outlined in Chapter 3 - *Principles Related to Marketing and Sale of ETF Shares* - found the agreement of all respondents, although a large majority remarked that rules relating to the marketing and sale of ETFs should be no different than the ones governing the distribution of other financial products. Additionally, some cautioned that recommending specific requirements for the distribution of ETFs may generate a negative bias against them to the advantage of competing products.

Chapter 4 - *Principles Related to the Structuring of ETFs* – presented two principles (13-14) aimed respectively at addressing conflicts of interest, and improving the management of counterparty risk for ETF providers. On conflicts of interest, the majority of respondents welcomed a clearer identification of potential conflicts of interest between the ETF manager and affiliated service providers (i.e., the index provider, the lending agent, the AP and a derivative counterparty), albeit held that such conflicts are sufficiently addressed in existing legislation. Most responses furthermore considered that regulatory intervention as suggested in the consultation report would prove disproportionate, create inefficiencies (e.g., by preventing customized index providers from being affiliates of the ETF tracking their index) and, in certain circumstances, may even be counterproductive (e.g., demanding that an AP not be affiliated to the ETF provider may lessen the former's commitment to provide liquidity under adverse market conditions). Globally harmonized rules on ETF listing requirements, greater disclosure and industry best practices to uphold an ETF's fiduciary duty vis-à-vis its investors, regardless of a provider's affiliations, from the majority of the respondents' viewpoint, would be a more practical and efficient outcome. Two respondents (Amundi, AFG) also requested that the term *affiliation* be clarified.

On the necessary measures to ensure that ETFs manage their counterparty exposures and receive adequate collateral, a large majority of replies stressed that these needs are not specific to ETFs, but should apply to the broader CIS industry.[44] Replies emphasized that collateral requirements should not be too prescriptive as the ultimate economic function of collateral, in case of counterparty default, is for it to be promptly re-sold in the market. On

[44] This view was also shared by a foreign regulator (*Intendencia de Mercado de Valores of Ecuador*).

the report's proposal to limit the proportion of an ETF's portfolio available for lending, the majority of respondents disagreed, citing lower returns and reduced competitiveness. Finally, a broad consensus emerged over the fact that exposures to OTC derivatives may be aggregated with those arising from securities lending transactions, with some respondents voicing that the treatment of counterparty risk would need to be addressed in the light of other forthcoming regulatory measures (e.g., the European Market Infrastructure Regulation – EMIR – in Europe, or the Dodd-Frank Act in the U.S.).

The final Chapter 5 of the consultation report - *Issues Broader than ETFs* – intended to address broader risks beyond the ETF/ETP industry. Principle 15 suggested that ETF exchanges adopt appropriate measures to prevent liquidity shocks and mitigate the impact of their transmission across correlated markets. Opinions ranged from those favoring trading interruption mechanisms (e.g., trading halts), to those more cautious, placing a greater emphasis on pre- and post-trade transparency. A general view among respondents however remains that ETF trading is not the sole to be potentially responsible for liquidity shocks and their propagation in the broader market. Regarding the risk of abusive behavior to the detriment of market integrity, the few respondents, among which one major exchange (LSE Group), suggested authorities request that exchanges implement appropriate monitoring systems to capture abusive behavior.

The final section of Chapter 5 addressed broader financial stability concerns not exclusive to ETFs. Respondents were invited to share their views on a series of questions, suggesting possible further avenues of work at the FSB/Joint Forum level. Within this section, less than half of the total respondents replied, believing potential financial stability issues to be either negligible (given the relative small size of the ETF industry compared to other asset classes), or to have been sufficiently addressed in the report, or in the existing regulation. Replies have thus confirmed few inclinations to see the launch of new initiatives within the abovementioned international fora.

Specific comments

CHAPTER 2 - *Principles Related to ETF Classification and Disclosure*

Disclosure regarding ETF classification (Principles 1-2)

The proposed principles are addressed to regulators with the aim to improve the quality of ETF product disclosures, allowing end investors (particularly retail) to clearly distinguish ETFs from other ETPs. Analogous requirements are intended to better differentiate between ETFs and other CIS, as well as between index and non index-based ETFs (i.e., passively vs. actively managed ETFs).

The vast majority of respondents supported both principles, arguing that greater clarity between ETFs and other ETPs is warranted, where ETFs are clearly a sub-category of the latter. They further recommend that such disclosures apply to all other ETPs. Another shared opinion was that use of an ETF identifier should moreover be limited to those products meeting a common definition of an ETF[45] and that non-CIS products should be barred from

[45] According to the definition of a *UCITS ETF* given by ESMA in its *Guidelines on ETFs and other UCITS issues*, published in December 2012, a UCITS ETF is a UCITS at least one unit or share class of which is traded throughout the day on at least one regulated market or Multilateral Trading Facility with at least one market maker which takes action to ensure that the stock exchange value of its units or shares does not significantly vary from its net asset value and where applicable its Indicative Net

using the ETF identifier.[46] As to the difference between index and non index-based products, the view was that this should be more appropriately explained in the prospectus or other pre-contractual documents. One respondent (EDHEC) maintained that even before proposing a clear distinction between the passively and actively managed indices, the word *index* would need to be given a legal definition and that regulators should decide on index transparency and audit requirements. The adoption of these consolidated standards would, in the view of EDHEC, furthermore slow current industry dynamics, i.e., the increasing shift of indices from passive to active management.[47]

Referring to disclosure standards in Europe, one respondent (Deutsche Bank) stressed that these should remain consistent between ETFs and other CIS. To another respondent (EDHEC), the difference between an ETF and a CIS would in fact be minor and should not be exaggerated. ETFs would in this sense be only CIS that need to comply with the rules of the exchange on which they trade. The need to not pit ETFs against CIS as two separate investment products was reflected elsewhere in the replies to the report.[48]

Further to ESMA's publication of its *Guidelines on ETFs and other UCITS issues* in December 2012, seven respondents (IMA, LSE Group, EFAMA, AIMA, Lyxor, ALFI, BVR) based in Europe replied that the proposed IOSCO principles have now been translated into EU law for European regulators to apply, particularly via the UCITS (Key Investor Information Document - KIID) and Prospectus directives' requirements. One respondent (ALFI) mentioned that, apart from the distinction between ETFs and CIS, or between index and non index-based products, it was important for providers to define risks (e.g., counterparty risk) deriving from certain ETF structures, from the varying liquidity conditions on an exchange, and from the particular role of the AP.[49] A similar view was echoed and further explained by other respondents (AFG), according to whom, the recommendations should recognize the important distinction between the replication technique of an ETF and its particular strategy in the pre-contractual disclosure documents (see *infra*).

- *IOSCO's response: IOSCO broadly agrees with the responses provided in the consultation and has introduced language, where relevant, to indicate how ETFs differ from other ETPs, as well as from other CIS products. These indications are to be disclosed to prospective investors in the prospectus or other pre-contractual documents.*

Asset Value. The majority of European ETF providers have supported this definition in the run-up to the finalization of the *Guidelines* in December 2012.

46 In this respect, Blackrock has even suggested that for those leveraged and inverse products (intended for short-term and institutional investors), the identifier "ETF" should not be used as a label.

47 For this purpose, EDHEC suggests measures to offer better (i) information on the type of index being tracked and the implications for the quality of tracking; (ii) transparency, quality, governance, and auditability of indices that can be used by index vehicles; and (iii) tracking performance and minimal standards.

48 In this regard, the AFG has suggested replacing Principle 2 with the following language: Regulators should seek to ensure a clear differentiation between index-based and non index-based ETFs through appropriate disclosure requirements.

49 As for other respondents representing the European industry, these further matters are sufficiently disclosed in the existing EU UCITS (*KIID*) and Prospectus legislation.

Disclosure regarding ETF strategy (Principle 3)

The proposed Principle 3 was for regulators to encourage the clear, accurate and complete disclosure by ETFs of their strategies and techniques, including the risks associated therewith, in their pre-contractual documents to investors.

Overall, the vast majority of replies supported the principle, but argued that it should not be specific to ETFs, and that it should (where it does not already) apply to all CIS in numerous jurisdictions worldwide.[50] More importantly, most replies emphasized the need to distinguish the manner in which the investment is managed or structured, from the way it obtains its economic exposure (i.e., the replication technique). These respondents further argued that an ETF's degree of complexity ultimately depends on the manner in which the relative risk/reward profile and pay-off profile can be understood by the investor. In the opinion of one respondent (EDHEC), disregarding or de-emphasizing the main risk drivers and the payoff profile generated by the investment strategy to instead focus on the techniques the investment vehicle uses (or the instruments it holds) to generate this payoff, could create a false sense of security vis-à-vis other *mainstream* products. On this basis, some respondents (AFG, IFIA, Lyxor) suggest that the wording of the proposed Principle 3, particularly that referring to "other complex techniques", be adjusted or deleted. These actors observed that what ultimately counts for investors is that they understand the investment strategy, but not necessarily the investment technique (however complex) that the ETF provider puts into place to deliver the desired economic return.[51] Another reply (IBFed) stressed that complexity does not equate to riskiness. On the contrary, some structured products could enable investors to diversify risk more easily, bringing the respondent to caution IOSCO against equating the complexity of the product with its riskiness for the investor.

In another reply, a respondent (ALFI) suggested that the principle on disclosures should be more suitably addressed in the national/regional legislation on the marketing and sale of investment products to the public. In its view, such rules are important for the sake of guaranteeing a level playing field among competing products (e.g., ETFs, other CIS, etc.), regardless of whether they may be deemed complex or not. In this sense, another respondent (EDHEC) noted that IOSCO's approach to product disclosure via the emphasis on ETFs in the consultation report would appear too *vertical* at a time where a more *horizontal* approach would better serve the purpose of a level playing field. To this end, it invited IOSCO to design principles harmonizing the marketing and sale of both CIS and non-CIS securities (e.g., other ETPs).

In the view of one private citizen (Chris Barnard), disclosures should accurately inform on whether a particular ETF strategy exposes the investor to additional "new" risk factors compared with investing directly in underlying securities (e.g., counterparty risk, leverage, etc.).

- *IOSCO's response: IOSCO agreed with the need to introduce a clearer distinction between investment strategy and replication technique. Both deserve adequate disclosures in prospectuses or in other pre-contractual documents, especially in*

50 One respondent (ICI) mentioned that the proposed principle would already be satisfied under the current U.S. disclosure requirements as implemented by the SEC (i.e., those of the 1940 Investment Company Act). Important is that the same disclosures apply to other forms of ETPs.

51 In their replies to the consultation report, AFG and Lyxor observed that "complex techniques" should not be confused with "complex strategies", i.e., techniques, like securities lending or the use of delta-one derivatives that are not in themselves changing the investment strategy of the fund.

explaining the nature and extent of counterparty exposures. In this sense, the purpose of the disclosures should be no different than that foreseen for other CIS products.

Disclosure regarding an ETF portfolio (Principles 4-6)

Principles 4-6 were aimed at encouraging regulators to increase the transparency with regard to the way in which an ETF tracks a chosen index and demand more disclosure on portfolio components, index composition, and performance tracking.

As a premise to the three principles, two associations (ALFI, AFG) and one research institute (EDHEC) pointed to the fact that the distinction in the consultation report between *traditional* (or so-called *physical replication*) and *non-traditional* (or so-called *synthetic replication*) ETFs could be misleading. According to these replies, indicating that synthetic ETFs are *non-traditional* with regard to their frequent use of derivative contracts to achieve their desired exposures (and without any further distinction between plain and leveraged/inverse indices), would introduce two orders of problems: (i) such a categorization could create confusion for the end investor since in Europe for instance, synthetics are UCITS funds and subject to the same stringent regulation that applies to the *traditional*, physically-replicating ETF category; and (ii) that the notion of a *non-traditional* ETF in the report implies a bias against products using derivatives to generate the desired exposure. Referring to the difference highlighted in the previous section between the investment strategy and the investment technique (used to obtain the desired economic pay-off), some of the respondents suggested that a distinction should be made between plain ETFs (including physical and synthetic ones alike) and leveraged/inverse ETFs.[52] The two categories therefore should be kept separate as they do not have the same investment strategies and therefore the same risks.

Concerning all three principles, the majority of replies stressed that they should apply to all CIS (where they do not already), as they are not specific to ETFs. Looking at the individual disclosure requirements more in detail, respondents were divided along the following lines:

Relative to the disclosure requirements on the chosen replication method under Principle 4, replies confirmed an overall support from all sides of the industry. Respondents particularly welcomed the balanced approach suggested by IOSCO whereby both replication methods are treated in the same way (i.e., physical vs. synthetic replication). Moreover, according to one reply (UBS), such requirements should not restrict an ETF manager from switching from one type of replication to another, depending on market signals. As confirmed by the majority of replies, the principle should apply to all CIS (as for the European industry in the recent 2012 ESMA *Guidelines*) and not be solely limited to index funds, but also to actively managed ones, regardless of whether they are exchange-traded or not.

On the publication of the index components, as suggested under Principle 5, index and ETF providers deemed it impossible to implement as intellectual property issues would impede the real time publication of the individual components, especially where the ETF is actively managed and the components of the underlying are proprietary information. One major index provider (STOXX) proposed changing the wording of Principle 5 i), suggesting that the information to be disclosed should concern the index and "its methodology" (instead of "its composition"). One association (AIMA) in this regard replied that an index calculation methodology will comprise an intricate computer program that is expressed in thousands of lines of codes. Describing it in words would simply not be practical and of no use to

[52] One industry player (Amundi), underscored the importance of discerning synthetic ETFs (in the form of CIS) from other "non-traditional" products such as ETFs based on specialised indices, leveraged ETF, inverse and ultra-short ETFs, etc.

investors.[53] Alternatively, as most replies have advanced, there could be a focus on high-level transparency and less on allowing investors to materially be able to track an index. An index's components could thus be published only selectively (e.g., only the top 10 components making up the chosen index), or with a certain delay.[54] Some providers also mentioned that most ETFs publish their portfolio holdings on a daily basis (often accompanied by collateral composition) on their website; hence, IOSCO should not consider additional requirements. Others (AIMA) considered it sufficient to provide investors with holdings' information on a semi-annual basis, whereas others (CEFTA) admitted that even shorter periods (i.e., monthly) in their domestic jurisdiction where possible. For synthetic ETFs, one respondent (Hermes) favored extending the required disclosures to explain the nature of the derivative or other arrangement at the basis of the replication, as well as the name and nature of the counterparty to the arrangement.

IOSCO’s proposal to require disclosure to investors on performance tracking was broadly supported. Certain associations (CEFTA) agreed with the proposed disclosure principles and deemed them to be sufficiently implemented in their home jurisdiction. However, one major industry player (Blackrock) noted that offering investor information on the quality of index-tracking may run into a series of problems, especially where investors observe greater levels of tracking difference and/or tracking error compared to an anticipated target. In this respect, Blackrock observed that disclosed information should remain "meaningful" to the investor, e.g., an *ex-ante* target threshold for "mis-tracking" should be offered alongside an alert for potential risks and causes leading to "mis-tracking". Despite supporting the recommended principle on the need to publish tracking difference and/or tracking error information, another industry player (State Street) cautioned that these predictions should be regarded as a mere prognosis with no legal/binding consequences. Agreeing with these positions, one reply (ALFI) even suggested that IOSCO provide guidance on how tracking difference and/or tracking error are to be calculated, possibly even through a uniform methodology. This latter view was shared by another respondent (EDHEC), inviting IOSCO to impose the use of standard formulae to compute performance measures, along with *ex-ante* (i.e., targeted) and *ex-post* (i.e., realized) tracking error information. The research institute also expressed some concern at the fact that until this day regulators have not provided a legal definition of *tracking*, as well as standardized measures for the market to assess the quality of the replication.[55]

A majority of respondents expressed support for the facilitation of the use of arbitrage activity under Principle 6, and welcomed any arrangement that would permit market participants to accurately assess an ETF’s underlying value throughout the trading day. Some (Amundi, AFG) adduced that the harmonization of exchange listing rules would be beneficial in this sense, as well as improve investor information. In their wording, it was suggested that

[53] AIMA further observed that any standard indices cannot be tracked by (retail) investors in practice. Highly diversified indices with a thousand or more components (e.g., Russell 1000 or 3000) are likely to be much more difficult to track than an index of e.g., 25 components with daily rebalancing.

[54] One European respondent (UBS) referred to the 2012 ESMA *Guidelines* addressed to index-tracking UCITS. These should be extended to non-UCITS index tracking CIS, but with few reservations: they would need to be high-level so as to not violate the proprietary information of the index provider or undermine fee collecting from registered users.

[55] In EDHEC's view, regulators should provide a formula for tracking error to be used across all index tracking products, impose a maximum tracking error for a fund to qualify as a *tracker* (with different limits to be applied according to different underlyings), and enforce initial and ongoing disclosure of targeted and realized tracking difference and/or tracking error.

the principle would need to apply only to those passive index-tracking ETFs, thereby excluding the actively managed ones for which portfolio components may not be disclosed to facilitate arbitrage activity.[56] Further, most industry associations responding to the consultation report shared the view that in this second case, the disclosure of the actual and detailed portfolio composition should be limited to APs for them to provide liquidity and guarantee tight bid-ask spreads on the secondary market. These indicated that full disclosure of index constituents or weights for the purpose of facilitating arbitrage activity could actually be detrimental to investors, as regular public availability of this information could lead to front-running of a successful investment strategy. Also, according to one of them (AIMA), this requirement would discriminate against ETFs compared to other funds, as the latter would not have to publish their full holdings after each trading day.[57] One association (CEFTA) mentioned that ETFs already publish on a daily basis the identity and weightings of securities in their purchase or redemption baskets. In its view, such daily disclosures of a sample of portfolio holdings are sufficient to facilitate arbitrage activity by the authorized AP. Another association (ICI) stated that while a mechanism that allows market participants to assess the value of the ETF relative to its holdings (e.g., transparency) is necessary for efficient arbitrage, it is not sufficient. In its view, the arbitrage mechanism is also affected by the size of the creation units.[58]

One respondent (IMA) suggested including references to an important body of IOSCO work on market timing and on the need for funds to have appropriate mechanisms in place to deter arbitrage activity in fund units to the detriment of other fund investors. Finally, as for Principle 5 above, some replies once again highlighted the difference between passively and actively managed ETFs, where higher portfolio transparency to facilitate arbitrage would run against the commercial interests of the active manager.

- *IOSCO's response: IOSCO agreed to revise the definition of "non-traditional" ETFs as previously included in the consultation report. IOSCO was of the view that the same disclosure requirements should apply both to index-based and non index-based (i.e., actively managed) ETFs. These would concern the replication method, the index and/or basket composition, and the operation of performance tracking. Whilst IOSCO encouraged the disclosure of index composition and weighting as much as practicable, IOSCO noted the concerns expressed by stakeholders on the protection of proprietary information. Regulators should consider the appropriate level of disclosure relating to index composition and weightings taking into account these concerns, the sophistication of concerned investors, local conditions and the overall efficiency of arbitrage activities.*

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56 According to another respondent (IMA), appropriate would be the reformulation of Principle 6 to include the following reference (in bold): "*[…] the transparency of an index-tracking ETF's portfolio […]*".

57 In its contribution, AIMA succinctly described the mechanism that allows an AP to conduct its daily arbitrage. In order to help arbitrage by APs, most ETFs provide a file including an indication of the investments of each ETF. This *Portfolio Composition File* also sets out the cash element to be delivered (a) by APs to the ETF the case of subscriptions; or (b) by the ETF to the APs in the case of redemptions. The Portfolio Composition File is usually made available to APs by the investment manager on each dealing day. With this information the APs will be able to evaluate arbitrage possibilities.

58 In the ICI's view, very small creation units would allow retail investors to transact directly with the ETF, while very large creation units could reduce the willingness or ability of APs to transact with the ETF, impeding the arbitrage pricing discipline.

Disclosure regarding ETF costs, expenses and offsets (Principles 7-8)

The last two principles concerning ETF classification and disclosure invited regulators to consider the disclosure of fees and expenses linked to ETF investing (Principle 7), to understand their impact on performance and, more particularly, to adopt measures enhancing the transparency of fees received/paid with respect to the borrowing/lending of securities (Principle 8).

Among respondents, there was unanimous consent on the need to consider disclosure requirements on these topics and on the overall fact that, again, these principles ought to be equally valid for other CIS. Opinions however ranged from those suggesting that information should not be too detailed (mentioning that what really mattered to investors was the global cost of the product), to those supporting the publication of all cost structure details possibly in a harmonized format (e.g., the KIID as required under EU legislation). Certain providers (State Street) introduced an important caveat in this context, i.e., that relevant fees and costs should not be confused with risks, considering for instance that spreads, discounts and premiums, are more appropriately to be considered as risks associated with investing in an ETF, rather than as costs.

As to securities lending, there was a broad agreement that the proposed disclosures should apply to all CIS for the sake of consistency and not place ETFs at a competitive disadvantage. One commenter (State Street) stated that due to local differences in regulations and disclosure for securities lending in CIS, it is more important for ETFs to be consistent with local CIS than for ETFs to achieve consistency across the globe. One association (ISLA) stressed the importance of having costs and performance of securities lending transactions recorded and disclosed as a separate line item in the total expense ratios (TERs) of the fund. However, it insisted requirements should not be too detailed such that constant updates (with their associated costs) will be required. Important to two respondents (Amundi, EDHEC) is also that fee-sharing arrangements between lenders and borrowers be disclosed in prospectuses and/or annual reports. One important industry player (Blackrock) fully supported both principles, adding that for securities lending, ETP providers further had to disclose the fee splits between themselves and any third parties involved (i.e., lending agents).[59] Moreover, it suggested that all fees paid by a fund in connection with securities lending revenue, including collateral management, administration or securities transfer fees borne by the lender, should be disclosed. Finally, according to Blackrock, the lending program should allow transactions with multiple counterparties and require over-collateralization with collateral that is highly liquid and diversified. According to an industry peer (Deutsche Bank), the above disclosures would go hand-in-hand with the regular publication regarding the identity of the securities lent, the nature of the collateral received[60] and of the counterparties involved with respect to the lending and borrowing of securities.

To offer investors a complementary measure to measure the total costs associated with ETF investing, one research institute (EDHEC) proposed a "Total Return (pass-through) Ratio" (TRR) that would capture the returns arising from securities lending operations. By highlighting the share of returns that does not accrue to the investor, such a ratio would

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[59] With respect to the division of fee revenues from securities lending between fund and third party lending agents, one industry player (UBS) cautioned that if in the future all benefits from securities lending were to go into the fund, lending agents may no longer be willing to supply their services.

[60] Regarding collateral, the reply from UBS also mentioned that, apart from type/quality and amount of collateral received, its value relative to the value of the securities lent would also deserve to be published.

permit an assessment of the true cost of asset management, beyond the information given by the total expense ratio (TER).

On the other hand, certain providers (Amundi) and associations (ALFI, AFG) have cautioned that certain costs may be difficult to disclose *ex-ante*, since they would sometimes be difficult to assess unlike other fund fees (e.g., depend on the number of operations carried out by the asset manager, the instruments used, operational costs when trading those instruments, legal constraints and tax issues, etc.). For some (AFG), the best indicator for investors to gauge the total cost of their investment (and to measure the fund's performance) remained the tracking difference. Only very few replies referred to the proposed disclosures of additional information on the treatment of rebalancing costs, on revenues derived from fund assets and on the way the latter are distributed between an ETF operator and the ETF's shareholders (e.g., dividend payments).

Another association (ICI) pointed to the ongoing work of the relevant work-stream under the Financial Stability Board (FSB) with respect to *shadow banking* and to Section 984 of the U.S. Dodd-Frank Act, requiring the SEC to increase the transparency in securities lending operations available to brokers, dealers and investors. It encouraged IOSCO to take on board the results of these parallel work-streams ahead of issuing final recommendations on securities lending for the sake of consistency.

- *IOSCO's response: IOSCO agreed that the same recommendations for fee and cost disclosures are broader than ETFs in general, even with respect to securities lending and to the enhanced revenues that such activities accrue to the ETF. It remains however important that investors are informed not only of the relative fees and costs, but also of the perceived revenues from securities lending, especially where these represent a significant source of return.*

CHAPTER 3 - *Principles Related to Marketing and Sale of ETF Shares* (Principles 9-12)

Viewed together, the proposed Principles 9-12 each introduced a series of parameters addressed to market intermediaries responsible for the marketing and sale of ETF shares. These range from the fairness of the information presented to investors in the marketing and sales materials (Principle 9), to the requirement for regulators to calibrate disclosure obligations to the entity (i.e., the producer or the distributor) that *de facto* has control over the contents of the information to be disclosed (Principle 10); from the suitability test to be administered by distributors when selling ETFs to investors (Principle 11), to the requirement for intermediaries to establish a compliance function to ensure that client suitability standards are upheld (Principle 12).

Overall, the majority of respondents observed that the proposed principles on disclosure are implemented through varying degrees in existing legislation across developed jurisdictions.[61] Some replies (IMA) questioned if the purpose of Principle 9 was to separate marketing and selling procedures from those envisaged for other investment products. If so, ETF providers and their intermediaries should not be allowed to tailor their own disclosures for the sake of

[61] On their part, many European industry players and their associations underlined the fact that the distinction between complex and non-complex products, as well as the rules on financial product selling practices, would already be sufficiently addressed in the existing EU legislation (i.e., in the MiFID framework).

preserving consistency among other non-ETF financial products.[62] One respondent (ETF Securities) suggested grading the ETF offer according to the discretion of the advisor/distributor as a possible method to advise clients on the suitability of a specific product. In its view, this would need to be accompanied by measures to improve investor education. With regard to Principle 10, one association (ICI) strongly suggested that in evaluating an intermediary's disclosure obligations, regulators should consider who has control over the information to be disclosed.

With regard to Principle 11, European ETF providers (and their representative associations) insisted that plain synthetic ETFs (i.e., those replicating a standard, recognized broad market index) are not to be considered as complex products[63] (despite the replication technique typically making use of swap derivatives) and that there should be no distinction among the two different replication models (i.e., physical vs. synthetic) concerning selling rules. On a different aspect, one important industry player (Deutsche Bank) suggested the principle reflect also an intermediary's duty to act honestly, fairly and professionally, while taking reasonable steps to manage conflicts of interest.

Some providers (Amundi) pointed out, with respect to Principle 12, that an intermediary should not be placed in a position to provide a written justification of its advice; as such an obligation would probably lead to abuses by unscrupulous customers. Moreover, other respondents (State Street, BVI, EFAMA) suggested that this principle be applied proportionately, depending on the intermediary or target investor. With regard to the former, one association (BVI) noted that the requirement would for instance not be appropriate for those individual advisers that are natural persons and that are not integrated in a corporate distribution structure.[64]

- *IOSCO's response: IOSCO acknowledges that concerns regarding marketing and sales practices relating to ETFs are no different from those applying to other CIS products. Relevant conduct requirements, including applicable suitability requirements that apply to other investment products are still applicable to the sales and marketing of ETFs. As is the case with other investment products, intermediaries that market and sell ETF shares also may have a role to play in addressing the investor protection concerns related to ETFs. In this regard, IOSCO encourages regulators and the industry to consider ETFs in connection with the guidance on the applicability of suitability obligations to market intermediaries in the context of complex financial products set out in IOSCO's recent report on Suitability Requirements with Respect to the Distribution of Complex Financial Products.*

[62] In this regard, IMA noted that the KIID in Europe is already an example as to how pre-sale information should be consistent.

[63] One association (AFG) suggested replacing the reference in Principle 11 from "[…] particularly a non-traditional ETF […]" to "[…] particularly an ETF that uses complex strategies […]".

[64] In its reply, EFAMA suggested rephrasing the principle along the following lines (additional wording in bold): "**Where appropriate in view of the nature, scale and complexity of their business**, intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations when recommending any CIS."

CHAPTER 4 - *Principles Related to the Structuring of ETFs*

Conflicts of Interest (Principle 13)

Regarding the potential conflicts of interest inherent in certain ETF business models, the consultation report identifies four different forms stemming from the intra-group affiliation of the ETF with other service providers: (i) between the ETF and the index provider, where the latter compiles and revises the index; (ii) between the ETF and a lending agent that facilitates the borrowing/lending of securities; (iii) between the ETF and the AP charged with buying/selling the ETF's shares on the secondary market; and (iv) between the ETF and a swap derivative counterparty for the delivery of the desired index returns. From these considerations, the proposed Principle 13 in the consultation report demands that regulators verify that the applicable securities and exchange laws sufficiently address the above, and possibly other, implied conflicts of interest.

All replies supported the need to manage conflicts of interest in principle, with one provider (Amundi) recommending that IOSCO also define the notion of *affiliate*, e.g., on the basis of a minimum holding threshold, to facilitate the implementation of the proposed principle. However, a large number of respondents disagreed with some of the proposed means of implementation to Principle 13 and particularly, where IOSCO suggested requiring that service providers not be affiliated to the ETF. To these respondents, the proposed measures would be disproportionate, and would not take into account the fact that ETF management companies first and foremost need to adhere to their fiduciary duties vis-à-vis their investors regardless of their corporate structure. Instead, most replies stressed that conflicts of interest should be addressed via sound standards and principles applied not only to ETFs, but also to other listed instruments. From a general perspective, one commenter (State Street) stated that what is key with regards to conflicts is that there are processes in place to identify and manage these conflicts and that these are disclosed in an open and transparent manner. One association (BVI) noted that business relationships within corporate groups are already governed by conflict of interest rules. If special ones were to apply, as advanced in the consultation report, to e.g., affiliated providers of customized indices, the same would have to be done for all customized index providers regardless of their affiliations. Concerning ETFs, replies revealed a consensus over the need to harmonize rules on admitting ETFs (and similar products) to stock exchanges worldwide. More particularly, on the more contentious points advanced in the report as possible implementation measures, respondents expressed the following concerns:

(i) Regarding the potential conflict between the ETF and the index provider, certain actors (Amundi, Blackrock) noted that where the index provider is an affiliate of the ETF management company, index maintenance and calculation is already performed with appropriate safeguards, in line with the proposed implementing measures in the consultation report under letters c) and d); e.g., operational and hierarchical separation, information barriers/firewalls, etc. Another association (ICI) stated that ETFs that track indices created by an affiliate of the ETF adviser receive exemptive relief in certain jurisdictions, under which they have agreed to a series of terms that are designed to prevent the communication of material non-public information between the ETF and the affiliated index provider. Another association representing the index industry (IIA) instead supported the full separation between index provider and ETF, but considered some of the proposed means to avoid conflicts of interest to be untenable. For instance, the means of implementation considered under letter e), whereby component securities should not be changed (as a result of index rebalancing) more frequently than on a specific periodic basis. To the IIA, this requirement would force those seeking to use an index as an ETF's underlying strategy, but with a different rebalancing frequency, to have to alter their investment objective. Always according to the IIA, limiting the scope for changes to indices and to their rebalancing frequency would be counter-productive for investors, as in certain market circumstances, the rules of an index would need to be adjusted quickly to ensure that it continues to reflect the reference market originally described to investors in the investment policy of the fund. A minimum rebalancing interval would moreover hamper those strategies that respond to corporate events (e.g., IPO indices, alternative betas in hedge fund strategies, etc.) and lead to the reduction of indices and investor choice. This view was also shared by a major exchange (LSE Group), as well as by all associations and ETF providers. Furthermore, the LSE Group did not agree that a conflict of interest could arise between the calculation agent and the index provider as they are very often the same entity and by definition affiliated, especially for custom indices. Mandating their separation, as envisaged among the possible implementing measures, would therefore prove disruptive in the LSE Group's view.

Two associations (ALFI, EFAMA) supported that the forced separation between the custom index provider and ETF, as well as the imposition of a firewall between these, would make the development of indices virtually impossible without the involvement of the ETF portfolio managers, whose investment objectives and strategy form the necessary basis for the index compilation.[65] An important industry player (Lyxor) added that if regulators were to assume that an asset manager alters the index at its discretion in violation of its rules, the fund should be simply treated and advertised as an actively managed fund. Finally, from a competition perspective, another association (BVI) raised the concern that the proposed standards for custom indices could have prohibitive effects on the possibility of index creation by ETF affiliates, which may curb competition and thus perpetuate the pricing powers of the existing large index providers who charge high license fees on their products. Only one response (STOXX) openly supported the need to mandate the full unbundling between index providers/managers and fund managers (with references to the 2012 ESMA *Guidelines*).

(ii) On the potential conflict between the ETF and a lending agent, one market participant (State Street) disagrees with the proposal to obtain quotes from non-affiliated lending agents on a continuous basis in order to ensure the fairness of fees. To State Street, this option would not be practical and appear disproportionate. Instead, it suggests that market conformity checks on transactions conducted *ex-post* should be sufficient to ensure that fees charged for securities lending are fair and reasonable. State Street's view is shared by another respondent (BVI). One association (EFAMA) observed in this respect that the market for securities lending in its current shape would appear opaque and is limited to a handful of agents. These agents, generally, would not be willing to disclose their conditions for transacting without good business prospects.

(iii) Regarding the potential conflict between the ETF and the AP, most replies pointed to the fact that stock exchange rules would already sufficiently address this issue in their formalized contracts with an AP. An industry association (ICI) described the exemptive relief in one jurisdiction that permits affiliations between an AP and an ETF provider,

[65] According to EFAMA, fund management companies should even have the right and be encouraged to create and manage indices themselves.

where affiliates are not treated differently from non-affiliates when engaging in purchases and redemption of ETF shares, and where there is no opportunity for them to engage in transactions that could be detrimental to shareholders. There was a consensus among respondents that the proposal to require a primary AP to not be affiliated with the ETF would be overly prescriptive. Moreover, according to these replies, a non-affiliated AP would not necessarily present the best solution for investors, as the former may be inclined to offer lower liquidity or less inclined to *make a market* under stressed market conditions, which in turn may disrupt trades and complicate meeting investors' redemption requests.[66] One ETF provider (Amundi) noted that requiring a minimum number of APs would also oblige an ETF to "forcefully" work with other "unknown" entities with which there is likely to be less homogeneity in terms of compliance rules, risk controls, reporting formats, etc. Another problem in requiring a minimum number of APs is that it would make listing difficult to achieve in narrow niche markets (e.g., in the commodities space), as put forth by one association (AFG).

(iv) On the potential conflict between the ETF and the swap derivative counterparty, a large majority of respondents saw no fundamental reason for regulation to prevent ETF providers from transacting with affiliated swap counterparties, as long as both entities are hierarchically separate and conflicts of interest are sufficiently managed.

Instead of rushing to separate affiliated entities, the large majority of replies proposed that IOSCO ought to require proper disclosures of all affiliated transactions to investors, rely on industry to develop best practices, apply to the extent possible existing legislation (which in the opinion of the majority of respondents already goes far enough), and harmonize ETF listing rules where necessary (particularly in terms of maximum spreads, offered size, minimum time of presence and iNAV policy). These measures would need to go hand-in-hand with appropriate disclosures. As one respondent (EDHEC) advanced, a more detailed disclosure of current fees paid by the ETF provider to affiliated or non-affiliated parties for the rendered services would ultimately enable stakeholders to assess whether the alleged conflicts of interest can either be managed, or resolved through bolder regulatory measures.

- *IOSCO's response: IOSCO decided to avoid providing a narrower definition of the notion of "affiliated" as beyond the scope of this report. IOSCO generally agreed that requiring the mandatory separation of an ETF from its affiliated service provider would be impractical and unnecessary to the extent that rules to manage conflicts of interest are already in place and applied. As to securities lending activities, IOSCO decided not to require ETF providers to obtain mandatory quotes from non-affiliates, relying rather on cost/fee and revenue transparency allowing investors to compare among providers.*

Portfolio Strategies (Principle 14)

Principle 14 is aimed at ensuring appropriate regulation addressing an ETF's counterparty credit risk exposure and mitigating it via proper collateral management practices.

Replies to the consultation report and feed-back to the proposed means of implementation addressing counterparty credit risk, reflected a general agreement on the underlying principle, with the reservation that it should apply to all CIS having counterparty credit exposures. In particular, one association (EDHEC) observed that neither OTC derivatives nor securities

[66] Two associations (BVI, EFAMA) noted that there would be no point in requiring a minimum number of APs. In Europe, for instance, UCITS ETF investors would under certain circumstances have the opportunity to also redeem directly from the provider.

lending are in anyway specific to ETFs, or even CIS, and suggested it would be preferable to approach issues related to these practices in a horizontal manner spanning the finance industry as a whole. A majority of responses confirmed that uniform guidelines should preferably apply regardless to how counterparty credit risk is assumed, and focus on the proper management of collateral.[67] Regarding collateral, most respondents stressed the importance of ensuring it remains of good quality and liquid, while allowing managers to maintain the necessary flexibility on these parameters.

Further, several respondents stressed that counterparty credit risk, particularly with regard to derivative transactions, would be more appropriately addressed through dedicated legal frameworks (e.g., the CESR 2010 Guidelines, the UCITS Directive, the European Market Infrastructure Regulation – EMIR - for EU jurisdictions; the Dodd-Frank Act in the U.S., etc.).

Considering synthetic and other derivative-based ETFs, the general opinion among respondents was that prescriptive collateral standards, e.g., ensuring that collateral be of the same quality as the instruments constituting the tracked index, would in reality be difficult to implement. One respondent representing the U.S. industry (ICI) cautioned that the structure and regulation of the use of derivatives is substantially different between Europe and the U.S., quoting from the consultation report that the types of "synthetic [ETFs] encountered in Europe or Asia do not exist as CIS in the United States." It further argued that in the U.S., the 1940 Investment Company Act already sufficiently addresses the concerns highlighted on counterparty risk and collateral management with respect to derivative transactions.[68]

Considering physical replication, a majority of respondents considered that limits on the proportion of an ETF's lendable portfolio, would limit the opportunities for ETFs to enhance their returns via securities lending and possibly lead to reduced competitiveness vis-à-vis other ETPs.[69] These recommended that decisions on how much to lend should rather be taken by the ETF management board, based on the information received (at least monthly) from custodian/lending agents.

One association (BVI) invited IOSCO to consider that collateral, no matter the chosen replication method, is by definition intended to be sold promptly in case of counterparty default, thereby allowing the ETF manager to repurchase those securities needed to carry out the advertised investment strategy. Also, independent of the replication model, one industry player (UBS) noted that as more and more market participants are moving towards over-

[67] In this regard, EDHEC recommends with the report proposal to limit net exposure on counterparty risk from a specific issuer, combined with an overall limit on net counterparty risk exposure, and accompanied by diversification requirements for instruments received as collateral. The latter are to be duly segregated with a third party custodian. Provided that counterparty risk arising from securities lending is mitigated to the same extent as that arising from OTC derivatives transactions, it would make little sense to pit physical against synthetic replication in its view.

[68] In the U.S., ICI observed that usually collateral is limited to cash and U.S. treasury and agency securities, with haircuts applied to other types where allowed. Other rules, as approved in the form of SEC Guidelines, set forth the types of collateral that funds may accept, as well as a number of conditions governing securities lending by the ETFs, e.g., that funds lending securities receive at least 100 % of the value of the loaned securities as collateral from a borrower, marked to market daily; or that a fund's board approve specific borrowers to whom the fund may lend shares.

[69] One association (AFG) would reinforce this point by rephrasing the proposed principle as follows: "Regulators should consider imposing requirements to ensure that ETFs appropriately address counterparty risks and collateral management."

collateralization, a more prescriptive regulation on collateral standards would stifle this positive trend.

- *IOSCO's response: On counterparty risks, IOSCO acknowledges that many other CIS also use derivatives and enter into securities lending agreements, and that these risks are not unique to ETFs. As for other CIS products, regulators should encourage ETF providers to appropriately address their counterparty exposures and adopt adequate risk management procedures, limits to counterparty exposures, collateral management requirements (e.g., rules for collateral eligibility and diversification), as well as other available safeguards.*

CHAPTER 5 – *Issues Broader than ETFs*

Risks arising on secondary markets - risk of shock transmission (Principle 15)

Taking into account broader financial stability and market integrity concerns, this Chapter pointed to two issues that had been flagged by the regulatory community: (i) the risk of shock transmission flowing from the degree of market interconnectedness; and (ii) the risk of abusive behavior on behalf of certain market players, as facilitated to a great extent by continuous innovation and rapid technological progress. The proposed Principle 15 addressed the first fundamental issue by inviting those exchanges listing ETFs to consider measures aimed at mitigating the occurrence of liquidity shocks and limiting their transmission to other trading platforms. Among the implementing measures advanced in the consultation report, of primary importance are trading control mechanisms (e.g., trading halts, volatility interruptions, limit-up/limit-down controls, etc.) to confront volatile market conditions. For the second issue of market integrity, IOSCO has made targeted recommendations in its *Market Integrity and Efficiency Report*, published in October 2011.[70] This report was more recently (April 2013) followed by a new IOSCO Report on the *Technological Challenges to Effective Market Surveillance Issues and Regulatory Tools* to help market authorities address the technological challenges facing effective market surveillance.[71]

Regarding Principle 15, nineteen respondents confirmed their endorsement of the principle. The overarching consensus is, again, that the danger of liquidity shocks and their transmission is by no means exclusive to ETFs among a myriad of other financial instruments. Trading controls should therefore be applicable to all securities traded through an exchange and measures to enhance both pre- and post-trade transparency should be welcome according to most respondents. Although supporting measures to confront liquidity shocks, only two respondents (EDHEC, IFIA) proved to be outliers. The former judged that trading interruption mechanisms may instead increase liquidity shocks and facilitate transmission across markets,[72] whereas the latter only stated that these would not be the most effective means and may actually distort the orderly functioning of the market. As to the issue of settlement delays as raised in the consultation report, one respondent (BVI) suggested

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70 See FR09/11 *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency*, Final Report, Report of the Technical Committee of IOSCO, 20 October 2011; available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf

71 See *Technological Challenges to Effective Market Surveillance: Issues and Regulatory Tools,* published by IOSCO in 22 April, 2013; available at: http://www.iosco.org/library/pubdocs/pdf/IOSCOPD412.pdf

72 In its response, EDHEC does not go into further detail, although admits that there has been little theoretical or empirical research on this issue and would advise caution.

introducing buy-ins (as under the EU's proposed Regulation on Central Securities Depositories – CSDs). Such tools, however, should more pertinently be provided by the national/regional legislation on capital market infrastructures. A respondent (ICI) strongly supported the establishment of limit up-limit down mechanisms to address extreme price movements in stocks in other jurisdictions where ETFs are traded and supported a more robust discussion and examination of the linkages and interdependency of the different types of financial markets.

One major exchange (LSE Group) provided an overview of the forms of trading controls it has implemented. These include (i) circuit breakers that are triggered by market volatility and lead to auction calls; (ii) tariff structures that provide incentives for lower order-to-trade ratios and are calibrated per instrument group; and (iii) real-time market surveillance that monitors misleading behavior. The use of circuit breakers/price volatility interruptions would be an effective method of operating trading halts. Moreover, the LSE Group, using the example of circuit breakers, recommended that these function according to the same parameters across markets, where regulators would be left to establish overarching guidelines and upper limits for tolerance, while leaving the details to be more efficiently set by market operators (i.e., market infrastructures).

In its comment to Principle 15, one market actor (ETF Securities) commented that it did not see an inherent vulnerability of ETFs to liquidity shocks. A more important consideration for investors when considering an ETFs' resilience to a liquidity shock, this actor suggested, is the number of APs (whether affiliated or not), as these parties can significantly influence the bid/offer spread, thereby aiding liquidity and determining the total cost for the investors owning ETF shares.

- *IOSCO's response: IOSCO decided to delete this principle, although noted that ETFs, as other financial instruments that trade on an exchange, have been cited in a number of reports focusing on issues of market stability, particularly with regard to their potential effects on the overall liquidity and their vulnerability as means of alleged market abuse. Although the evidence gathered remains at this stage still inconclusive, in this regard, IOSCO encourages regulators and industry practitioners to consider ETFs in connection with recommendations developed in the IOSCO 2011 Market Integrity and Efficiency Report.*

ETFs and market integrity (risk of abusive behavior)

As mentioned above, IOSCO has made targeted recommendations to deal with forms of market abuse in its *Market Integrity and Efficiency Report*, published in October 2011. Out of the responses received, only a handful sought to provide comments on this second important issue addressed under Chapter 5 of the consultation report. Among these, the LSE Group agreed that regulators should oblige exchanges to have monitoring systems in place, extending also to order entry and deletion (not just executed trades). Under LSE Group rules on misleading acts, conduct and prohibited practices, instructions exist to member firms around prohibiting the entry of orders into the auction or during continuous trading, with the intention of deleting or otherwise amending them before execution, as this could give a potentially misleading impression of liquidity in a security or the likely auction uncrossing price. The exchange does monitor this activity and take action against firms acting in breach of these rules. The LSE Group however remains concerned about forms of market manipulation, e.g., large orders aimed on one side of the book to move the bid/offer and then to trade against it. Overall, the Group is wary of the fact that market manipulation can be an ETF issue.

Risks to financial stability and avenues for future FSB/Joint Forum work

Taking stock of the observations and the conclusions of the FSB April 2011 note,[73] the third and final section of Chapter 5 in the consultation report presented three questions on a series of broader financial stability implications not exclusive to the ETF industry and indicating areas where further work by the FSB or Joint Forum would be worthwhile.

The first question sought replies as to whether there are particular financial stability concerns linked to ETFs that have not been addressed in the consultation report, in particular the issue of securities lending and counterparty risks. In this regard, all replies agreed that all issues had been covered in the report. Also, one association (AFG) found the advantages of ETFs to have been understated in the consultation report. Accordingly, ETFs would be simple products that have reached an unprecedented degree of transparency. Such transparency, in its view, would benefit the public and, ultimately, the broader financial system.

A second question asked whether there were specific counterparty risks raised by ETFs and whether further policy work from either the FSB or the Joint Forum would be warranted. Again, almost all respondents agreed that there would be no ETF-specific counterparty risks outside those identified in the consultation report and that at this stage there was no need for either the FSB or the Joint Forum to carry out further work, particularly on issues like securities lending where the FSB is expected to deliver broader policy recommendations in the context of its broader *shadow banking* mandate. One association (IMA) suggested that further scrutiny should be devoted to other competing non-CIS ETPs issued by banks, or possibly by insurance companies. Another actor (Hermes) welcomed the question and believed that the interactions between collateral treatment and new Basel III rules would deserve additional attention and consideration.

A third and final question raised in the consultation report was whether the FSB or the Joint Forum should seek a mandate to further study issues like the impact of ETPs on the price formation of the underlyings. On this issue, an industry association (BVI) replied that an ETF's extensive transparency and overall passive investing strategy makes its trading predictable and thus less relevant in determining the price in one or more markets, particularly in niche markets where only positive liquidity effects would be expected. Another industry actor (ETF Securities) held that although ETFs would contribute to liquidity and price formation, they would not "drive" it. Liquidity and the pricing of an ETP would ultimately always be controlled by investor interest in the reference underlying. The one research institute to reply (EDHEC) would however welcome IOSCO’s consideration of further academic studies and enforcement cases upon concerns related to potential liquidity shocks, market integrity, and upon the financial stability issues highlighted in April 2011 by the FSB.

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[73] See *Potential financial stability issues arising from recent trends in Exchange Traded Funds (ETFs*), Financial Stability Board, 12 April 12, 2011; available at: http://www.financialstabilityboard.org/publications/r_110412b.pdf

<u>Appendix III</u> – List of Working Group Members

C5 Member jurisdiction	Organization
France	Autorité des Marchés Financiers (AMF) - Co-Chair
United States of America	Securities and Exchange Commission (SEC) - Co-Chair
Canada (Québec)	Autorité des Marchés Financiers (AMF)
Canada (Ontario)	Ontario Securities Commission
Germany	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFIN)
Hong Kong	Securities and Futures Commission (SFC)
Ireland	Central Bank of Ireland
Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)
Luxembourg	Commission de surveillance du secteur financier (CSSF)
Spain	Comisión Nacional del Mercado de Valores (CNMV)
Switzerland	Swiss Financial Market Supervisory Authority (FINMA)
United Kingdom	Financial Services Authority (FSA)

Appendix IV – Broad Overview of ETF Structures and Regulation Across Three Key Regions

UNITED STATES

1. Main features of ETF structure

As of the end of 2012, the total number of U.S. ETPs organized as CIS was 1,194 with total net assets of over $1.3 trillion, most of which are index-based ETPs.[74] The vast majority of assets in these ETPs are in ETFs that are registered with and regulated by the U.S. SEC under the Investment Company Act of 1940. At year-end 2012, 9% of assets were held in ETPs that are not registered with and regulated by the U.S. SEC under the Investment Company Act of 1940; these ETPs primarily invest in commodities and currencies.[75]

2. Applicable regulation

In the United States, ETF shares are approved for listing and trading on a national securities exchange (i.e., an exchange that has registered with the U.S. SEC under the Securities Exchange Act of 1934). The registered national securities exchanges promulgate and administer listing standards that govern the securities that may be traded in its market. The rules of national securities exchanges, including listing standards, also are subject to review by the U.S. SEC. ETFs accordingly are subject to the listing standards of the exchange on which their shares are listed and traded. For example, the NYSE Listed Company Manual currently includes generic listing standards for ETFs based on U.S. stock indices, non-U.S. or global stock indices, fixed income indices and indices consisting of both equity and fixed income securities. ETFs listed pursuant to such generic standards must be traded in all other respects under the exchange's existing trading rules and procedures that apply to ETFs and are covered under the exchange's surveillance programs for equities. ETFs in the U.S. can be traded on or off exchange. All trades in ETFs (subject to a few minor exceptions), on or off exchange, however, must be reported to the consolidated tape. The index underlying the ETF also must meet a variety of conditions set forth in such standards, including requirements related to the nature, liquidity, and diversification/weighting of securities in the index and requirements with respect to index methodology and index value dissemination.

2.1 ETFs regulated under the Investment Company Act of 1940

In the United States, ETFs are registered with the U.S. SEC and are organized either as open-end investment companies or unit investment trusts (UITs). Open-end CIS have investment portfolios that are subject to active management by investment advisers (operators) and are overseen by a board of directors or trustees. A UIT does not have an

[74] The total number of these ETPs that are actively managed at the end of 2012 was 44, with more than $10 billion in assets, excluding ETP funds of funds, which are ETPs that hold and invest primarily in shares of other ETPs. At year-end 2012, there were 45 ETP funds of funds. Source: ICI 2013 Investment Company Factbook, (http://www.ici.org/pdf/2013_factbook.pdf).

[75] Source: *Ibid*.

operator (or a board of directors) because its investment portfolio is not subject to active management. A UIT is organized under a trust indenture, contract of custodianship or similar instrument. ETFs in the United States generally meet the definition of *investment company* in the Investment Company Act because such entities issue securities and are primarily engaged (or propose to primarily engage) in the business of investing in securities. ETFs generally are subject to the same provisions as other mutual funds. Namely, ETFs generally cannot engage in affiliated transactions and their ability to use derivatives generally is limited. To the extent that an ETF uses futures or swaps to generate synthetic exposure to an underlying asset or index of assets, its operator may also be regulated as a commodity pool operator as defined under the Commodity Exchange Act if the ETF's use of futures or swaps exceeds certain de minimis trading thresholds.

2.2 Commodity ETPs

ETPs that are not based on securities and whose portfolios may consist of physical commodities, currencies, futures, or swaps are created and redeemed by APs and traded on a national securities exchange in a manner similar to ETFs, but the entities offering the ETPs are not registered or regulated as investment companies under the Investment Company Act. These include ETPs that invest primarily in commodities or commodity-based instruments, such as crude oil and precious metals or futures thereon (*commodity ETFs*). Commodity ETPs typically are organized as trusts or, in the case of commodity pools, as limited partnerships, and issue shares that trade on a securities exchange like other ETFs. An offering of shares in a commodity ETP is registered under the Securities Act of 1933 (Securities Act) and the issuer is subject to the periodic reporting requirements of the Securities Exchange Act of 1934 (Exchange Act).

- One type of commodity ETP is based on a physical commodity and uses its assets to buy and store the physical commodity itself. The product's price is based on the traded spot or cash market price of the physical underlying commodity (e.g., gold, silver, platinum, palladium).

- A commodity ETP based on a physical commodity typically is not regulated as a *commodity pool* as defined under the Commodity Exchange Act, as amended (Commodity Exchange Act). The sponsor and the trustees of this type of commodity ETP also may not be subject to regulation by the CFTC as a commodity pool operator or a commodity trading advisor.

- Another type of commodity ETP is based on futures and other swaps. These products hold futures contracts (i.e., agreements to deliver a certain commodity at a certain date in the future for a price paid today) that trade on exchanges and do not require storage like a physical commodity does and may be cash-settled (as opposed to physical settlement). Commodity futures contracts are regulated under the Commodity Exchange Act administered by the CFTC. Commodity ETPs based on futures or swaps typically are used for exposures which cannot be physically stored or which represent a basket of commodities. The price of such commodity ETPs is based on an index level which is derived from underlying futures contracts (e.g., agriculture, energy, industrial metals, livestock).

- A commodity ETP based on futures may be organized as a limited partnership that is a commodity pool subject to the Commodity Exchange Act and whose general partner is registered as a commodity pool operator with the CFTC. Alternatively, such a commodity ETP also may be organized as a trust that is a commodity pool subject to the Commodity Exchange Act and whose manager is registered as a commodity pool operator with the CFTC.

3. Other Exchange Traded Products

Other ETPs include exchange-traded notes (ETNs) which, unlike interests in ETFs, generally are unsecured debt securities, issued by public companies, in most cases by financial institutions. ETNs also are exchange-traded securities that can provide the investor with investment exposure to certain market benchmarks or strategies. As ETNs are debt obligations of the issuer of the security, the ETN does not provide the investor with any ownership interest in the referenced security or securities in the referenced index. In addition, an investor in an ETN is exposed both to the market risk of the linked securities or index of securities and the credit risk of the issuer. ETNs do not share the same fund-like or trust-like structure as do other ETPs, and are not registered or regulated as investment companies under the Company Act. An issuer that publicly offers ETNs is required to register the offer and sale of the ETNs under the Securities Act and the issuer is subject to the periodic reporting requirements of the Exchange Act.

EUROPEAN UNION

1. Main features of ETF structure

Whereas in the US almost all ETF assets are managed via physical replication structures as defined above, in Europe, approximately one-third of ETF assets are managed through synthetic structures

2. Applicable regulation

In Europe, the majority of ETF structures, regardless of the chosen replication method, are authorised under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive (2009/65/EC). As UCITS funds, among other requirements, European ETFs are subject to strict diversification requirements at the level of their investment portfolio and are obliged to respect precise limits in terms of leverage (no larger than twice the value of their NAV) and of counterparty exposure (a limit equal to 5-10% of NAV). More recently, in December 2012, important aspects of the UCITS Directive have been clarified and broadened by the ESMA *Guidelines on ETFs and other UCITS issues*. Most recommendations apply to all UCITS-authorised funds, whereas the remaining ones are aimed specifically at UCITS ETF structures, regardless of their chosen model.

The Guidelines firstly provide a clear definition of a *UCITS ETF* through a single identifier that bars any UCITS from branding itself as an *ETF* or *exchange-traded fund* where it does not meet the prescribed definition. A second important feature of the *Guidelines* is an extensive catalogue of required disclosures, ranging from the detailed description of the chosen index to the replication method chosen, from the explication of the tracking error to that of the eventual recourse to leverage (or inverse leverage) and implied risks, from the illustration of redemption procedures (including direct redemption under certain circumstances) to the justification of using financial derivatives and other efficient portfolio management techniques, etc.

A second important section of the ESMA *Guidelines*, dedicated to all UCITS CIS, specifies important requirements to be met when engaging in efficient portfolio management techniques (i.e., investment in money market instruments, repo and reverse repo operations, securities lending, etc.), including those relating to risk and liquidity management. These are followed by analogous prescriptions relating to the use of financial derivatives. Collateral management and quality requirements that are to accompany any of the above operations emerge as one of the most innovative features of the *Guidelines*. At all times, the UCITS must receive collateral that meets specific liquidity characteristics, is valued on a daily basis, displays low correlations with issuers, is sufficiently diversified and enforceable at any time, with no further possibility of being sold, reinvested or pledged, if of a non-cash nature. Stress tests for collateral are required above certain thresholds and an appropriate haircut policy takes into account the classes of assets received, their credit quality, price volatility and outcome of stress tests. Finally, completing these *Guidelines* is an important section on the eligibility of indices, laying out a series of conditions for indices to meet if they are to become benchmarks for any UCITS CIS.

With regard to EU rules applying to sale and marketing of ETF products, these are respectively disciplined by the requirements of the Markets in Financial Instruments (MiFID) Directive (2004/39/EC) and of an implementing EU Regulation (No. 583/2010) to the UCITS Directive on key investor information.

3. Other Exchange-Traded Products

Regarding the other non-CIS exchange-traded products (ETPs) referenced in the above sections of the report, these in Europe are generally distributed in Europe via the EU-wide passport recognised by the Prospectus Directive (2003/71/EC) for products that are admitted to trade on a regulated market and offered to the public. Generally qualifying as structured products, compared to ETFs (which in Europe are typically UCITS funds), ETPs like notes (ETNs) or commodities (ETCs) are for instance not subject to comparable diversification or credit risk management rules. Moreover, investors in these products are less protected in terms of the custody requirements that apply to the referenced underlying assets, compared to the corresponding depositary regime under current UCITS rules.

ASIA

CHINA

1. Main features of ETF structures

The first ETF in the mainland China market was issued in 2004. Since then China's ETF market experience net inflow of capital every year. By the end of 2012, the ETF space had expanded to 49 products with AUM of RMB 160.8 billion. The ETF market continues to grow rapidly, new products such as gold ETF will likely be launched in 2013, while foreign currency, leverage and inverse ETF products are also being studied.

In terms of product type, the mainland China market currently has equity ETFs, bond ETFs and across jurisdictions ETFs. Equity ETFs replicate various major domestic indices as well as investment indexes based on sectors, themes and investment strategies. The two cross jurisdiction ETFs are equity ETFs that invest in the Hong Kong stock market.

In terms of product structure, all ETFs are structured as open-ended contract funds. Investors could purchase creation units using a basket of equity and debt securities and/or cash, investors could also redeem creation units for the redemption basket of securities. The current range of ETF products serve as substitutes for basic index funds, which could be understood by the general investor base. There are currently no synthetic, leveraged, inverse and commodities ETFs and other ETVs and ETPs.

2. Applicable regulation

According to the Securities Investment Fund Law, all ETFs, whether it is equity, debt, cross jurisdiction or commodities, require CSRC's approval prior to its offering. Apart from the Securities Investment Fund Law, ETFs must follow regulations issued by the CSRC. ETF investment, listing and operations must follow the Measures for the Administration of Securities Investment Fund Operations. ETF distribution is governed by Measures for the Administration of Securities Investment Fund Distribution. Currently, all ETFs are listed on either the Shanghai or the Shenzhen stock exchanges. The exchanges have each issued its own Securities Investment Fund Listing Rules to regulate the listing and exchange of ETFs.

HONG KONG

1. Main features of ETF structures

In Hong Kong, all exchange traded funds (ETFs) are collective investment schemes (CIS) authorized by the Securities and Futures Commission (SFC) under section 104 of the Securities and Futures Ordinance. ETFs that seek SFC authorization are required to comply with the disclosure and structural requirements as set out in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (the Handbook), in particular, the Code on Unit Trusts and Mutual Funds (i.e., Section II in the Handbook) (the Code). SFC-authorized ETFs are passively managed and open-ended CIS, with an objective to track or replicate the performance of an underlying index or benchmark. The index must have a clearly defined objective and be broadly based, investible, transparent and published in an appropriate manner. Hong Kong has ETFs tracking different asset classes including equities, fixed income securities, commodity futures as well as physical gold, silver and platinum, and ETFs focusing on regional, single-country and sectoral indices.

SFC-authorized ETF must be listed on the Stock Exchange of Hong Kong Limited (the SEHK). The structures adopted by SFC-authorized ETFs in Hong Kong are similar to those found in US and EU. Hong Kong's ETFs broadly falls into two categories, physical ETFs and synthetic ETFs. Physical ETFs track the index using full replication strategy and/or representative sampling strategy , while synthetic ETFs use financial derivatives instruments (such as funded swaps, unfunded swaps and/or performance-linked structured products) to replicate index performance.

The operation of the primary market creation and redemption and secondary market trading of ETF units is very similar to that in the US and Europe. In Hong Kong, creation and redemption of ETF units in the primary market are usually conducted through participating dealers (PD) in creation/redemption unit size. The function of PDs is similar to that of APs in the US. PDs create or redeem ETF units in creation/redemption unit size in return for a basket of securities and/or other assets. The basket generally reflects the contents of the ETF portfolio and is equal in value to the aggregate NAV of the ETF units in the creation/redemption unit size.

The creation/redemption unit size is typically much larger than the trading board lot size of the ETF units on SEHK. Therefore, the capital investment required for primary market creation and redemption is much higher. Investors (mostly retail investors), who do not have the required capital investment, usually buy or sell ETF units in the secondary market via a broker on the SEHK. ETF units on the SEHK are traded at market price, which may be higher or lower than NAV of the units.

As most retail investors have to rely on the secondary market to exit their ETF investments, secondary market liquidity is of paramount importance in the context of ETFs in Hong Kong. SFC-authorized ETFs are expected to have at least one market maker to provide liquidity to facilitate the trading of the ETF on the SEHK.

2. Applicable regulation

The SFC is the primary authority for regulating ETFs in Hong Kong and is responsible for the authorization of ETFs and their offering documents. Hong Kong Exchanges and Clearing Limited's (HKEx) role in ETF regulation is primarily to ensure a fair and orderly market for the trading of ETFs. Besides, HKEx also oversees the listing of SFC-authorized ETFs, supervises the conduct of the listing process and monitors continuing compliance with the Listing Rules, in each case in accordance with the applicable rules of the HKEx.

Generally, ETFs are subject to the same provisions as other unlisted open-ended CIS under the Code, such as the requirement for an up-to-date offering document, ongoing disclosure requirements, the requirements for a regulated manager and safekeeping of assets by trustee/custodian.

SFC-authorized ETFs are also subject to the rules of the HKEx among others, those rules relating to listing, trading, market making, and clearing and settlement. For example, in conducting market-making activities, ETF market makers are subject to a set of market making obligations, such as the maximum bid/ask spread and minimum quote size under the rules of the SEHK.

To mitigate counterparty risk, synthetic ETFs are subject to full collateralisation and prudent haircut measures. In addition, collateral has to be sufficiently liquid and must not include any structured products. It has to be marked to market daily, appropriately diversified and must be held and readily accessible/enforceable by the trustee/custodian of the ETF. To further enhance product transparency and better product differentiation, synthetic ETFs are subject to specific name annotation requirements.

3. Other Exchange Traded Products

Apart from ETFs, other non-equity products traded on the SEHK in Hong Kong include fixed income/debt instruments, derivative warrants, callable bull/bear contracts, and market access products. The listing of these products is subject to the Listing Rules of SEHK. Futures and options products are traded on Hong Kong Futures Exchange.

These other ETP products are generally unsecured debt securities and, unlike ETFs, are not CIS. They are not subject to authorization by the SFC. In general, investors of these products are subject to a direct exposure to the credit risks of the product issuers.

JAPAN

1. Main features of ETF structures

As with any listed security, investors may purchase and sell ETF shares continuously at market prices. However, in fact retail investors cannot redeem their individual ETF shares. Certain financial institutions (known as designated participants or DPs) purchase and redeem ETF shares directly from the ETF, but only in large blocks called creation units.

Most often, a DP that is to purchase a creation unit of ETF shares, first deposits with the management company (MC) of ETFs a purchase basket of certain securities, and then receives the creation unit in return for those securities, which are managed as corpus by trust banks. The basket is generally composed of portfolio whose value is designated to link to specific indices and is equal in value to the aggregate NAV of the ETF shares in the creation unit. After purchasing a creation unit, the DP may hold the ETF shares, or sell some or all of the ETF shares in secondary market transactions. The redemption process is the reverse of the purchase process. The DP acquires the number of ETF shares that comprise a creation unit, and redeems the unit from the MC of ETFs in exchange for a “redemption basket” of securities. An investor holding fewer ETF shares than the amount needed to constitute a creation unit (e.g., most retail investors) may dispose of those ETF shares by selling them on the secondary market. The investor receives market price for the ETF shares, which may be higher or lower than the NAV of the shares, and pays customary brokerage commissions on the sale. The ability of DPs to purchase and redeem creation units at each day’s NAV creates arbitrage opportunities that may help keep the market price of ETF shares near the NAV per share of the ETF.

2. Applicable regulation

In Japan, ETFs most commonly have a legal form of investment trusts which are regulated under the Act on Investment Trusts and Investment Corporations. When a MC is to enter into an investment trust contract with a trust bank, the MC shall notify the JFSA of the basic terms and conditions of the investment trust contract. The activities of a MC correspond to the Investment Management Business and the activities of a DP correspond to the Type I Financial Instruments Business (e.g., dealing in public offering of securities, etc.), respectively, in the Financial Instrument and Exchange Act (FIEA) and they shall be registered and regulated under the FIEA.

ETF shares are approved for listing and trading on a Financial Instruments Exchange licensed under the FIEA. The exchanges promulgate and administer listing standards that govern the securities that may be traded in its market. The rules of the exchanges, including listing standards, are subject to examination on the application for license and the amendment of them requires the authorization by JFSA. ETFs accordingly are subject to the listing standards of the exchange on which their shares are listed and traded.

3. Other Exchange-Traded Products

ETNs are also traded in Japan, although they are currently eligible for listing only in the form of depositary receipt (Japan Depositary Receipt, JDR). JDRs are the beneficiary certificates of a beneficiary certificate-issuing trust issued in Japan as entrusted securities which are foreign securities under the Trust Act. Their transaction volume is quite small in comparison with that of ETFs.