International Capital Market Association

ASSET MANAGEMENT AND INVESTORS COUNCIL

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European Securities and Markets Authority
103 rue de Grenelle
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Sent by email

Dear Richard,

Discussion Paper – ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

The ICMA Asset Management and Investors Council ('AMIC' or 'the Council') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concerned to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to ESMA Discussion Paper entitled ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS. The AMIC set up following its December quarterly meeting an ETF working group to consider issues related to the evolution of the product. The Council ETF working group supports the efforts by the international and European regulatory bodies to increase the understanding of ETFs. Our response will make some general points as regarding ESMA Discussion Paper and will be complemented by a report on the ETF 'brand' prepared by the AMIC ETF Working group.

Investors' views on the ETFs

The AMIC Working Group firmly believes that the growth of the ETF market is directly linked to and in response to investors' needs and demands. We see strong evidence that there is a real demand for the newer ETF products and that providers are meeting that demand rather than creating it.

The motivations for using ETFs have expanded, beyond the ever-relevant issues of cost advantage and broad market access. Examples of strategies being implemented include managing asset allocation, taking tactical positions, and increasing diversification. Investors are also using ETFs to take negative positions in asset classes, either to remove existing unwanted exposure or to express a negative view.

This expansion has been fuelled by the increase in the range of asset classes accessible through ETFs. Therefore, the introduction of ETFs covering emerging markets, commodities and property has allowed investors to access some of the best performing asset classes of the past few years.

Many surveys, and anecdotal evidence, show that liquidity is the most important factor for both asset managers and institutional funds when it comes to selecting an ETF provider. After liquidity, as far as quantitative considerations are concerned, institutional funds and asset managers focus mainly on providers' tracking error[1] and total expense ratios[2], followed by the performance of the fund[3] and the track record[4] of the fund itself. Finally valuation of the fund[5] will be considered. Other qualitative information about products and strategies can be used for further filtering. For the qualitative assessment, questions regarding the ETF sponsor[6] will be considered, the replication techniques used[7], counterparty risks; use of securities lending[8]; conditions for eligibility for the underlying assets and index construction; transparency[9]; creation and redemption process; availability of iNAVs[10]; liquidity and size of the fund; Domicile of the fund and UCITS compliance; and client services. Finally for an ETF investor, another question is whether the distribution policy, the different replication techniques, and the fund volume amongst other factors have a systematic influence on the deviance between fair values and traded ETF prices.

A critical component to understanding the risks inherent in an ETF is the ability to assess counterparty risk. Ultimately, investors need to ask themselves whether the ability to turn their ETF investment into cash at or near NAV is achievable in a stress scenario. This is both a question of the likely outcome of an event of default by a swap counterparty and the potential lack of pricing liquidity in a stress scenario.

In order to assess the impact and events of a counterparty default, an investor needs to be able to understand a number of aspects:

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1 The lower the tracking error on the targeted index the better

2 Lower is better, but one has to bear in mind that for swap-based ETFs costs can be hidden in the swap structure. This would not be included in the TER.

3 A good ETF is expected to replicate the net return of the targeted index plus X where X stands for some basis points showing additional performance.

4 Normally a track record of at least three years is expected before considering the fund in a strategy.

5 Is the ETF in average over-or undervalued?

6 What is the company structure and setup? How is the relation of the issuer to his main swap counterparties, if total return swaps are used to replicate the index? Often the parent bank of the sponsor is also swap counterpart; Operational due diligence.

7 Full replication; Partial replication; Sampling Techniques; Unfunded swap-based; Funded swap-based.

8 Process, redemption and termination policy, how does the investor participate in these gains

9 What grade of disclosure does the ETF-manager have? Especially with regards to swaps: will the swap margin be disclosed? This margin will be re-negotiated with every reset and leave room to make gains without participation of the investor.

10 Indicative Net Asset Value - a measure of the intraday net asset value (NAV) of an investment.

1. The credit quality of the swap counterparties that ETF providers are dealing with.
2. The type of collateral or substitute securities that are being provided to mitigate counterparty risk.
3. The haircuts applied to each collateral type.
4. The ability for the collateral policy to change.
5. The rights over the collateral / substitute basket and the ability to liquidate under a default event. The security interest held by the ETF fund will both impact their ability to control collateral movements and determine how quickly they will be able to access collateral in a default.

In terms of these 5 considerations, each ETF provider has a slightly different profile with varying levels of transparency. The differences in collateralisation between providers ultimately mean that different ETFs entail different counterparty credit risk. It was noted that major efforts have been made by many of the large providers recently to address some of these issues of transparency.

Investors' motivations for using ETFs have expanded and are no longer limited to cost advantage and broad market access concern. Although initially investors mainly used ETFs for managing asset allocation and increasing diversification (for which the simpler "early version" ETFs were entirely adequate), they are now seeking to use ETFs to take tactical positions, including negative positions in asset classes, either to remove existing unwanted exposure or to express a negative view. In all of this investors are utilising the essential characteristics of ETFs: their intra-day liquidity and enhanced flexibility, allowing investors to take both long and short positions. ETFs have been embraced because in a back-to-basics' environment, they provide transparency, simplicity, liquidity and other favourable features.

The increase in usage, breadth and product flexibility has driven a steady growth in the use of ETFs over the past decade. This expansion has been fuelled by the increase in the range of asset classes accessible through ETFs. Moreover, the introduction of ETFs covering emerging markets, commodities and property has allowed investors to access some of the performing asset classes of the past few years. On top of greater asset breadth, the range of instruments has also grown.
The AMIC Working Group considers that the early ETFs (ie, version 1.0 or plain vanilla ETFs) clearly did and still do meet all three of these conditions, and moreover do so in a way that is unmatched by other competing products. Plain vanilla ETFs meet a genuine end-investor need, do so in a robust and efficient manner, and have a structure which is transparent and easy to understand. It is no surprise therefore that the ETF market has grown rapidly, or that the plain vanilla ETF product remains very popular and retains the confidence of investors.

The importance of considering the ETF 'brand'

The AMIC Working Group considers that the more structured ETFs (ie, version 2.0 or synthetic ETFs) also clearly meet an investor need. The growth of the market, both in the number of ETF products and in the total assets under management that they represent, is strong evidence that there is a real demand for these products. The Working Group does not consider that the rate of growth that the synthetic ETF market has experienced is consistent with an artificial product created by providers for which there is no real demand.

However the move to a more derivatives-based structure for version 2.0 ETFs has inevitably increased the complexity of the product and reduced its transparency, to the point that it is arguably no longer so easy for end investors to be confident they understand all the details of their operation.

Furthermore, while the case for synthetic ETFs to be “an efficient and robust solution” can be made, and many providers make claims for their products that they are indeed both efficient and robust, the product as a whole is as yet untried in more volatile markets and there remain issues of counterparty exposure and liquidity in times of market stress.

Both of these two concerns have led to increased regulatory interest in the ETF market: for regulators, the first (complexity and lack of transparency) raises issues of investor protection and suitability, and the second (efficiency and robustness) raises issues of systemic risk. The AMIC Working Group understands these concerns, and is keen to contribute to the process of addressing and resolving them.

The AMIC Working Group identifies, however, a challenge of ownership. The success of the ETF product, and the enthusiastic reception from investors for ETF offerings, has brought many new providers into the marketplace, and whereas the creation, provision and management of the early plain vanilla ETFs was concentrated in the hands of a few major players, the current ETF universe is characterised by a very wide and diverse range of offerings and providers. While this has the advantage of diversity, it carries with it the disadvantage that the ETF industry is without a central agreed authority or spokesman, to the extent that different providers’ definitions of what is an ETF and what qualifies to carry the ETF label can vary considerably.

Indeed, the AMIC Working Group observes that there is a risk that if left unchecked, this could cause the definition of what is an ETF (ie, what qualifies to use the ETF “brand”) to be stretched beyond what is useful, either for investors or regulators. The ETF brand is at the moment valuable – investors like and trust it – and the lack of an agreed formal definition of what qualifies as an ETF could lead to a situation where providers claim “ETF status” for products which differ in significant ways from what the investor community generally understand by the term.

The AMIC Working Group would see this as a retrograde step, reducing clarity for investors, and bringing the risk that a malfunction (for example a fund default or liquidity stop, or a counterparty event) in one product that claimed to be an ETF could adversely affect the reputation of the whole ETF market, including other products that are significantly different from the defaulting product.

Views on the ESMA Discussion Paper

The AMIC ETF Working Group believes that it is important for investors to understand there are various forms of exchange traded products (ETPs) which tend to be loosely defined as ‘ETFs'. The ETP industry needs to educate investors and be clearer on the labelling of various ETPs. The main areas of complexity and opacity relate to instruments often confused with ETFs - these are ETNs, ETCs and ETVs. In Europe, derivatives regulations are very well detailed and well established in the context of the UCITS directive. There is no such level of EU regulations concerning securities lending by UCITS.

It is worth noting that the size of the over-the-counter (OTC) swaps used within ETFs is small compared to the overall size of the market. At the moment the non-vanilla segment of the ETF industry is probably not of sufficient scale to create any systemic risk. At the end of June 2010, according to the Bank for International Settlements, total forwards and swaps in equity linked derivatives amounted to $1,745bn, whereas the total size of assets under management in swap-based ETFs was only $124bn. All equity-linked exposures at the end of June 2010 totalled $6.3trn so again, as a proportion of this, European ETF swap exposure would be less than 2% of the total. European ETF swap exposure cannot easily be presented as a source of contagion and systemic risk when compared to the broader swap and OTC market.

The AMIC ETF Working Group believes that the growth of the ETF market is linked to genuine end-investor demand. The product is understood by investors and to a very great extent retains their confidence and trust, and the Working Group expects the recent growth in the number of ETFs to continue and the assets under management in ETFs to continue to rise. Indeed it is very possible that the growth of the market will encourage even more providers to enter the market, so that the outlook could be for the ETF sector to play an increasingly important part in both retail and institutional investment.

It is against this backdrop of a growing role for the ETF market that regulatory interest in the market has increased. Indeed in a real sense the official interest in the ETF market marks the importance of its position in the universe of investment vehicles today. The Working Group welcomes the increased scrutiny of regulators towards the ETF market and their willingness to work with providers to improve the functioning of the market.

Nevertheless the Working Group feels that it is important that ETFs are seen as part of the general investment landscape rather than unique and distinct from other forms of investment. Rules and regulations applied to ETFs should therefore not be out of line with those applied to other investment vehicles. On a practical note, and as this report has observed, the definition of what is and is not an ETF is not a hard or clean criterion: the lack of ownership of the ETF “brand” means that no single body – official or industry association – “owns” the ETF name or therefore can grant or withhold it (unlike, for example, the UCITS appellation, which is owned by the European Union and entirely within their control). It follows that any legislation aimed at ETFs per se risks being based on a weak and informal appellation: if the regulatory environment for ETFs becomes too onerous, providers will simple call their products something else.

This is unlikely to change: it is clear that there is no consensus between regulators and providers at the global level of what precisely constitutes an ETF or which funds can claim to be ETFs. Therefore the Working Group urges regulators to ensure a level playing-field between ETFs and other investment products: the industry will not be served well by restrictions and conditions applied to ETFs (or rather, funds which claim to be ETFs) which are not paralleled elsewhere, and indeed any regulations based on such an approach may prove insecure and not well-defined. In particular, any regulatory provisions that will affect UCITS-compliant ETFs need to be consistent with other regulatory provisions affecting UCITS funds.

Furthermore, Working Group members urge regulators to consider commensurate and proportionate measures in line with the risks posed by the ETF product. The emphasis should be on more transparency rather than the implementation of restrictive practices affecting ETFs products. Members of the Working Group feel strongly that the risks inherent in an ETF structure should be clearly explained; but this call for increased and understandable transparency is in fact a general principle which should apply to all investments, not specifically or uniquely to ETFs. (It is acknowledged that in fact the biggest providers already provide relevant and easily accessible information on their website – which could constitute best practice).

In conclusion, the ICMA AMIC Working Group welcomes the growth of the ETF market and recognises this as a positive and investor-led development. In firstly creating the ETF product and more latterly developing it into the now wide range of derivatives-based ETFs that are available, the investment industry is responding well to investors' needs and concerns, and has so far met with end-user approval for their initiatives. The Working Group recognises that the increased size, importance and role of the ETF market demands and requires the interest and close attention of the regulatory community, and is committed to working with regulators in their endeavours. But the Working Group also believes strongly that the regulation of ETFs should be commensurate with the risks they pose, and should be in line with the regulation of other investment vehicles and not subject to a "special regime".

The AMIC, and the ETF Working group. would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

John Nugée
Chairman of the ETF WG