ETFs: possible need for specific rules

Gerben Everts

Member of the Executive Board, Dutch Authority for the Financial Markets (AFM)

An efficient ETF market requires an effective arbitrage mechanism

Global markets for exchange-traded funds (ETF) continue to show considerable growth.

Global assets under management (AuM) reached approximately $4.5 trillion ultimo 2018, distributed over roughly 6,500 ETFs. The US (AuM $3 trillion) is by far the largest market, followed by Europe (AuM $700 billion). The European ETF market differs significantly from the US ETF market. In Europe, retail investors account for less than 20 percent, whereas in the US this is approximately 70 percent. The rapid growth and developments in the ETF market may elevate risks to investors and raises questions about their impact on the functioning of the financial markets and corporate control.

The popularity of ETFs can be attributed to perceived advantages they offer to investors.

ETFs are seen (and marketed) as low-cost products that deliver diversification benefits, with intraday liquidity. ETFs combine features of open-ended investment funds with securities traded on exchange. ETFs operate on the primary and secondary market. They employ authorized participants (AP) and liquidity providers (LP) to set the price and enhance liquidity.

ETFs promise liquidity, but particular features and risks can result in disappointments if investors rely too much on the perception of unlimited liquidity.

Although ETFs still account for a small proportion of total market capitalisation, they represent a large portion of the daily trading volume in stock markets, fuelling the perception of liquidity. Specifically, ETFs are shown to increase the level of co-movement of the underlying securities. Given the market share of ETFs to the daily traded volume in the stock market, an increase in the co-movement of asset prices makes it more likely that investors experience capital losses simultaneously, potentially even leading to fire sales. Investor expectations should be aligned with the way ETFs operate and perform. Depending on market circumstances, liquidity can dissipate quickly, or trading costs could be higher than expected. Furthermore, a wide variety of exchange-traded instruments are often sold as ETFs, like ETNs, which could possibly result in an underestimation of liquidity risks in these instruments. Retail investors need to be aware of this. Solely focusing on the perceived benefits would ignore these risks. Whether the benefit of intraday trading is a prerequisite for retail investors who often invest in a diversified, passive portfolio, is a question one could legitimately raise.

>>>

>>> The liquidity and pricing mechanism of the ETF markets depends on the effectiveness of the arbitrage mechanism applied by APs and LPs.

It is paramount that APs and LPs function properly and that the market infrastructure is facilitating participation by independent APs and LPs to safeguard efficiency of pricing. Open and effective competition among parties contributes to an active and efficient primary and secondary market, enhancing advantages ETFs offer to investors. To enable an effective arbitrage mechanism, APs and LPs must have state-of-the-art technology, often with high frequency traders (HFT) acting as AP/LP. Without such technology deployed by HFTs, the benefits for investors would not be as high. Furthermore, anticompetitive practices should be avoided. A limitation of the number of APs for an ETF could results in higher costs for investors and increase dependency on a single party.

The rapid growth of ETFs deserves a proper analysis and attention of regulators and institutions such as the ESRB and IOSCO.

European ETFs operate within the regulatory framework of UCITS, AIFMD and MiFID II, providing safeguards to investors, such as (cost) disclosure and investor protection. The growing trend of passive investment raises concerns vis-a-vis liquidity, shareholder rights and the effectiveness of corporate control and could potentially affect market efficiency. Apart from the attention on the contribution of an effective arbitrage mechanism to efficient markets, one must not neglect the impact of ETFs on corporate control. With significant percentages of individual shares owned by three ETFs issuers, one could wonder about shareholder influence over corporate control and their capacity to influence the outcomes of corporate decision-making. Therefore, market initiatives to take responsibility should be welcomed and stimulated. ●

Gerry Cross

Director of Financial Regulation - Policy and Risk,
Central Bank of Ireland

Exchange Traded Funds – considering risks, vulnerabilities and safeguards

Ireland is the largest domicile for ETFs in Europe with total AUM at almost €400bn at end-2018. As regulator of this significant cohort, the Central Bank of Ireland is cognisant of the important role we play given the sector's global footprint. This is why at the Central Bank we have focused on the review of ETF related issues including the publication of our Discussion Paper and holding an international risk and regulatory conference in 2017 followed by a Feedback Statement in September 2018.

Other European regulators have also focussed their lens on ETF and internationally IOSCO has a strong focus on ETFs, all of which is very welcome. A global industry like ETFs requires a consistent global regulatory approach. It is appropriate and necessary that regulatory authorities highlight concerns and ensure they are addressed, considering the fast rate of growth and increased complexity in ETFs recently.

In 2018, IOSCO carried out an exercise to review and agree those ETF issues which warrant further attention by regulatory authorities. This work has now progressed to the establishment of two dedicated workstreams. One will focus on the review of investor / conduct related matters while the other will concentrate on market structural issues. The Central Bank of Ireland is co-leading one of these workstreams with the US Securities & Exchange Commission (SEC), and supporting the production of a joint workshop >>>

>>> between IOSCO and the Financial Stability Board (FSB) on ETFs and market liquidity. The purpose of the workshop is to highlight the potential risks arising from the way in which ETFs are traded, examine certain inconclusive matters relating to liquidity in ETFs and review the impact of ETFs on market liquidity generally.

Regulators have made it clear that they have concerns regarding the potential risks that ETFs pose. One of the core issues highlighted is related to investor expectations, and specifically the alignment of investor expectations and the actual functioning of the ETF, particularly during times of market stress. In order to understand this, regulators have to understand the structure and functioning of ETFs, such as the unique role of the Authorised Participant (AP).

Whilst APs are a key source of liquidity, there are no obligations on an AP to continue to operate during varying market conditions. Furthermore, the price arbitrage mechanism is key to the overall functioning of an ETF. A potential risk is whether the arbitrage mechanism can be relied on during all market conditions to ensure primary and secondary market prices remain closely aligned. The interface between the regulation of market participants critical to the functioning of the ETF and that of the underlying investment fund itself warrants further consideration to assess whether the calibration of requirements is appropriate. Further risks include potential interconnectedness and concentration risks, which may be driven by counterparty risk, AP dependence or the involvement of connected parties in the structuring of the ETF. Another consideration for regulators is the question of whether ETFs may give rise to "fragile liquidity" where investors invest significantly in an asset class where in most situations they would not otherwise invest due to liquidity concerns.

Securities regulators need to consider, whether existing safeguards related to identified risks are fit for purposes or, in fact should be strengthened. It is however also the responsibility of market participants to engage in this process in a constructive and meaningful way. Regulatory authorities have already provided high-level analysis of the potential risks that ETFs may pose, and as such, it is up to market participants to be ready to participate in forthcoming consultations in order to respond to these concerns. To date, the Central Bank has experienced a high quality level of engagement with stakeholders, particularly in response to our discussion paper. Academia also have an important role to play in the analysis of ETF risks. The IOSCO / FSB workshop will be a further waymarker in this work. It is imperative that such work leads to operable conclusions with regards to the risks that ETFs may pose and whether the current safeguards in place are appropriate to address these concerns, and if not, what policy enhancements are required to address remaining risks. ●

Noel Archard

Global Head of SPDR ETF Product, State Street Global Advisors

Unlocking the potential of ETFs for retail investors

The growth of exchange-traded funds (ETFs) is continuing at a remarkable rate and they are becoming an ever-more important part of the fund landscape in Europe. A natural by-product of their increasing popularity amongst European investors is the growing discussion on the potential need for a dedicated and specific regulatory framework for ETFs.

However, in our view, this is an unnecessary debate. In the EU, ETFs are highly regulated, primarily under the UCITS framework. The general consensus amongst industry participants is that this framework is robust, functioning well and, amongst other things, has promoted liquidity and investor protection. ETFs are also required to abide by the rules of the relevant exchange. In addition, we fully support the promotion of good market practices but given ETFs are primarily structured as UCITS, there is little reason why they should be subject to different standards relative to other UCITS managers.

Notwithstanding this view, the innovative nature of the ETF sector means it is important that policymakers are engaged and remain flexible, so they are able to adapt to market >>>

>>> developments. A recent example of where this was done well is the work undertaken by the Central Bank of Ireland and, more specifically, their approach to different dealing cut-off times for hedged and unhedged share classes, which is likely to have significant benefits for investors.

"Policymakers can do more to help EU retail investors fully benefit from investing in ETFs."

- NOEL ARCHARD

Looking more broadly, we believe that policymakers can do more to help EU retail investors fully benefit from investing in ETFs. The European Commission, in their 2018 study, recognised the various benefits of ETFs, whilst simultaneously recognising the difficulty that retail investors in Europe have in accessing ETFs, particularly when compared to the US. While this can be partly attributed to the substantive differences between the European and US markets, there is significant scope to improve both access to, and distribution of, ETFs for retail investors.

In this regard, we welcome the efforts of European policymakers as part of the Capital Markets Union agenda, including the recently agreed proposal on facilitating the cross-border distribution of investment funds. Distribution is one of the key obstacles and efforts to move away from the current highly-restricted distribution model in Europe will allow retail investors to better utilise ETFs for their investment objectives.

As Europe makes the transition from establishing the post-crisis regulatory framework and looks to the future, now may be the right time to consider where further improvements can be made, in order to support broader policy objectives. This includes addressing unintended consequences of EU regulation. One particular example is the impact of MiFID II and the PRIIPs Regulation. While these respective pieces of legislation have generally had a positive impact, certain provisions have resulted in limiting the distribution of non-EU ETFs into Europe. Ultimately, this has reduced investor choice, even where the non-EU ETFs have better liquidity and lower costs. Of course, if policymakers wanted to be truly ambitious, we would encourage the development of a consolidated tape in Europe, which will further enhance liquidity and transparency. ●

Niels Lemmers

Managing Director,
European Investors' Association

Are we heading to a fee-free European ETF market?

For ages, retail investors have been buying actively managed funds. That has changed. Disclosure has been scrutinized and standardised through regulation. Investment details of all kind of investments are available on multiple websites. Costs and charges related to returns are out in the open. Competition results in fees going to zero. Countless scandals on overcharging and mis-selling also opened long closed eyes. There is no such thing as a free lunch. Finally, retail investors realised this cocktail of actions should benefit them. Hence the booming ETF market for retail investors. In January 2019 the EFT market had €675 Bn AUM, with an inflow by net sales of €7.9 Bn in the European ETF segment, adding to an inflow because of underlying market performance of €34.1 Bn (Data: Lipper Alpha – Refinitiv, 2019/2/17).

Cornerstone

ETF Investing is or should preferably be a cornerstone for the retail investors' portfolio. Facing lower fees, they are able to follow numerous markets and investment styles. This should build a solid fundament. However, the retail investor has to stay focussed while deciding which ETF ends up in their portfolio. Key aspects thereto: asset class, indices, market risk, costs, liquidity and size (AUM). Despite the severe issues retail investors encounter since the implementation of MiFID and PRIIPS with the exemption of UCITS products, overall the information has been made available through this regulation is supporting retail investors in their decision-making process. They are better informed and more 'street wise' when investing in different types of ETFs. Nevertheless, solving the unavailability of thousands of US-based ETFs and even European ETFs because of the fragmented European financial market, should be the main focus of the legislators and regulators in 2019. Preferably without creating another, new framework. This will only add to the confusion.

Fee-Free

Recently, two new ETF's were launched in the US, free of costs and charges for at least the first year in operation – by online lending and personal finance platform SoFi. This introduction leads to a lowest cost range of 0.09-0.14% for US ETFs available for the average retail investor. Within Europe, the competition is heavy but did not result in a fee-free ETF. The shattered EU financial markets and their different regulatory regimes and compliance are the most frequently mentioned causes.

Should we applaud this final race to the bottom? Certainly, but only if the ETF is a viable proposition. Manufacturing an ETF comes at a cost. Some revenues can be made by securities lending. With the right collateral and contracts, this could be sustainable. Furthermore, the Fee Free ETF is a marketing tool and the starting point of a customer-journey through other products and services of the promoter. Experiences in consumer protection show that retail investors have to be conscious of the pricing of these other products and services. A 'waterbed effect' on the sole expense of the retail investor should be averted. Ultimately, relatively simple, low cost and transparent ETFs (and their promotors) are bound to prompt affection rather than rumbling concern. Optimistically the markets will lead this way. ●

Frédéric Bompaire

Head of Public Affairs, Finance and Strategy, Amundi Asset Management

Adjusting to retail trading in ETFs

Till now the ETF market in the EU is an institutional market. In contrast with the US, retail clients weigh around 20% of the ETF AuM in Europe. Hence, it is a fantastic reservoir for future growth. This development should not reduce the strong protection framework that applies to retail clients in the EU. Existing regulation is sufficient, and proportionality is necessary to take stock of the diversity of the ETF world. In order to ensure investors protection, regulators should focus on two items: more clarity on listed funds and effective circuit breakers.

ETFs have the unique feature to be both a fund and the issuer of listed instruments. There is a good practice to name "UCITS ETF" those funds that are UCITS and listed on an exchange. But retail investors have not such a transparency on other types of ETPs. Trading venues should be more attentive to segment their offer and differentiate through specialised trading compartments at least in three ways: (i) UCITS ETFs, (ii) other ETFs which are AIFs either based in the EU or in a third country and (iii) all other ETPs (notes or certificates) which are not funds and do not benefit from the sectoral regulation applicable to funds. This is a first step to ensure fairness. A second, also relating to transparency, would be to classify ETFs according to the degree of discretion in their management. It is very useful for an investor to understand at first sight whether he is about to invest in an indexed ETF with an explicit reference to the index, in an active ETF managed in a systematic manner on the basis of predetermined investment rules that apply automatically, or in an ETF actively managed in a discretionary manner. We believe that smart beta would belong to the second category and do not see many candidates for the 3d category, we count them on our fingers in the EU today. The third point where transparency is required is liquidity. MIFID increased fragmentation of financial markets among different venues. Like for other listed instruments ETFs suffer from the absence of a consolidated tape that centralizes all the transactions of a day on an ETF and makes these data public. Due to this lack it is very difficult for investors, and particularly retail investors, to understand flows and take informed investment decisions.

> *"More clarity on listed funds and effective circuit breakers."*
>
> \- FRÉDÉRIC BOMPAIRE

We now turn to circuit breakers which we see as the most efficient way to effectively protect retail investors. The first level of protection should be installed in the distribution chain. Retail clients should have access only to those funds, and ETFs are funds, that are authorized to be distributed in their country of residence. With the development of internet trading platforms, investors can navigate and sometimes reach a page where they have the possibility to deal on ETFs not authorized in their country. We see it as a major issue in terms of investor protection exactly like the presence of circuit breakers on ETF trading venues. Standard "limit down" mechanism that applies on stock exchanges is insufficient for protecting investors. It overlooks the reality that the key factor for an ETF is not its absolute change in price due to offer and demand but the high correlation of its performance with the benchmark. ●