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16 May 2011

Dear Sir/Madam,

BlackRock appreciates the opportunity to comment on the Financial Stability Board ("FSB") report of 12 April 2011 concerning "Potential Financial Stability issues arising from recent trends in Exchange-Traded Funds" (the "Report"). We commend the FSB for highlighting issues presented by certain (but, as explained below, not all) types of exchange traded funds ("ETFs").

Executive Summary

BlackRock strongly supports efforts to increase transparency and to improve disclosure requirements, through both regulatory and industry actions.

We generally share many of the concerns raised in the Report regarding non-transparent synthetic ETFs, **particularly where the swap counterparty and the promoter are in the same group.**

We believe a clear distinction needs to be drawn between exchange traded notes and exchange traded funds. Regulators should regulate according to the differing levels of investor exposure and protections.

BlackRock also believes that regulators should consider current differences between the basket swap and the fully funded model.

We do not agree with the issues raised in the Report regarding securities lending by ETFs. Securities lending is a well established practice across the asset management industry and provides significant benefits to both financial markets and at a micro level to the individual investor.

Background

ETFs are one of the most significant financial innovations benefitting investors within the past twenty years. **ETFs are used by both institutional and retail investors, who appreciate their low costs, transparency and ease of access to a wide range of investment exposures.** This combination of factors makes ETFs ideal portfolio building blocks, giving investors the ability to tailor portfolios to meet their investment objectives and adapt them quickly and efficiently as circumstances change.

The original, conventional, "physical ETFs"

The original ETF structures developed in the United States, and latterly in Europe and Asia, were structured as investment funds which held an underlying basket of securities designed to track the reference benchmark index of the fund. These funds are today known as "physical ETFs".

These offered daily transparency of the index constituent list of securities and their relative weights and were cost efficient. Their liquidity was supported by multiple market makers and brokers who were authorized to create and redeem at the primary market level and market make for onward sales on the secondary market exchanges.

Globally, **the regulatory framework supporting ETFs, being funds, exercises stringent control over the nature of investment exposure that could be offered and also inbuilt requirements around the levels of investor protection,** with requirements for independent custody of assets, segregation of liability within the funds, strict limits on permitted investments of the funds and independent oversight.

Evolution of the ETF model – "synthetic" ETFs

In Europe the regulatory framework established under the Undertakings for Collective Investment in Transferable Securities Directive (UCITS) was extended by the UCITS III Directive allowing, *inter alia,* indirect replication through the use of derivatives and extending the types of investment exposure that is permitted. In this way UCITS III enabled fund promoters to launch “synthetic ETFs” in addition to conventional physical ETFs.

The introduction of these synthetic ETFs has resulted in several different models. These are offered by a range of promoters including standalone entities, to traditional asset management houses to investment banks.

These models which may be loosely categorized under either “fully funded” or “partially funded/"basket style" swap, may, depending on how they are structured, **alter the level of transparency of the underlying holding** due to the nature by which the exposure is achieved.

Costs may be similarly less transparent to [synthetic] ETF shareholders as the commission and annual financing costs of swaps are considered transaction costs and not disclosed to ETF shareholders as part of the ETF’s total expense ratio. In addition, the number of brokers who are authorized to create/redeem or mark up or down the swap is typically much lower then physically backed ETFs.

The parallel rise of non-fund structured exchanged traded products

In parallel to the development of the ETF model we have seen a significant rise in the number of non-fund structured exchange traded products (including exchange traded notes “ETN”s and exchange traced commodities (“ETCs”), representing just over 10 per cent of the combined total of the exchange traded universe globally. **These often offer a more exotic range of exposures than would be permitted under funds legislation. The mechanisms used to deliver this exposure may have the appearance of a fund but may not offer the equivalent, or any, protections, as would be required in a regulated fund structure.**

The U.S. has different legal rules, and US regulators have generally not permitted swap-based or other derivative-based ETFs. The exception to this general rule has been leveraged or inverse ETFs – exchange-traded funds that seek to achieve a daily return equal to a multiple of the return of an underlying inverse, or the opposite return (or multiple of the opposite return) of an underlying index, by holding a portfolio of swaps.

In addition to the issues associated with European synthetic ETFs referenced above, these products have raised **questions regarding whether investors fully understand that these products are designed to meet a daily (rather than long-term) investment objective.** US law also permits exchange-traded notes (ETNs), which in the US are typically unsecured debt obligations that trade in a manner similar to ETFs.

General remarks

The rapid expansion of the ETF and the ETN industry under an overarching exchange traded product label has lead to some confusion about the nature and regulation of permitted exposures and the robustness of different delivery mechanisms. **The expansion in the use of derivatives and more exotic exposures through both fund and note platforms has lead to concerns that ETFs and ETNs may in general lead to significant investor and systemic risk.**

Overall, BlackRock agrees with the FSB’s concerns (and those raised recently by the Bank for International Settlements and the International Monetary Fund) that synthetic ETFs that are not fully transparent – in particular, those where an affiliated entity is the swap counterparty – may not be in investors’ best interests and could potentially add to systemic risks. **BlackRock**

supports full transparency and regulatory rules for ETFs that would mitigate the conflict of interest involved in fund managers investing in swaps with affiliated swap counterparties.

We welcome the opportunity to address and comment on the issues in the report. We also outline how, in our view**, the best practices adopted by iShares** in respect of its physical ETF and ETNs, its synthetic platform in Europe and its securities lending program, **are in line with the FSB's conclusions on necessary steps to allay regulatory and investor concern.** As noted above, we welcome calls to increase transparency and disclosure requirements either through increased regulation or industry action.

Specifically, we will comment on three areas that the FSB report focused on:

- The distinction between fund and note structures
- The inherent conflicts in swap based ETFs entering derivative contracts with their promoter's investment banking arm
- Securities lending

Specific remarks

The distinction between fund and note structures

The Report references the development of close substitutes of ETFs, namely ETN/ETCs or Exchange Traded Vehicles ("ETVs"), which are essentially debt products. It also recognizes within both ETV and ETF structures, the move away from the plain vanilla standardized nature of the original ETFs, to offerings such as leveraged, inverse and leveraged-inverse ETFs.

We believe a clear distinction needs to be drawn between offerings through funds and offerings through notes. The latter may be approximately divided into notes being backed by a physical holding – typically precious or industrial metals – and notes being backed by the credit of the issuers promoter or another third party banking or financial institution ("credit backed notes"). In our view the genesis of much of the concern around ETFs arises from the risks experienced in respect of credit backed note structures during the credit crisis. The fact that the notes-based structures trade and settle like a fund leads many to assume that notes based structures enjoy the same protections required of a regulated fund. Investors and regulators cannot, however, rely on this.

Furthermore, broadly speaking, **there is much less regulatory scrutiny of the nature of the investment exposure offered through a note structure than through a fund offering.** Provided the nature of the investment exposure and the risks associated with it are comprehensively disclosed in the prospectus, there is no initial and/or ongoing regulatory oversight as to appropriateness for the investors who may access the product. While the exotic exposures referenced above may be offered through fund structures in some jurisdictions, they are typically found in the notes based variety.

It is imperative that funds authorized under a retail distribution regulatory model be comprehensible to a broad base of investors. Regulators have questioned whether leveraged or inverse exposures should be available to retail investors. BlackRock acknowledges concerns that all investors may not understand these products.

If all funds are to be treated as non-complex then notes must also face an increased level of scrutiny. If the investment risk exposure they offer is significantly higher than that available through a funds offering, or if the vehicle does not have the in-built protections that automatically apply in a fund, there is a cogent argument that these products may not be suitable for the retail investor on an execution only basis or that they should be available to institutional or professional investors only, on a separate segment of the exchange. Are we saying ‘we believe all funds should be treated as non complex and that notes should face an increased level of scrutiny. Or that regulators should be focusing on notes and not funds?

It is incumbent on regulators to understand the fundamental difference between exchange traded notes and exchange traded funds, to understand the differing levels of investor exposure and protections, and to regulate accordingly.

The inherent conflicts in swap-based ETFs entering derivative contracts with their promoter’s investment banking arm

BlackRock believes that the Report accurately analyzes the risks associated with swap-based ETFs. We endorse the call for increased disclosure and transparency to mitigate concerns around the incentives behind the creation of synthetic ETFs, where there may be a perceived or actual conflict of interest arising from the dual role of some banks as both promoter and derivative counterparty.

We note, however, that **the report focuses on funds constructed using a basket style swap** – a style broadly favored by the promoter/derivative counterparty banks - **and does not draw-out the distinction between funds constructed using a fully-funded swap.**

The important distinction is that under the basket style swap construction, the 'collateral' is represented by the holdings of the fund whereas the fully-funded swap is collateralized outside of the fund.

The positions held by the fund under the basket-swap model are not treated as collateral under UCITS guidelines and simply need to satisfy the standard eligible assets and diversification rules. These rules allow considerably more flexibility for the assets that can be provided as 'collateral' and do not require over-collateralization, though it should be stressed that the holdings must still not compromise the liquidity of the fund.

In contrast, under **the fully-funded swap model, there are strict guidelines regarding the type of assets that can be used to collateralize the position** - for example equity collateral must be traded on exchanges in certain developed markets and is subject to 20% over-collateralization. Importantly the collateral should be held to the account of the fund by an independent third party.

The UCITS collateral requirements have been specifically designed to protect investors from some of the issues described in the paper. BlackRock believes that regulators should treat both structures consistently.

The BlackRock approach

BlackRock recognizes the utility of swap-based models in accessing certain markets where it may not be possible or practicable for the fund to directly hold the underlying physical assets. Our model adopts, however, best practice, utilizing a multiple counterparty, fully funded swap structure involving a tri-partite collateral arrangement. Collateral positions and exposures are disclosed on a daily basis as are the applicable fees.

We also ‘gold-plate’ the requirements of the UCITS Directive and local regulation by further restricting the markets from which we will accept equity collateral, accepting only G10 government bonds and applying a haircut of between one and three per cent if maturity is greater than one year.

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Futhermore, BlackRock accepts no more than ten percent collateral in any one entity and applies a forty per cent average daily trading volume ("ADTV") limit for all securities posted by counterparty across all positions. This means that if a counterparty is providing swaps for several funds BlackRock will never need to unwind greater than forty percent ADTV across all funds in the event that the counterparty defaults.

Finally, we note the following statement in the report - 'In case of unexpected liquidity demand from ETF investors, the provider might face difficulties liquidating the collateral and may be faced with the difficult choice of either suspending redemptions or maintaining them and facing a liquidity shortfall at the bank level. In short, risks increase if the bank considers the synthetic ETF structure as a stable and inexpensive source of funding for illiquid securities.' (p.4 para.2)

In a properly established structure, **the fund should not be required to liquidate collateral in the case of large redemptions** – it would do so only in the case of counterparty default. If the swap counterparty has hedged itself appropriately then it will also have no need to liquidate the collateral positions. In practice when the fund receives a large redemption request it passes the holding back to the counterpart who delivers the cash to fund the redemption.

Securities lending

Securities lending is a well established practice across the asset management industry and **provides significant benefits to both financial markets and at a micro level to the individual investor.**

The FSB raises the concern that a prevalence of securities lending could create a market squeeze in the underlying securities, if ETF providers recalled on-loan securities on a large scale in order to meet redemptions. While BlackRock acknowledges that securities lending by any investment fund that could face redemptions (such as mutual funds or hedge funds, not just ETFs) could result in recalled loans, **we note that the FSB does not cite any data, or even anecdotal evidence, that fund redemptions have resulted in recalled loans in a manner that has caused actual stress to markets.**

BlackRock believes this is unlikely in the case of ETFs, as ETFs that engage in securities lending typically loan only small percentages of their portfolios and would generally have to suffer very significant redemptions before other-than-ordinary recalls would be needed. Indeed, because ETFs – unlike many other types of lenders – are typically index-based investors, they generally trade infrequently and therefore tend to have lower rates of recalling loans. In short, **there is no evidence, of which BlackRock is aware, to suggest that securities lending by ETFs poses greater systemic risks than securities lending may pose more generally.**

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We appreciate the opportunity to address and comment on some of the issues raised in the FSB's Report. We are prepared to assist the FSB in any way we can, and we welcome continued dialogue on these important issues. Please contact either of the undersigned if you have comments or questions regarding BlackRock's views.

Sincerely,

Axel Lomholt,
Managing Director
iShares Europe Product Development
TEL +44 (0)20 7668 7443
axel.lomholt@blackrock.com

Gareth Juul
Managing Director
Legal & Compliance
TEL +44 (0)20 7668 8708
gareth.juul@blackrock.com

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iShares is the global product leader in exchange traded funds with over 480 funds globally across equities, fixed income and commodities, trading on 19 exchanges worldwide and assets under management, excluding iPath, totaling €439 billion.