IOSCO GOOD PRACTICES FOR ETFS

IA Response to IOSCO's Good Practices for Exchange Traded Funds

The Investment Association (IA) represents UK investment managers. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.4 trillion for savers and institutions in the UK and beyond. The UK asset management industry is the largest in Europe and the second largest globally.

As providers of and investors in ETFs, the IA membership support the ETF Good Practices set out by IOSCO that aim to achieve the efficient functioning of ETF markets through effective product structuring, liquidity provisions, volatility control mechanisms and sufficient disclosures.

To this end the IA is delighted to respond to IOSCO's report on 'Exchange Traded Funds – Good Practices for Consideration' (from here in, referred to as 'Good Practices report').

The below sets out in further detail the IA's response to the Good Practices report.

Effective Product Structuring

The IA's members support the objectives set out in IOSCO's Good Practices report with regards to effective product structuring, and indeed note that the proposed measures are already well-covered in existing UCITS regulation and legal standards, including very detailed terms on liquidity and diversification. We believe that additional rules or legislation in Europe would be unnecessary in this instance, as investors are already well protected by existing European regulation, and the increased costs from complying to additional rules would ultimately fall on the end-investor.

Per Measure 3, the IA and its members already believe firms are striving to promote the fairness and efficiency of ETF markets through transparent, accurate, and up-to-date reporting of clients' ETF holdings. The IA and its members do not consider in this instance additional rules or legislation around iNAV as necessary, and the potential additional costs would ultimately be assumed by the end investor through higher management fees. Moreover, we note that are significant issues surrounding the calculation of the iNAV and we believe that regulators should consider removing the requirement to have an iNAV in those jurisdictions where it is currently mandatory.

We support Measure 4 in principle. We welcome guidance on good practices for conducting due diligence on Authorised Participants and Market Makers, as it will help increase confidence in a fast-growing product which has proved resilient during market

The Investment Association
Camomile Court, 23 Camomile Street, London, EC3A 7LL
www.theia.org
[Team or your Email Address]
@InvAssoc
@The Investment Association

stress events, and indeed members will already have robust due diligence and selection frameworks in place. However, the IA and its members believe there may well be scenarios where only a limited number of APs are available due to the nature of some underlying assets. Nonetheless, the IA does not consider that such arrangements would negatively impact the effectiveness of the arbitrage mechanism of these products.

The IA and its members consider that that there are a number of mechanisms that help facilitate effective ETF arbitrage mechanisms and manage liquidity. The IA's membership note that direct redemptions rights as an alternative mechanism would be highly problematic given the ETF structure and difficulties in confirming the identity of the end investor.

The IA membership believe that strict internal policies already help to effectively mitigate any potential conflicts of interest and to operate in a way that is impartial and objective.

Question 1
What additional considerations do regulators or responsible entities consider in determining the range of assets and strategies to be invested or implemented by an ETF and how are they different from those concerning OEFs?

The IA's members do not consider that there are significant differences between the approach of ETFs and OEFs. Considerations such as investability, liquidity, index, environment and the appropriateness of the AP/broker will apply to both.

There are some differences, such as that investors can trade in and out of ETFs throughout market opening hours. The IA considers the dual execution of ETFs on the primary markets through creations and redemptions and in the secondary markets is beneficial to investors. However, whereas specific requirements or dedicated regulatory guidelines (as in the EU) may be warranted to account for some ETF specificities, at their core ETFs remain OEFs and as such should continue to fall beneath the more comprehensive rules designed for the latter.

Question 2
What other good practices have been put in place to take into account the target investors at product design phase?

The IA considers that the European regulatory framework under MiFID II already sets out effective suitability rules.

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

Yes. The IA's members consider disclosures to be well covered by existing UCITS regulations and portfolio holdings are made available daily via the distribution of portfolio composition files (PCFs).

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

The IA considers that it is important sufficient transparency exists in respect of the valuation of ETFs for the arbitrage mechanism to work. Accurate daily dissemination of Portfolio Composition Files (“PCFs”) and support of Authorised Participants (“APs”) transacting in the primary and secondary markets is sufficient to maintain and support an efficient and robust ETF arbitrage mechanism.

<u>Question 5</u>
What additional means or disclosure have been put in place to address issues relating to iNAV?

As noted above, whilst our members do not in principle oppose the objectives set out in IOSCO’s Good Practices report to enhance the attractiveness and usefulness of iNAV (Measure 3), the IA and its members consider that firms are already striving to promote the fairness and efficiency of ETF markets through transparent, accurate, and up-to-date reporting of clients’ ETF holdings. The IA would not support additional rules or legislation around iNAVs, and we believe that regulators should consider removing the requirement to have an iNAV in those jurisdictions where it is currently mandatory.

We note that there are significant issues surrounding the calculation of the iNAV and would strongly oppose any efforts to make its calculation mandatory. The IA members are concerned about the accuracy of iNAVs and the potential detrimental impact that the use of an unreliable iNAV can have for investors. This issue is particularly acute in EMEA, in comparison to e.g., the U.S., given that only 29.3% of UCITS ETF AUM tracks European indices, while the remaining 70.7% UCITS ETF AUM tracks indices that include some element of non-European securities (source: Bloomberg) that would contribute to some degree of stale pricing over the course of the European trading day. The IA and its members do not consider in this instance additional rules or legislation around iNAV as necessary, and would potentially hinder rather than help investor understanding, as well as potentially create additional costs would ultimately be assumed by the end investor through higher management fees.

<u>Question 6</u>
Have the examples of considerations above captured the key considerations relating to selection and due diligence of APs, and where relevant, MMs, by responsible entities?

Yes. The IA’s members have robust selection and due diligence frameworks in place to ensure they contribute to the functioning of the arbitrage mechanism and liquidity provision. The IA’s members also have robust AP onboarding processes with regular monitoring of APs, carrying out due diligence and AML checks on an ongoing basis in order to ensure that they have the best in-class trading ecosystem.

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

It is in the interest of the issuer to have as many APs and MMs as possible. However, in some cases it will not be possible to have in place multiple arrangements, often due to a lack of APs or MMs trading a given underlying asset. In these instances you may have a scenario where there are not specific exclusivity arrangements in place, but where there are nonetheless a limited number of APs or MMs available due to the specialist nature of the assets. The IA does not consider that such arrangements would negatively impact in anyway the effectiveness of the arbitrage mechanism of these products.

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

The IA's members are supportive of the proposed good practices, which are already standard practice for many ETF issuers.

The IA would not support a Hong Kong-style obligation on APs to transact with other market participants on an agency basis. While an AP's ability to do so remains valuable, this should be voluntary rather than mandatory, so as not to interfere with the AP's own incentives to partner with an ETF structure and thus reduce AP availability.

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

While fully daily portfolio disclosures to APs and MMs are vital to the functioning of the arbitrage mechanism, we do not believe it is warranted to disclose this information to the broader public. Instead, we note that a number of ETF issuers already partially or fully disclose the underlying basket components with a time lag, providing a reasonable level of transparency.

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

The IA's members agree that the report captures the key operational risks that may lead to disruption. However, the IA does not support proposals to introduce direct redemptions, which it considers not a viable option.

In part this is down to difficulties in identifying end-investors. ETF providers do not have access to this information and thus any effort to confirm the identity of an investor seeking a direct redemption would be extremely challenging.

In any case, the IA considers that direct redemptions would not necessarily mitigate much operational risk in a scenario where secondary market trading is disrupted. Recent suspensions of trading of ETFs with significant Russian exposure would likely not have been addressed by the introduction of direct redemptions, as trading of the underlying assets was stressed and/or frozen.

Question 11

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

Strong frameworks for managing conflicts of interest are already in place under UK and European legislation. The IA membership believe that strict internal policies already help to effectively mitigate any potential conflicts of interest and to operate in a way that is impartial and objective.

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

The IA considers that ETF issuers consistently and diligently work to manage any conflicts of interests with other stakeholders within the ETF ecosystem. The concepts of treating clients fairly and understanding that the clients' interests must always come first are basic principles that are widely adopted by the ETF industry.

Disclosures

IA membership strongly support high disclosure standards for ETFs which aim to increase transparency and promote confidence in ETF products. We believe disclosures for ETFs are mainly well covered in existing regulatory frameworks in Europe, which incorporated the recommendations of IOSCO's 2013 Principles for the Regulation of Exchange Traded Funds report. The Good Practices report does however highlight the need for a Consolidated Tape in ETFs and other ETP products to provide investors with an additional level of transparency.

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

The Good Practices report captures the disclosures that have been put in place across a number of jurisdictions to help investors better understand the arbitrage mechanism and the specificities of ETF investment strategies.

However, we note that with regard to the SEC's requirement for the disclosure of average bid/ask spread, such disclosures will be difficult in Europe and the UK without the introduction of a consolidated tape for ETFs. The IA calls for the introduction of such a tape in Europe and the UK, as it would promote greater transparency for all investors and showcase the true liquidity of ETFs in the UK and European marketplace.

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

The IA agrees that the Good Practices report captures these fees and costs, and notes disclosure of fees and costs are already governed by existing EU and UK legislation.

It is the case that the ultimate cost to an investor of trading in shares of an ETF is highly dependent on the investor's situation. For example, the fees and costs associated with ETFs can depend on an investor's brokerage account and associated fee/service arrangement, as well as tax status, domicile and other circumstances. For these reasons, the consultation report points to many regulators' general preference for qualitative rather than quantitative information on fees and expenses in ETF disclosures. We acknowledge that a qualitative approach to general product disclosures by ETF managers is more appropriate given investor idiosyncrasies.

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

A European consolidated tape, or a harmonised EU and UK consolidated tape for ETFs, would enhance transparency of ETF market trading in Europe. This would help investors better understand the costs associated with executing a trade in ETF shares, thus enhancing investor protection and, at the same time, improving execution outcomes and contributing to more robust supervision of markets. One way of achieving this would be to encourage jurisdictions globally to support the establishment, where they do not already exist, of consolidated tapes of record for market data that operate at as close to real time as possible. For ETFs, consolidated trading information should include both pre- and post-trade data, with contributors to the tapes, such as trading venues and approved publication arrangements (APAs), required to provide harmonised reporting to ensure efficiency in the aggregation and utility in the use of such data. While consumption of the tapes by market participants should be voluntary with the fee to access the tape always remaining cost-effective, contribution to the tapes should be mandatory, and contributors to any tape should be compensated at a fair workable rate based on the value of the data contributed to the tape(s). In UCITS ETFs, the Key Investor Information Document ("KIID") and (in most cases) the fact sheets provided to investors clearly detail the costs of investing in ETFs.

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

The 2014 ESMA *Guidelines on ETFs and other UCITS Issues*[1] clearly establishes a UCITS ETF identifier in the fund name identifying a structure as an ETF. This forms a key differentiator with other forms of ETP. Further education of the investor public would be helpful nonetheless in providing greater clarity – we note EFAMA's 2020 investor guide 'Demystifying ETFs: A simple guide for the European investor'[2] as being useful for this purpose.

Liquidity Provisions

Trading venues and regulators which have the tools and oversight to conduct market surveillance are able to help achieve the aim of IOSCO's Good Practices' Measure 10, and we believe they are already doing so. The IA reiterates its call for a consolidated tape, which it believes would significantly boost liquidity and transparency of liquidity in UCITS ETFs.

[1] ESMA, *Guidelines on ETFs and other UCITS Issues*
[2] EFAMA, *Demystifying ETPs: A simple guide for the European investor*

Question 17

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

As noted above, trading venues and regulators who have the tools and oversight to conduct market surveillance are able to help achieve the aim of IOSCO's Good Practices' Measure 10, and we believe they are already doing so. The IA also reiterates its call for a consolidated tape, which it believes would significantly boost market transparency and liquidity. Furthermore, ETF issuers also closely monitor contractual market making performance and spreads in the secondary market.

Question 18

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

Issuers will work with MMs to boost secondary market liquidity where possible. In terms of the rules in place the IA will defer to the exchanges. ETF issuers in Europe have signed and executed contractual market making contracts that govern liquidity provision in ETFs, which include rules that govern any possible cessation of liquidity provision by a market maker. Furthermore, an individual MM's decision to stop providing quotes for ETFs does not necessarily have a detrimental impact on the liquidity thereof. For example, in EMEA, certain market makers (e.g., KCG Holding, IMC Trading) have stepped away from providing quotes for ETFs in the region, yet liquidity in the ETFs for which they were providing quotes was not detrimentally impacted.

Volatility Control Mechanisms

The IA strongly supports Measure 11 and views volatility control mechanisms (VCMs) as essential for the effective functioning of the markets. While the IA does not want to be overly prescriptive in determining the key parameters that should be considered. However, we note that in terms of high level principles any such VCMs should be harmonised and automated, with appropriate transparency in place as to their functioning.

Question 19

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

As noted above, The IA does not want to be overly prescriptive in determining the key parameters that should be considered. However, we note that in terms of high level principles any such VCMs should be harmonised and automated, with appropriate transparency in place as to their functioning. Additionally, the IA would encourage IOSCO, regulators and trading venues in relevant jurisdictions to reconsider the appropriateness of a VCM based on the iNAV given the known shortcomings of the iNAV, which are outlined in the IOSCO consultation report and in our response to Q5. Basing the use of a VCM – an important market control and investor protection mechanism – on a potentially unreliable and increasingly less relevant metric such as the iNAV does not contribute towards market efficiency, despite the best efforts of regulators and trading venues to put in place appropriate adjustment mechanisms as discussed on page 66 of the consultation report.

The IA membership advocates that IOSCO encourages regulators and trading venues in Europe to take a more harmonised approach and to utilise VCMs based on the historical secondary market price in order to ensure greater market efficiency and investor protection.

Question 20

- What additional good practices related to design or implementation of VCMs have you been in place?

The IA considers that trading venues should automate their VCMs and have clear cut volatility interruption rules whenever the potential next execution price of an order lies outside of a dynamic and/or static price range around a reference price. The IA's members consider that VCMs should be harmonized across European Exchanges as it would facilitate well-functioning and efficient markets.

Next Steps

The IA remains available to IOSCO to provide further feedback on good ETF practices. We would like to thank IOSCO for the opportunity to provide feedback on the report.