European Regulatory Update on ETFs

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I. Regulatory Spotlight on ETFs - Origins

Rapid growth of ETF global market from $410m AUM in 2005 to $1.3tr AUM currently – regulators drew high level comparisons with CDS market evolution, financial crisis
Increasingly complex ETF structures (derivatives-based, leveraged & inverse)

"ETFs are reminiscent of what happened in the securitisation market before the crisis" – **Mario Draghi**, former FSB Chairman

"Those offering ETFs and the synthetic variable of it are using UCITS as a shield of defence. If the industry is using UCITS as a shield the regulator is entitled to see if it complies with UCITS – and if we think there are issues its our prerogative to see that the UCITS rules must be changed." "We are not relaxed about ETFs, especially the synthetic ETFs. If you cannot buy it because it is not sufficiently liquid or somewhat exotic, why would you want exposure from a derivative contract?" - **Tilman Lueder**, European Commission

"It's important to understand that, when it comes to ETFs, there are two broad issues we're considering," said Turner. *"One relates to financial conduct and consumer protection—in other words, do investors in these funds adequately understand the risks—but there are also prudential risks; those risks, in other words, that are created for the banks involved in this market"* - **Adair Turner**, Chairman, Financial Services Authority

" The drift of Exchange-Traded Funds away from their original bearings is striking. Compared with their vanilla forebears, there are now ETFs incorporating leverage, active management and synthetic structures"- **Paul Tucker**, Deputy Governor for Financial Stability, Bank of England

ETFs under unprecedented regulatory scrutiny & media attention

II. The Leading Edge of Macro-Prudential Supervision (1/2)

Central banks charged with identifying & containing possible systemic risks, enhancing financial system resilience in view of increased interconnectedness of markets

July 2010 Bank of England Financial Stability Report
highlights intraday liquidity management, leveraged ETFs' high turnover, securities lending transparency & risks, counterparty risks for swap based ETFs

FSB

IMF

BIS

April 2011 Financial Stability Board, International Monetary Fund and Bank for International Settlements reports

- Potential risks of securities lending by synthetic ETFs and cash-based ETFs; "complexity and opacity" of synthetic ETFs, their potential counterparty and liquidity risks
- Conflicts of interest when banks are acting as both ETF issuer and swap counterparty
- Synthetic ETFs as source of contagion and systemic risk due to chain of risks embedded in their design and operation (counterparty, collateral & liquidity risks)

II. The Leading Edge of Macro-Prudential Supervision (2/2)

Central bank and other regulators' systemic risk warnings about ETFs are the first example of product market intervention using macro-prudential supervisors' new preventive and anticipatory powers in the wake of the 2008 financial crisis

National Initiatives

- **UK**: The Bank of England in its June 2010 Financial Stability Report points out the lack of transparency around synthetic ETFs and their potential to contribute to the build-up of systemic risk.
- **US**: US Senate Securities Subcommittee hold a hearing in October on ETFs to consider 1) factors that influenced the growth of ETFs and the related impact on investors; 2) whether ETFs present systemic risks or affect volatility; and 3) what changes or improvements should be made in the regulation of ETFs. **The SEC and Congress will continue to monitor ETFs but new regulation is not imminent.**
- **Asia**: Both the SFC in HK and MAS in Singapore have been at the forefront to enact tougher requirements on ETFs, in general and particularly on synthetics, with special focus on minimising counterparty risks.

II. ETFs and Investor Protection Initiatives

The EU is furthest ahead with specific detailed investor protection initiatives
International – the International Organisation of Securities Commissions (IOSCO) will consult shortly
National – Swiss & Asian marketing and distribution requirements for ETFs

International Initiatives	▪ **IOSCO** is carrying out in-depth investigation of ETFs and other products such as ETPs, ETNs, ETVs, looking at classification, transparency, conflict of interest, financial stability, market integrity/supervision issues. IOSCO should consult publicly on recommendations regarding these issues, for the purpose of dealing with market integrity, market efficiency and investor protection, in late 2011/early 2012.
National Initiatives	▪ **UK:** The FSA and the Serious Fraud Office (SFO) have both officially announced this summer that they were looking into ETFs. ▪**CH:** FINMA introduced in September strict requirements for marketing/distributing ETFs in and from Switzerland (definition, naming of ETFs, replication methods, information to investors) – more details in Annex 1 ▪**Asia**: Both the SFC in HK and MAS in Singapore have been at the forefront to enact tougher requirements on ETFs, in general and particularly on synthetics. The SFC has mandated that all synthetic ETFs listed in HK must be fully collateralised. In addition, an “X” has been added to the trading names and stock code of synthetic ETFs to warn investors – more details in Annex 2

III. European Securities and Markets Authority (ESMA) Initiatives on ETFs (1/3)

ESMA investigation 2010-2011

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Existing regulatory regime applicable to UCITS ETFs and structured UCITS deemed not sufficient to take account of the specific features and risks associated with these types of fund

ESMA's consultation on policy orientations on guidelines for UCITS ETFs and Structured UCITS July-August 2011

▼

Sought stakeholders' views on possible guidelines to address UCITS ETFs and structured UCITS concerns on:

▼

1) **Retail investor protection**

2) **Financial stability**

ESMA Guidelines for UCITS ETFs and Structured UCITS

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Subject to further public consultation this winter, ESMA final guidelines expected to require:

1) greater marketing differentiation between synthetic/physical ETFs;

2) enhanced disclosure on underlying exposures, counterparties and collateral for UCITS ETFs

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Non-legally binding transparency standards to be implemented by national regulators in 2012

III. ESMA Initiatives on ETFs (2/3)

TRANSPARENCY/DISCLOSURE REQUIREMENTS

- **Setting an "identifier" in ETFs' name**, fund rules, prospectus and marketing material to identify them more clearly as ETF to reduce the risk of confusion among investors when they buy UCITS ETFs with other exchange traded products
- **Improved prospectus (for index-tracking, UCITS ETFs)** to contain clear and comprehensive description of the index to be tracked and the mechanism to gain exposure to the index
- **Enhanced disclosure requirements (for synthetic ETFs)** as regards the underlying exposure, counterparty(ies), collateral as well as the risk of counterparty default and the effect on investor returns
- **Possible collateral requirements (for synthetic ETFs)** on the type and quality of the assets constituting the collateral which may be received from counterparty(ies)
- **Enhanced transparency on securities lending** with appropriate information in the prospectus including detailed description in the prospectus of the risks involved, the collateral policy, related fees earned by the UCITS ETF
- **Possible limits on the amount of a UCITS portfolio which can be lent** as part of securities lending transactions
- **Actively-managed UCITS ETFs**: to provide clear information to investor about their "active" nature aimed at outperforming an index or other benchmark, and their investment objectives and policies as well as their policy regarding portfolio transparency
- **Leveraged UCITS ETFs**: prospectus to disclose the leverage policy, how it is achieved and the associated risks, as well as description of the methodology for daily calculation of leverage impacts on investors' returns over medium/long term
- **Strategy indices:** index to have a clear single objective, the index components and the basis for their selection to be clear for investors and competent authorities, prospectus to disclose the index' rebalancing frequency and its effects on the costs within the strategy and inform investors, where relevant, of the intention to avail of increased diversification limits together with a description of the exceptional market conditions justifying this investment

III. ESMA Initiatives on ETFs (3/3)

CONFLICT OF INTEREST CONCERNS

- In cases where the manager/investment manager of the UCITS ETF, the counterparty to the swap and the index provider are part of the same group, obligation to have a well documented conflicts of interest policy and disclose it in the prospectus
- Any valuation of the swap to include an independent assessment of the underlying index

FURTHER POSSIBLE ACTION – RETAIL INVESTOR PROTECTION

- ESMA to issue warnings to retail investors about the risk associated with certain UCITS ETFs and Structured UCITS
- ESMA to limit the distribution of certain of such products to retail investors

=> ESMA will have to ask for appropriate powers to be included in the relevant sectoral legislation

IV. EU MIFID 2 and ETFs

Pre & Post Trade Transparency Requirements

- Extension of MIFID transparency rules to equity like instruments, incl. ETFs
  - ✓ Pre-trade transparency = bid and offer prices and the depth of trading interests at those prices
  - ✓ Post-trade transparency = price, volume and time of the transaction
- MIFID 2 revised rules expected to take effect from Q4 2014

Increased transparency objectives:

- provide investors with access to information about current trading opportunities and help them to make more informed choices
- facilitate price formation and assist firms to provide best execution to their clients

New Distinction Between Complex & Non-Complex UCITS

- MIFID 2 introduce strict distinction of complex UCITS – defined as embedding a derivative or incorporating a structure which make it difficult for the client to understand the risks involved
- To sell ETF classified as complex UCITS, suitability and appropriateness testing will be required – execution only service no longer permitted

Heightened protection in the provision of investment services objectives:

- Improve investor protection by making sure that investor has sufficient knowledge and experience to understand the risks of the complex UCITS ETF and that the investment firm will warn the investor as necessary

V. EU Forward Regulatory Outlook for ETFs?

Potential Tightening of ETFs Regulatory Framework	▶ **Some national regulators call for regulatory work on ETFs to go beyond ESMA transparency guidelines.** Regulators remain doubtful about investors' ability to fully understand the ETF products they are buying, their investment objectives and appreciate the different types and levels of risks involved. ▶ The European Commission wants **UCITS to remain a trusted brand** for investors, including internationally; and is therefore considering whether better rules may be needed for collateral, swap transactions and securities lending. ▶ Regulators' new focus on ensuring enhanced retail investor protection in relation to **complex financial products** that may be more difficult to understand and evaluate is likely to prompt the development of enhanced and stricter transparency and governance standards/requirements on ETFs.
Proposed Financial Transaction Tax	▶ **Very broad definition of financial transactions includes ETFs:** ✓ purchase and sale of a financial instrument before netting and settlement including repo and reverse repo, and securities lending and borrowing agreements ✓ The transfer between entities of a group implying the transfer of risk associated with the financial instrument ✓ The conclusion or modification of derivatives agreements ✓ Tradable securities (e.g. stocks, bonds, structured products, units in unit trusts) ✓ Intra-group transactions ✓ Delivery and redelivery of collateral, including margin calls ▶ **Exemptions**: Primary market transactions, loans, deposits, spot foreign exchange transactions, emissions credits, physical commodity transactions ▶ **Apply to financial institutions only.** Corporates are exempt with the exception of their joint liability if the financial institution fail to pay the tax ▶ **Minimum Rates** ✓ 0.01% for derivatives transactions (the tax is calculated on the notional value of the derivative at the time of the purchase/sale, transfer, conclusion or modification of the contract) ✓ 0.1% for financial transactions other than derivative agreements (as defined above) Each financial institution party to a financial transaction is required to pay at the rate applicable in its Member State of establishment ▸ **Cascade effects expected:** multiple incidences of the tax levied on "one" transaction if that transaction is multi-layered or involves several counterparties.

Annex 1 – Outline of Swiss ETF Requirements

FINMA-Newsletter on ETFs from 21st September 2011

Detailed information available at: http://www.finma.ch/d/finma/publikationen/Documents/finma-mitteilung-29-2011-d.pdf

- **Legal nature:** The Newsletter sets out criteria considered by FINMA as requirements for marketing/distributing ETFs in and from Switzerland. The Newsletter is legally binding, although it does not meet the requirements of a formal law.

- **Scope of the Newsletter**
  - ✓ both (i) Swiss ETFs and (ii) ETFs marketed/distributed in and from Switzerland
  - ✓ but transparency requirements regarding Index and Substitut basket are only applicable to Swiss ETFs (see below).

- **Criteria strictly defining an ETF**
  1. Daily (i) redemption with the Management Company / Fund (primary market) and (ii) trading on the SIX (secondary market)
     => ETF units have to be listed at SIX.
  2. Market Maker has to ensure liquid market according to the spreads requirements published by SIX
  3. Index has to be replicated.

- **Replication methods**
  - ✓ physical replication including optimised sampling
  - ✓ synthetical replication including unfunded and funded replication

  => FINMA doubts whether the funded replication method meets the criteria of open-ended collective investment schemes and asks issuer to prove these criteria if filing for distribution of ETFs in or from Switzerland (i.e. collective investment; management for the account of investors; etc).

- **Naming**
  - ✓ All subfunds within an umbrella called "ETF" and all share classes within a subfund called "ETF" have to be listed at SIX
  - ✓ Products called "ETF" are not allowed (i) to use the replicated index purely as a benchmark, and (ii) to aim exclusively for an outperformance against the benchmark index.

- **Transparency** – only applicable to Swiss ETFs
  Issuer has to disclose details both (i) on the Index provider and potential conflict of interests, and (ii) on the Substitut basket for unfunded swaps.

Annex 2 – Outline of Asian ETF Requirements

Hong Kong Securities and Futures Commission (SFC)

Detailed information available at:
http://www.invested.hk/invested/en/html/section/products/ETFs/about_etf/what_is.html
http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=11PR101

Identifier for synthetic ETFs

- To help investors identify synthetic ETFs more easily from traditional physical ETFs, all synthetic ETFs have been required to add the marker "X" to their stock short names since 22 November 2010 and an annotation to their fund names since 16 January 2011

Collateral

- Effective from end March 2011, synthetic ETF managers are required to provide and update on their websites information regarding 1) on a daily basis, the overall collateralisation level/total invested assets; 2) on a monthly basis – (i) pictorial presentation of collateral/invested assets information by way of pie charts to illustrate notably the breakdown by type of collateral/invested assets and (ii) top 10 holdings in the collateral/invested assets
- Effective from 12 Sept. 2011, domestic synthetic ETF managers are required to publish the latest collateral management policy on the ETFs' websites
- Effective from 31 Oct. 2011, domestic synthetic ETF managers are required:
  - ✓ to top-up the collateral level for each of the synthetic ETF to achieve at least 100% collateralisation to ensure there is no uncollateralised counterparty risk exposure arising from the use of financial derivatives to replicate index performance
  - ✓ to put in place a prudent haircut policy, in particular, where the collateral taken is in the form of equity securities, the market value of such equity collateral must be equivalent to at least 120% of the related gross counterparty risk exposure.

Singapore Monetary Authority (MAS)

- MAS is not less strict in classifying mutual funds and ETFs as non-exempt products requiring full client profiling and product suitability test even for straight execution
- In addition to MAS' current requirements to properly disclose the features and risks of investment products, financial institutions acting as intermediaries for "Specified Investment Products" (includes ETFs) will be required as from 1 January 2012 to assess whether a retail customer has the relevant knowledge or experience to understand the risks and features of a Specified Investment Product before offering the product to them

More information available at:
http://www.mas.gov.sg/resource/publications/Safeguards%20when%20purchasing%20specified%20investment%20pdts_UPDATED.pdf

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