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FINANCIAL STABILITY BOARD

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AFG's feedback to the FSB's note on "Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs)"

The Association Française de la Gestion financière (AFG)[1] welcomes the opportunity given by the FSB to express the French asset management's opinion on the ETFs topic. Our ETF industry represents € 45.8 Bn as of end 2010, a figure both growing quite rapidly and still representing less than 2% of overall French asset management.

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

- ***The risk of confusion for final investors between ETFs (as a UCITS fund) and other ETPs (Exchanged Traded Products), ETCs (Exchanged traded commodities), ETNs (Exchanged Traded Notes) is currently very high.***

ETPs (Exchanged Traded Products), ETVs (Exchange Traded Vehicles), ETCs (Exchanged Traded Commodities) and ETNs (Exchanged Traded Notes) are products that may appear similar to ETFs from a financial standpoint, but their legal form is completely different! These products are notes or certificates issued by investment banks and that do not offer the same product safety as the one offered by the legal framework of a fund (more precisely, a UCITS fund in Europe).

These products are less protective than ETFs for investors as the risks borne by investors are substantially different (issuer risk, lack of independent valuation, no counterparty risk control, lack of diversification requirements, no control on Global Exposure, lack of best execution obligations, no auditor nor depositary, no fiduciary duty, etc). The "ETF" label should be protected and current risks of commingling between legally different wrappers should clearly be reduced.

- ***In Europe, ETFs are all UCITS funds and as such they benefit from a strong and highly esteemed regulatory framework***

European ETFs abide by the **UCITS** rules as do all the other funds submitted to this strong European regulatory framework. All UCITS (including UCITS ETFs) are regulated and are subject to the same requirements and constraints. This robust product regulation is at the heart of the high level of investor protection UCITS provide. Key elements of the framework include: a fiduciary duty for the management company to act in the best interest of the fund and of investors; that the assets of the fund are held separately from the management company's balance sheet; that there is an independent depositary that oversees the activity of the manager and safeguards the assets; and that the manager is subject to detailed requirements relating to the management of conflicts of interest. There are also strict rules for the calculation of the global exposure (that is limited) which have been reinforced by the European regulator and will become effective as of July 2011, etc. This is paramount and constitutes a very important protective and complete set of constitutive characteristics of European ETFs.

In addition, ETFs (unlike the other UCITS funds) must also abide by a second set of rules, which are the "**listing rules**" such as the obligations to publish an indicative NAV, to publish an intra-day NAV that respects the spread limits and minimal bid/ask spreads, to have several market makers etc. This is also a feature that proves valuable for investors.

In short, European ETFs are regulated by two set of rules concomitantly; they benefit thus from a highly robust environment.

- ***Counterparty risk***

For physical ETFs the counterparty risk is primarily related to securities lending, whereas for synthetic ETF the counterparty risk is related to the use of the swap.

Synthetic ETFs :

The counterparty risk limits and collateral rules in the UCITS framework ensure that at all times the exposure of the Fund to a single counterparty is managed to a very low level.

Counterparty risk rules limit to 10% of AUM the exposure to any individual counterparty for OTC derivative transactions[2], and collateral for transactions in OTC derivatives is subject to strict liquidity and issuer credit quality criteria[3], thus mitigating collateral risk to a substantial degree.

It should be noted that the swap structure used in synthetic ETFs is a simple index swap product.

Internal rules of the asset manager are a further step that helps mitigating the counterparty risk of a synthetic ETF:

- the assessment of the credit quality of the swap counterparties;
- the use of internal stricter rules than the UCITS regulation, for instance the counterparty risk may in practice be on average much less than the 10% limit;
- the transparency offered to investors in terms of fund assets or counterparty risk (on demand or via the asset manager's website)

Physical ETFs:

Counterparty risk for physical ETFs is related to securities lending. It would certainly be useful for investors to be offered more transparency on which counterparties are used and on the collateral used in securities lending operations. Indeed, securities lending exposure seems often less well disclosed than equivalent synthetic risk measures and it would be probably useful to harmonise European regulations on securities lending, that would help prevent that proceeds from securities lending be paid to the manager or the custodian rather to the fund itself.

- ***Liquidity risk***

The liquidity of an ETF is correlated to its underlying index. Indeed, an ETF is liquid if its underlying index is liquid and there is no link between the types of the set up of an ETF and its liquidity. In other words, the liquidity of a synthetic ETF or a physical ETF based on the same index is equivalent.

The nature of the underlying index is the determining factor of the effective liquidity of an ETF. For this reason the liquidity of a synthetic or a physical ETF is not different as indeed, an ETF may be traded if its underlying index trades. If a lack of liquidity were noted on a

[2] Art. 52 of the UCITS Directive.
[3] CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS
(http://www.esma.europa.eu/popup2.php?id=7000)

specific market at a given moment, it would be transmitted on the secondary market, i.e. at the moment when the investor requests the execution from his broker, in an equivalent way for both types of structures. Thus, the liquidity of the swap (in the case of a synthetic replication) is transparent in the sense that it reflects the liquidity of the index.

If an underlying market were illiquid, the ETF market maker would widen the quotations' spreads intra-day to take into account the difficulties he encounters to cover in the underlying market. This is similar in both types of replication.

➢ ***The systemic risk***

In our view, ETFs with synthetic replication do not bear a systemic risk for several reasons:

- ETFs represent 5% to 6% of mutual funds market and synthetic ETFs less than 1%. At the end of June 2010, equity linked forward & swaps represented $ 1.745 bn whereas synthetic ETFs only $ 124 bn (that is about 7%). Thus, compared to the global market of OTC swaps, it can be argued with difficulty that ETFs represent a source of contagion and systemic risk.
- In addition, physical and synthetic ETFs are equivalent in that respect too. Indeed, if the distribution of the roles is different between the market payers (asset manager and investment bank), the consolidated position that is generated on the markets is the same.
- Also, an ETF is not different in this respect to any other UCITS that makes use of derivatives.

➢ ***Inverse and leveraged ETFs***

These products represent a very tiny part of the ETFs' market. These funds are also UCITS funds in Europe, thus highly regulated products and for example their leverage cannot exceed 100% of the net assets. They disclose clearly their methodology in accordance with UCITS rules.

In conclusion, European ETFs benefit from a very robust regulatory and legal environment. ETFs are probably today among the most transparent products in the savings industry in terms of the disclosure of funds assets. They are simple products, whether based on physical or synthetic replication. The two replication methods are equivalent in the main areas of concern, especially in what concerns the impact on the overall market but also in terms of the risk-return profile expected by the investor.

If you need any further information, please don't hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr) or myself at +33.1.44.94.94.29 (p.bollon@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre Bollon