Exchange Traded Funds

A Regulatory Overview

November 2016

Evolution of the ETF product

Since they were first launched 25 years ago, Exchange Traded Funds (ETFs) have become one of the most successful investment products offered to investors. They have proved to be innovative financial vehicles, which have shaped how investors invest and how the market itself functions.

The growth in the ETF market has been extraordinary, to the extent that global assets under management have increased from USD 400 billion in 2005 to some USD 3 trillion in 2015.[1] In Europe, the ETF market is worth USD 454 billion. Ireland [2] has been a major beneficiary of this extraordinary growth in the ETF market and is currently Europe's leading ETF domicile with USD 247 billion in assets under management, representing 54% of the European market.

Why the growth and why have ETFs become so popular?

At their core, ETFs are hybrid investment products, combining many of the features of managed mutual funds, predominantly passively managed but not exclusively, with the trading features of common stocks. They provide liquid access to many asset classes and allow investors, including retail investors, access to broadly diversified index funds.

Another attraction is that management fees are typically significantly lower than mutual funds. And unlike mutual funds, ETF shares are traded on global stock exchanges, with continuous pricing and liquidity throughout the trading day. Because of higher levels of transparency for both holdings and the fund's investment strategy, investors are better able to evaluate an ETF's potential risks and returns.

This combination of lower fees, greater transparency and easier access than mutual funds means that ETFs are attracting assets away from mutual funds, and the outlook for future growth remains strong.

But there are issues that need to be addressed

The growing popularity of ETFs among retail investors, along with the huge growth in assets under management, have revealed vulnerabilities that have previously not been addressed by regulators. In response, regulators, in the last four years, have launched several initiatives on a European and global level aimed at increasing investor protection and strengthening market integrity.

The following provides a brief overview of the specific initiatives that have shaped, and will continue to influence regulation for ETFs in Europe.

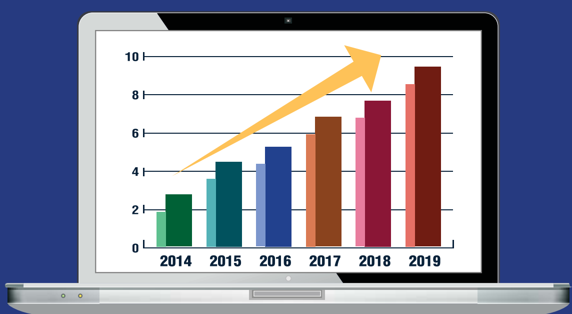
The current regulatory landscape

Ensuring investor protection

In Ireland, all ETFs listed on the Irish Stock Exchange are UCITS funds, which is also the dominant structure for ETFs across Europe. From the regulator's perspective, the focus is on fair completion and effective governance measures which put the best interests of consumers at the centre of all business activities, as these are two of the core principles to protect retail investors in the UCITS sector.

The increasing popularity of ETFs has, however, attracted more product providers to enter the market and this has intensified competition among providers. Besides fair competition, effective investor protection requires that all market participants follow high standards of governance and controls in order to protect investors.

Even though the current UCITS framework provides a high level of investor protection, European regulators want to eliminate any practices in the ETF industry that are contrary to the principles of fair competition and sound governance.



[1]According to ETFGI LLP – an independent research and consulting firm
[2]Irish Funds Q2 2016 Factsheet

ESMA Guidelines on ETFs and other UCITS issues

The first major regulatory initiative, specifically directed at the ETF industry, occurred in 2012 when the European Securities Markets Authority (ESMA) published a consultation paper (CP) on draft *Guidelines on ETFs and other UCITS issues*. As well as dealing with some general UCITS matters, the consultation paper was designed to address practices that were commonplace among ETF providers at the time but exposed investors to additional risks, the main ones being:

- **Management of the tracking error**
  The tracking error is the performance difference between an ETF and the index it is tracking. In order to reduce this risk, many ETF providers launched "synthetically replicating ETFs" which are ETFs that use derivatives – either on their own or in combination with physical investments – to track the index more closely.

  This practice, however, exposed investors to significant counterparty risks, despite collateralisation as there were no clear requirements regarding its quality. Moreover, the risks arising from synthetic replication were not adequately disclosed in the fund documents.

- **The use of efficient portfolio management techniques**
  Some product providers charged extremely low management fees but compensated for this by employing efficient portfolio management techniques, such as securities lending and borrowing, or repo transactions, and by retaining part of the respective proceeds. Again, this practice exposed investors to counterparty risks that were not appropriately disclosed. Furthermore, the retention of the proceeds from these activities was often not transparently described in the fund documentation.

The Guidelines on ETFs and other UCITS issues was initially issued in February 2013 and was revised in August 2014. The guidelines introduced the following measures to mitigate the issues described:

- **Extended disclosure requirements**
  Fund documentation now needs to include more detailed information on the index that is tracked, how it is tracked (i.e. physical, synthetic replication or a combination of both), the risks associated with it and the expected level of the tracking error. In respect of the use of efficient portfolio management techniques, fund documentation should contain detailed descriptions of the risks involved for investors as well as disclosures about the direct and indirect operational costs and fees arising from the use of these techniques.

- **Collateral management**
  The guidelines set out new requirements regarding the quality and diversification of the collateral received when entering into OTC derivative transactions or when employing efficient portfolio management techniques detailed above.

  In Ireland, there are additional qualitative requirements and guidance in relation to the collateral taken by a UCITS. There are rules regarding the determination of 'high quality' and these rules are supplemented with guidance which sets out the Central Bank's expectations where a UCITS is holding collateral of deteriorating quality.

- **Use of proceeds from efficient portfolio management techniques**
  All revenues from the use of efficient portfolio management techniques must be returned to the fund net of direct and indirect operational costs. Hidden costs for the manager may not be charged to the fund.

ESMA statement on "closet index tracking"

The majority of ETF assets are in passively managed funds, and, as such, management fees should be significantly lower than for actively managed funds. But regulators have become increasingly concerned with the question of whether or not some funds could justify the high level of fees they charged for active management and whether investors are being adequately compensated for bearing the additional risks and costs of investing in such active funds. This concern prompted the publication of a statement from ESMA, in February 2016, about work it conducted on the phenomenon of "closet index trackers". The term describes funds that claim to be actively managed but in fact stay very close to a benchmark.

ESMA used a number of metrics to identify potential closet trackers and concluded that up to a sixth of actively managed funds could potentially be "closet trackers" and as a result may not warrant the high level of fees charged. Some market participants question the methodology used and feel that the level of "closet tracking" could actually be higher than ESMA's "one-sixth" estimate.

Closet index tracking is shaping up to be one of the hottest European regulatory topics of 2016 with various regulators across Europe, including the Central Bank of Ireland, publicly stating that they will conduct reviews to establish the extent to which funds are charging high fees for strategies that merely track indices, a practice which is misleading and costly for investors.

Regulatory focus: Value for Money

Another example of this focus on value for money, from the regulator's perspective, can be found in the FCA's Asset Management Market Study, issued on 18 November 2016. In that report the FCA found that the price of passive funds has fallen and that active prices have remained static. Furthermore the FCA found that investors are not always clear about the objectives of the fund and fund performance is not always reported against an appropriate benchmark.

A new trend: Exchange Traded Managed Funds (ETMF)

Active ETFs are particularly common in the U.S. In November 2014, the Securities and Exchange Commission (SEC) approved an application by the asset manager Eaton Vance for a new active, non-transparent variation on the ETF theme - Exchange Traded Managed Funds (ETMFs).

The ETMF pioneered by Eaton Vance was innovative in that it allowed intra-day divergences between the fund's traded price and its net asset value. As a result, ETMFs combine the benefits of actively managed funds with the efficient trading model of ETFs that allow lower costs, with the fees of the Eaton Vance ETMF being lower than traditional funds but higher than passive ETFs. ETMFs only disclose holdings on a quarterly rather than on a daily basis.

It remains to be seen whether ETMFs will appeal to the broader public in the U.S., but the development may spur further innovation in the fund market and give investors access to new fund structures with innovative strategies at competitive fee levels. Regulators continue to monitor these innovations to ensure the best interests of investors are being protected.

ETMFs have yet to be launched in Europe but the environment is conducive to them, in that actively managed ETFs are already a feature of the market and regulatory developments continue to occur, for example, the Irish Stock Exchange, in its Policy Note 01-14, has removed the requirement for daily disclosure of portfolio details for actively managed ETFs.

EFTs – what's on the regulatory horizon?

Ensuring sound governance and controls: Benchmark Regulation

The rapidly changing landscape has brought market players into focus that previously had not been on the radars of EU regulators and as a result did not have to follow the established high standards of governance and controls. One significant example of this, in the context of ETFs, is the increasing presence and relevance of index providers.

The negative impacts of index manipulation on the economy became apparent with the recent LIBOR scandal. The European Parliament introduced Regulation 2016/1011 (the "Benchmark Regulation") in response to this scandal. The Regulation aims to ensure sound governance and controls around the composition and operation of key benchmarks and entered into force on 30 June 2016. It will generally apply from 1 January 2018.

ETFs that are structured in the form of a UCITS or an AIF will fall under the scope of the Regulation if they are tracking indices that meet the criteria of being a "critical" or "significant" benchmark. Key requirements for product providers are:

- The funds must only use benchmarks that are provided by an authorised benchmark administrator or a non-EU provider that satisfies the equivalence requirements. The Regulation sets out the requirement and a process for the authorisation of benchmark providers.
- The funds must include information on the benchmark administrator's compliance with the Regulation in the prospectus.
- The funds must put robust written procedures in place that describe the process to be followed if a benchmark is materially changed or ceases to be produced.

Preserving the integrity of financial markets: FSB's Consultation on Structural Vulnerabilities from Asset Management Activities

Fair competition and high governance standards have traditionally been the key pillars of European fund regulation to ensure investor protection. They are now very much shaping the regulatory landscape for ETFs. However, since the financial crisis in 2008 matters of market integrity in connection with investment funds have also increasingly raised the attention of regulators.

During the 2008 financial crisis many investors in large money market funds in the United States were temporarily unable to redeem their investment because the funds were overwhelmed with redemption requests. A few years later, in early 2012, several large German open-ended real estate funds froze due to insufficient cash buffers. These are just two of the more prominent examples of incidents that put the liquidity risk of funds on the regulatory agenda.

The Financial Stability Board's ("FSB") consultation document on *"Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities"* was issued on 22 June 2016. It sets out 14 recommendations to address structural vulnerabilities from asset management activities that it has identified. The recommendations seek to address four key risks, one of which is a potential threat to financial stability based on liquidity risk, arising from funds, including ETFs.

The FSB acknowledges that the liquidity risk related to ETFs is lower than that of traditional open ended funds because only market makers called "authorised participants" (APs) can purchase or redeem shares from the fund in large blocks usually in exchange for a specified basket of securities.

However, the FSB considers that this "creation/redemption" mechanism may be vulnerable in distressed market conditions. As APs are not obliged to create or redeem fund units, APs will only engage in these transactions if they are in the APs best interest.

This may lead to the situation that ETF units can only be traded at a significant premium or discount to its NAV. Some markets have rules that constrain fluctuations of the ETF market price to a certain range close to the NAV.

The FSB also describes a scenario where markets are under such extreme stress that no AP is left functioning which would again result in significant discounts or premiums of fund units which could affect hedged positions and the pricing of securities closely linked to the ETFs.

The FSB has considered these scenarios in its recommendations on liquidity mismatch, some of which will be operationalised by the International Organisation of Securities Commission (IOSCO). The final policy recommendations are expected to be issued by the end of 2016.

EFTs – the future regulatory agenda?

So far in issues relating to investor protection and market integrity, the regulatory landscape of ETFs has been predominantly influenced by general fund regulation. Will it stay this way?

In the US in January this year John Bogle, the founder of Vanguard and creator of the first ever index fund, told the Financial Times: "Yes, it is time both the ETF industry and policymakers re-examine the entire ETF ecosystem. Why? Because of its sheer size and fragility in times of market stress."

This statement may turn out to set the tone of the regulatory agenda in the years to come. Indeed, in October this year the French regulator Autorité des Marchés Financiers ("AMF") told reporters that it has initiated a thorough study on ETFs, indicating that an era of increased regulatory scrutiny for ETFs is also a European phenomenon.

It seems clear that changes affecting ETFs are on the way. Everybody involved in the ETF industry is well advised to be well prepared for these changes.

How can we help?

KPMG is an industry leader providing audit, tax and advisory services with over 10,000 professionals around the world serving the global investment management and funds industry. In Ireland, we have a 400 strong dedicated investment management practice with strong and longstanding relationships with all the administrators and custodians. We work with over 210 global investment managers including almost 30% of Irish domiciled ETF managers.

www.kpmg.ie/etfs

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