ETFS: POSSIBLE NEED FOR SPECIFIC RULES

1. Growth of the ETF market and comparisons between the EU and the US

An industry representative noted that there has been a rapid growth of the ETF market in Europe with 1575 funds registered at present, although the market is smaller than in the US. At the end of 2017 there were €630 billion of assets under management in ETF funds in the EU compared to just below €97 billion in 2008, corresponding to an average yearly growth of +23% over the last 10 years. Growth however somewhat stalled in 2018. Development in the EU has been mainly due to institutional clients who hold 80% of the market and usually want bespoke references, which is quite different from what is sold in the retail market. Retail clients who represent the other 20% are looking for simple products providing diversification and transparency. A regulator stressed that the ETF market has developed significantly since the financial crisis with the continuous launch of new products offering different exposures.

Another industry representative added that the global footprint of the market is over $5 trillion invested in ETFs, with more than $3 trillion in the US, where the retail proportion is stronger than in the EU. The US market is larger for a few reasons. First, independent advisors play a bigger role. In addition many US retail investors used to invest in individual securities and consider ETFs as a less risky and more diversified product, so moving towards ETFs was a natural evolution for them after the dot.com bubble. There is an 80/20 rule. 20% of the funds hold 80% of the assets, and they are broad-based, diversified, and relatively unsophisticated products. The cost advantage of ETF products is structural, in that it is driven by their broad accessibility in terms of distribution.

2. Current framework and on-going regulatory work at the EU and global levels

2.1. Main characteristics of ETF products and present regulatory framework in the EU

ETFs bring effective investment solutions for institutional and retail investors, being relatively cheap in terms of management and distribution costs, transparent, and an easy way to get exposure to specific asset classes or indexes. A Central Bank official noted that these benefits that ETFs can bring to investors and the economy are widely recognised. The ETF is a distinctive and unique product that combines features of open ended investment funds with access to secondary market liquidity. ETFs also use specific mechanisms such as APs (authorized participants)[1] and the arbitrage mechanism. The regulatory community is seeking to better understand the dynamics behind the growth of the sector, and also identify any potential risks posed by ETFs and how to mitigate them. A regulator added that ETFs raise other specific issues in terms of price formation and use different redemption mechanisms.

An industry representative explained that on the investment management side, ETFs are subject to product regulations such as UCITS in the EU or the '40 Act in the US. The majority of EU ETFs are UCITS and less than 2% are AIFs. There is sufficient flexibility in these regulations to adapt to the specific features of ETFs. On the capital market side, ETFs are subject to capital market regulations such as MiFID. Rules applying to single securities may not fit as neatly with the characteristics of ETF markets, although there has been an evolution over time to improve this. Another aspect is that there is more and more demand outside Europe for products structured under UCITS because of the safeguards the framework provides. This could help to develop the global footprint of ETF products structured under UCITS, potentially enhancing liquidity and bringing down trading costs. An industry representative emphasized that the ETF market is relatively recent but there is 26 years' experience which has seen many market events and changes made in the market ecosystem. Some changes have been made post-crisis, as the crisis showed for example that one could not internalise some of the derivative and securities lending structures previously used that could inherently increase some of the risks in the product sets.

Answering a question from the audience about whether the UCITS label is adapted for ETFs with a shareholding that is mainly institutional, another industry representative felt that UCITS is an appropriate label for these products, appreciated by institutional investors. UCITS is very protective, particularly for retail investors but also for institutional ones. There is no adverse effect to using the UCITS label for ETFs and it is adapted to most of them except commodity ETFs, which represent about 7% of ETF assets in the EU, compared to 2% in the US.

2.2. Ongoing regulatory work at the international level

A regulator explained that a range of international organisations including the FSB, the BIS, IOSCO and the IMF have been assessing the possible implications and risks of the strong development of the ETF market. IOSCO in particular has fostered a dialogue between national supervisors and the industry and this has shown that the ETF standards published six years ago are still relevant and necessary to implement. These standards cover a wide range of topics: disclosure on portfolios, cost, risk, strategy, structuring issues, and conflicts of interest. The first principle, which is one of the most important ones, is disclosure aiming to help investors differentiate proper ETFs from other non-CIS (collective investment schemes) ETPs (exchange traded products) i.e. non-fund ETPs. There are also principles relating to the risks of ETFs using complex investment strategies and also to conflicts of interest. Potential conflicts of interest between different ETF stakeholders – management companies, APs, liquidity providers, index sponsors, and others – are an area that retail investors are less aware of. It was positive to be able to find a consensual approach within IOSCO on these principles as that will facilitate their consistent implementation at the regional or national level. This is an added value for the investor community, especially retail investors. These principles apply at a worldwide level, which does not mean that additional regional requirements cannot consider for example the difference in levels of maturity between professional and retail investors. Additionally, in February 2018 specific comments were published on ETFs in the context of a broader IOSCO report on liquidity risk management for open-ended collective investment schemes (CIS) emphasising notably the importance of day-to-day liquidity management.

A Central Bank official noted that a significant portion of the European ETF sector is located in Ireland. The Central Bank of Ireland issued a discussion paper in 2017 aiming to better understand how ETFs will react and function in different market conditions, favourable ones and more difficult ones. No broad-ranging conclusions have yet been reached, but a set of considerations have been fuelled into the on-going IOSCO work on ETFs.

2.3. Potential issues raised by authorized participants (APs) and the current market structure

A Central Bank official felt that more international regulatory consistency and convergence would be highly desirable regarding APs, as well as further discussion amongst stakeholders to gain a better understanding of different risks these mechanisms may pose in different parts of the world.

A first issue is having a clearer picture as to which APs are active in respect of which funds. This is important in itself, but also to understand whether there is potential for concentration risk and if it needs to be disclosed. This overlaps with the potential for counterparty risk and whether the same entities are concerned. There may also be overlaps with the providers themselves. Greater transparency is needed around these activities in the market, as so much is dependent for ETFs on the functioning of the AP mechanism. Some of the information emerging also suggests a significant degree of concentration in terms of the ETF providers themselves, and further clarity on the possible implications of this would be helpful as well.

The possibility that the AP mechanism does not function in times of stress has been addressed in, for example, ESMA's guidelines on this topic. Work should be done to better understand how the idea of "direct recourse" in the context of a stress situation would work in practice. It is outlined in guidance, but more work is needed on how an investor would be able to have access to liquidity in a stress situation.

The ESRB has also produced an interesting piece of work on the functioning of the AP mechanism and on liquidity in this space and what it means in terms of herd behaviour potential, volatility, correlated movements, and potential for hard stops. This does not mean that there is a need for intervention, but it is important to understand these mechanisms.

3. Potential development of the retail ETF market in the EU

3.1. Improvements needed in financial education

An industry representative emphasized that the plain vanilla, broadly-diversified, lower-cost ETFs are one of the best products for long-term asset allocation of both institutional and retail clients. Lower costs are due to the larger distribution footprint in particular. ETFs fit well with some evolutions observed since the financial crisis in the US, with many financial services firms having shifted to a top-down asset allocation approach, rather than allowing individual wealth managers to develop their own allocation plans. Another encouraging evolution is that retail investors are starting to act more like institutional ones. They are taking a longer-term view of their investments and are more cost-conscious, considering the full cost of an investment product. Ideally they should be very much aware of access and exit costs from a product set in particular.

In countries with more of a bank distribution footprint and a domination of bank products, as is the case in most EU countries, ETFs can help savers move towards capital market exposure, but encouraging that move will require further education about the long-term benefits of equity market participation. A challenge also is the provision of retail investors with appropriate tools for their long-term wealth management.

A regulator noted that in Belgium there is a strong agenda on financial education as part of the legal mandate of the market and conduct supervisory authority (FSMA). There is a dedicated financial education website - Wikifin,- providing objective and independent information to financial consumers. ETFs are relatively easy to understand, but investing in ETFs is not only about costs and paying lower fees.

3.2. Developing the distribution footprint of ETFs

An industry representative felt that for retail investors, distribution footprint is very important and how they can get access to these products. It can be directly, although that is fairly marginal representing about 10% in the US or through a wealth management advisor. A regulator noted that the mainly bank-dominated distribution in the EU means that many people do not have access to ETF products.

A regulator agreed that a major characteristic in Europe is that ETFs are distributed in a bank-driven landscape. However, the products distributed in the Netherlands, Germany or France are not the same due to the distribution model developing quite differently – and not for tax reasons or gold-plating. This is why a compromise was needed for inducements at the implementation of MiFID, with different rules, e.g. in the UK, Sweden and the Netherlands, versus Germany and France. For ETFs there are some impediments in terms of distribution. Non-EU ETFs for instance are not proposed to retail investors, as they qualify as AIF products, which are as a rule not offered to retail investors.

3.3. Possible need for more specific ETF rules in the EU

An industry representative felt that several questions regarding retail investment in ETFs still need addressing, such as: how clear is cost information? How accessible are the best products from a liquidity standpoint? How robust are the markets in terms of liquidity of the underlying assets and also of bid and offer? The speaker favoured a very simple and clear framework for retail investors, notably for ETFs, helping them to understand the main features and risks of the products they need to be aware of. Favouring trading in lit venues also helps retail investors in the long-run, providing them with more clarity about trading costs and bringing those costs down. Sufficient clarity is also needed on the actual liquidity conditions. Institutional investors have access to a better toolset in this regard for the moment.

Answering a question about whether more specific ETF requirements would foster more retail market development and better risk mitigation, an industry representative suggested three possible improvements that could complete UCITS requirements and support the retail distribution of ETFs. A first suggestion would be to propose a UCITS ETF label, which could lead trading venues to separate UCITS ETFs from other, less safe, ETPs (exchange traded products). That could be an effective way of attracting more retail clients. A second element would be to improve transparency on ETF products. This could be done at two different levels. First, it would be useful to identify the degree of discretion used in the management of ETFs, in order to differentiate ETFs that track an index very clearly, those that use active management according to predefined rules, without discretion, and finally those that are managed with a high degree of discretion. There are three possible levels there, but only a limited number of ETFs at present are managed in a totally discretionary way. Second, transparency would help to better manage potential conflicts of interest. The starting point with conflicts of interest is to identify them, for example those related to the role of APs, then to provide transparency on them on an on-going basis if needed. This could be done possibly through disclosure to investors. A third suggestion would be to put in place circuit-breakers, but with different protections from those used for listed securities, i.e. to limit the difference with the tracked index rather than an excessive price movement of the ETF itself.

A Central Bank official agreed with the relevance of improving ETF nomenclature and disclosures, although the active/passive distinction may not be the most helpful distinction. The IOSCO principles move in that direction, and are the seed for different jurisdictions calling for the labelling of products. The fact that there is a discussion about the role of index providers and whether there is potential for conflicts of interest in that area is also welcome.

A regulator felt that to tackle ETFs, which are relatively new products, supervisors need to think “outside the box”. There needs to be a level playing field across different products that may be perceived as similar by retail investors and these products need to be treated in an objective way by regulators in terms of the risk they pose. This is not easy with ETFs, because the discussion is mostly focused on their competitive advantages and benefits in terms of low management fees and distribution costs compared to other investment products, rather than on their potential risks. A more comprehensive approach is needed to ensure that consumers understand the product and that all costs are disclosed. Management fees do not reflect all costs incurred by the investor, for example the embedded bid-ask spread costs need to be clarified. Additionally, all types of ETFs do not have low costs. The so-called classic ETFs that track an index do, but this is not necessarily the case for the more complex ones. This latter point, which involves trying to have a complete overview of the risk return consideration of the investment strategy and other features of all types of ETFs. is the most difficult aspect of the debate, the regulator felt.

Another regulator added that whilst ETFs may be passive in their management, engagement of investors must be active. The responsibility of shareholders to be engaged in ownership and the corporate control market is crucial.

Conclusion

As a summary, a speaker stressed that the ETF market is rapidly growing and has experienced impressive evolution with different types of products, index-related or more active. More transparency could be beneficial on certain features of the ETF product, notably for retail investors, and the creation of a UCITS ETF market could be useful in this regard. In terms of trading, the type of protection needed may be different from regular traded securities, with a focus on the capacity to ensure the tracking of the index rather than avoiding excessive price movements. ETFs have become a major investment option, due to their lower costs, but some questions need answering as to whether the information provided on the products is clear enough, how robust the markets are, and whether there is sufficient liquidity.

Benefit must be gained from the on-going work at IOSCO on risks, returns and other features, in order to establish appropriate principles for ETFs. Further transparency may be needed on conflicts of interest and the role of APs in particular. In terms of vehicle, UCITS seems to be the best vehicle for ETFs, with most of the firms using them in the EU, because investors know they are protected in the UCITS environment. The UCITS brand also helps to develop a global footprint for these products.

The UCITS ETF label needs to be built on, with a simple and clear framework for ETFs linked to lit markets. The potential risks posed by ETFs need to be further assessed among stakeholders, but any further regulatory action should be carefully considered. A final point is active corporate governance engagement which needs to be preserved in a perfect world, despite the passive index-related nature of ETF products.

1. Authorized participants (AP) are one of the major parties at the centre of the creation and redemption process for exchange-traded funds (ETF). They provide a large portion of liquidity in the ETF market by obtaining the underlying assets required to create a fund. When there is a shortage of shares in the market, the authorized participant creates more. Conversely, the authorized participant will reduce shares in circulation when supply falls short or demand. This can be done with the creation and redemption mechanism that keeps share prices aligned with its underlying net asset value (NAV).