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FSB Note on Potential Stability Issues Arising from Recent Trends in Exchange-Traded Funds (ETFs)

Dear Sir or Madam

BVI[1] welcomes the opportunity to furnish comments on the recently published FSB note in relation to Exchange-Traded Funds. As the representative body of the German asset management industry, BVI comprises among its members major players in the ETF market in Germany including providers of both physically replicating as well as synthetic ETFs.

General remarks

We are glad about the perspective to engage in further discussions with the FSB pertaining to the recent developments in the ETF market and their possible implications for other market participants and the financial system as a whole. However, the note at hand suggests that there are some misperceptions on the part of FSB regarding the current market structure of ETFs. Hence, we would like to use this opportunity in order to provide more clarity with regard to the functioning of the European ETF market.

[1] BVI Bundesverband Investment und Asset Management e.V. represents the interests of the German investment fund and asset management industry. Its 85 members manage currently assets of nearly EUR 1.8 trillion both in mutual funds and mandates. For more information, please visit www.bvi.de.

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Legal structure of European ETFs

By far the most ETFs launched in Germany are UCITS; this holds also true for the rest of Europe. As such, it must be borne in mind that ETFs are subject to the same comprehensive set of rules and must adhere to the same constraints as other UCITS. The UCITS Directive provides a robust regulatory framework for investment funds with strict rules applicable i.e. to risk management and measurement, quality of collateral in OTC derivative transactions and disclosure towards investors. These rules will be further enhanced with the entry into force of the UCITS IV reform by 1 July 2011.

As regards the structure of synthetic ETFs, the FSB paper apparently presumes that the ETF provider might be identical with the bank acting as swap counterparty. In the European market this situation can never possibly occur due to the overriding separation principle between banking and asset management activities. The ETF provider as the entity responsible for ETF management must be authorized as a UCITS management company whose license is limited to asset management, investment advice and some other ancillary services.[2] The provision of swaps, on the other hand, is clearly a banking domain and cannot be performed by a UCITS manager.

Under the UCITS Directive, the ETF provider has the sole legal responsibility for management of ETFs. The safe-keeping duty in terms of fund assets as well as important control tasks especially regarding valuation and observance of fund rules are entrusted with the depositary being a separate legal entity, usually a credit institution. In addition, many ETF providers delegate the performance of administrative tasks to a fund administrator providing an additional layer of control. The typical structure of German and Luxembourg ETFs as examples for the European market[3] is shown in the **Annex** to our reply.

ETFs and other Exchange-Traded Products

We regret that the FSB note focuses exclusively on ETFs. This is especially unfortunate since the note itself quite clearly demonstrates that the

[2] Cf. Article 6 of Directive 2009/65/EC (UCITS Directive).

[3] Luxembourg is a major centre of fund activities in Europe and place of foundation for many UCITS, including ETFs managed by German fund managers.

perceived drawbacks of ETFs may occur similarly or even more manifestly in other Exchange-Traded Products (ETPs) such as ETNs or ETVs (see Footnote 4 of the FSB Note). It is very important that a level playing field be maintained (or established, as the case may be) among financial products, and that regulatory arbitrage among ETFs, ETNs, ETCs and other product structures be avoided.

Regrettably, ETFs are often confused in the public domain and in the press with other ETPs, and more investor education is required to correct some of the misperceptions. The educational efforts on the part of both industry and regulators should be strengthened to make investors understand that only ETFs have certain features, and that in Europe they operate within the UCITS framework which provides the highest level of investor protection.

Systemic relevance of ETF activities

Albeit being a successful business model, ETFs still constitute only a small fraction of the entire fund market. By end of 2010 only 5.9% of global fund assets have been invested in ETFs.[4] In Europe, only 2.6% of funds are launched as ETFs (3.5% of UCITS)[5] and the high growth rates of the ETF market observed in the recent years are due to a low starting base.

In Europe synthetic ETFs represent 45% of the ETF market what in absolute numbers amounts to nearly USD 138 billion of assets under management[6]. Compared to the global fund volume, synthetic ETFs constitute a tiny fraction of 0.6%. On the other hand, the OTC swap market for equity-linked swaps reached the volume of USD 1,854 billion in 2010 according to BIS statistics.[7] Thus, even assuming that all positions of synthetic ETFs are held in equity swaps, the proportion of ETF engagements in the global equity-linked swap market would be no more than 7.5%.

Eventually, new ETF types such as leveraged, inverse and leveraged-inverse ETFs amount only to a tiny proportion of the ETF universe, as highlighted by the FSB note.

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[4] Source: Blackrock Industry Review end Q1 2011, p. 50
[5] Source: EFAMA and Blackrock statistics
[6] Source: Deutsche Bank Research, Q1-11 ETP Market Review and Outlook, p. 24
[7] BIS Triennial Central Bank Survey at end June 2010

On balance, it is quite clear that the ETF market cannot give rise to stability concerns in relation to the entire financial system due to its limited size. Some ETF market activities are also overestimated by the FSB note, thus providing a distorted picture of associated potential risk. This pertains in particular to the “potential impact of heavy ETF trading” to which we will revert in detail in our comments below.

Comments on the asserted risk implications of ETFs

Conflicts of interests in synthetic ETFs

The FSB assumes that banks can take up a “dual role as ETF provider and derivative counterparty”. This is clearly not the case for the European ETF industry. As already explained, the EU law system explicitly prohibits such mingling of functions, thus significantly mitigating the potential for conflicts of interests.

The risk of conflicts of interests resulting in improper valuation has also been overrated by FSB. In Germany, the valuation of fund assets is mostly performed by the depositary being a designated credit institution. ETF providers tend to appoint a depositary outside the respective financial group on the basis of its capacity to provide ETF specific services such as facilitating exchange trading of fund units. Consequently, in most cases the derivative counterparty to synthetic ETFs is different from the entity responsible for valuing the ETF swap positions and assessing the quality of collateral. In addition, many ETFs delegate the administrative tasks to a specialised fund administrator which entails the involvement of another third party in the asset valuation process.

Furthermore, it must be duly recognized that European ETFs like other UCITS are subject to tight rules on management of conflicts of interests under the UCITS Directive[8]. Equivalent provisions apply to the banking counterparties according to the Markets in Financial Instruments Directive (MiFID)[9]. These sets of rules require the implementation of comprehensive measures in order to resolve conflicts of interests pertaining also to other members of a financial group.

[8] Cf. Articles 17-20 of Directive 2010/43/EC implementing the UCITS Directive.
[9] Articles 21-23 of Directive 2006/73/EC implementing MiFID

Lastly, the counterparty limits applicable under the UCITS Directive reduce the possible risk exposure to a swap counterparty to 10% of ETF assets in case the counterparty is a credit institution with its registered office in an EU Member State and 5% of ETF assets in all other cases, and thus provide an additional mechanism of investor protection.

Level of transparency made available by ETF providers

The UCITS regime applicable to European ETFs requires publication of a full prospectus and a simplified prospectus for the fund (the latter to be replaced by the Key Investor Information Document, the KIID, under UCITS IV[10]). These documents contain detailed information on the investment strategy of a fund and the associated relevant risks. In addition, ETFs are obliged to publish annual and semi-annual reports on the fund holdings and investment activities.

In practice, ETF providers make much more frequent disclosures relating to collateral composition as well as portfolio holdings and counterparty exposures of ETFs. However, it should be noted that this enhanced transparency is provided on a voluntary basis.

Risks for market liquidity

The effect of maturity transformation perceived as critical by FSB is not a specificity of ETFs, but a common feature of all open-ended investment funds. In fact, provision of easily redeemable investment opportunities in less liquid market segments is one of the indisputable benefits of fund investments.

The redemptions “in kind” mentioned in the note are not a common standard for ETF trades. Nevertheless, it is important to recognize that market makers facilitating secondary trading in ETFs play a key role in alleviating potential liquidity pressures by netting the incoming buy and sell orders. This “liquidity buffer” provided by market makers is a distinct feature of ETFs as compared to traditional investment funds.

In the same vein, the role of market makers significantly limits the impact of ETF trades on liquidity and price formation of the referenced securities. By netting of orders market makers ensure that the volatility of ETF volume and

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[10] To come into force by 1 July 2011 in Germany.

the corresponding trading activities are reduced to a minimum. Hence, it is incorrect to assume that a correlation necessarily exists between the trade volume at ETF level and the turnover of relevant index elements. In fact, “heavy ETF trading” objected by FSB might have only marginal effects for the referenced assets.

Risks associated with securities lending

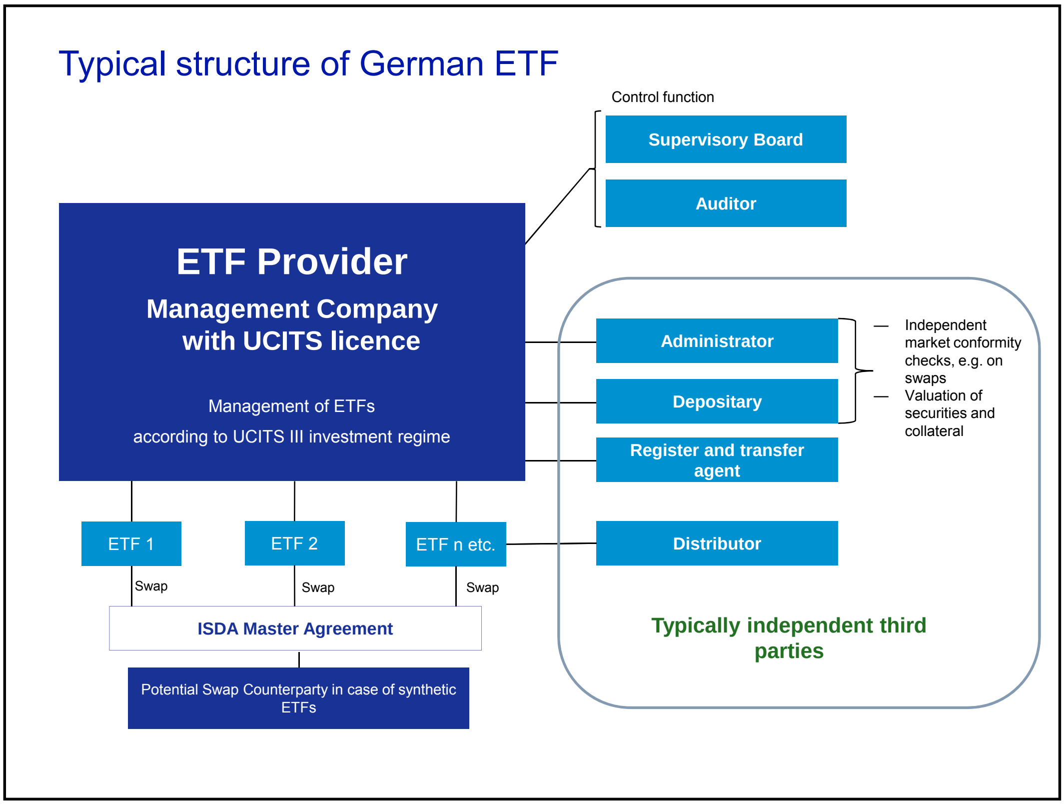
Securities lending is an established practice across the asset management industry and provides significant benefits to both financial markets and fund investors. The FSB’s concerns relate to potential market squeeze in the underlying securities to be caused by securities lending in case ETFs recall significant volumes of securities to serve requests for redemptions of fund units. While we acknowledge that securities lending by investment funds facing enhanced redemptions (such as traditional mutual funds or hedge funds, not just ETFs) could result in recalled loans, no data has been provided by FSB to support a view that fund redemptions have ever prompted loan recalls of a size that has caused a market squeeze. Furthermore, ETFs engaging in securities lending typically lend low percentages of their overall portfolios. Significant redemptions would need to be placed before other-than-ordinary recalls were necessary. There is no evidence suggesting that securities lending by ETFs poses greater systemic risks than securities lending by other market participants. In addition, the small share of ETFs in the global investment fund market indicates that any impact in terms of market stability must be considered highly unlikely.

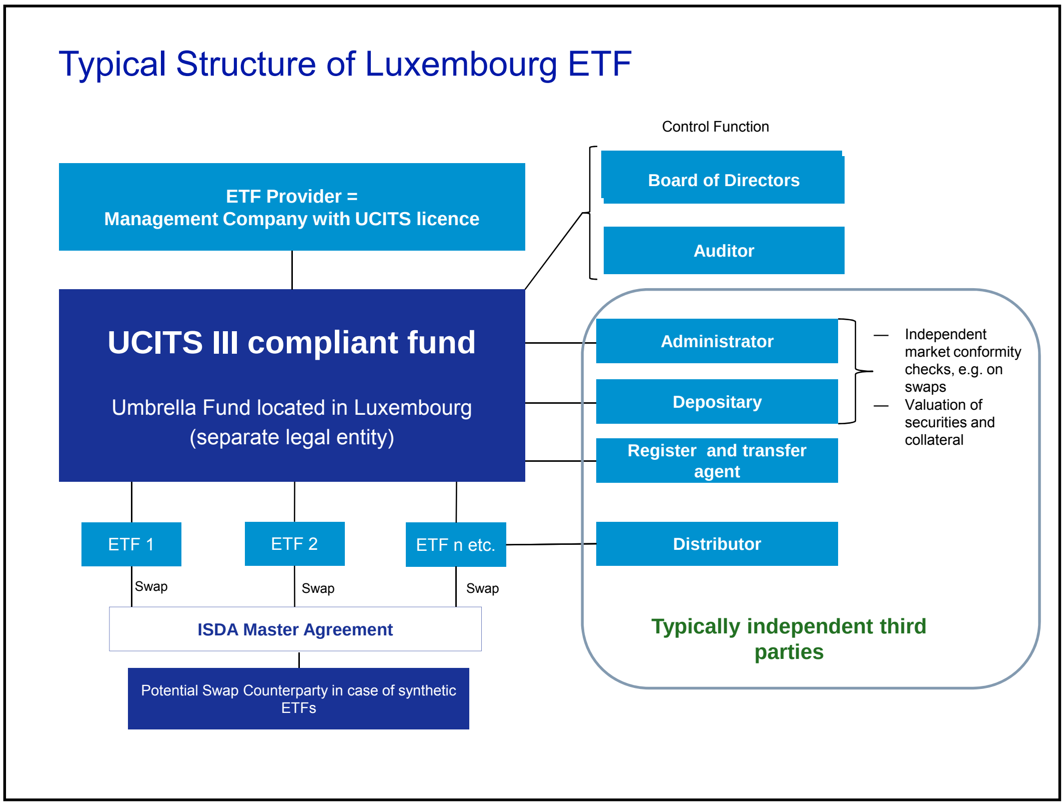
To sum up, we think that the most concerns brought forward in the FSB note can be allayed by the above explanations. Nonetheless, we would be happy to answer any questions and stand at FSB’s disposal to engage in further discussion on regulatory issues pertaining to ETFs.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

Thomas Richter Marcus Mecklenburg


Typical structure of German ETF
Control function
Supervisory Board
Auditor
ETF Provider
Management Company with UCITS licence
Management of ETFs according to UCITS III investment regime
Administrator
Depositary
Register and transfer agent
Distributor
Independent market conformity checks, e.g. on swaps
Valuation of securities and collateral
ETF 1
ETF 2
ETF n etc.
Swap
Swap
Swap
ISDA Master Agreement
Potential Swap Counterparty in case of synthetic ETFs
Typically independent third parties


Typical Structure of Luxembourg ETF
Control Function
Board of Directors
Auditor
ETF Provider = Management Company with UCITS licence
UCITS III compliant fund
Umbrella Fund located in Luxembourg (separate legal entity)
Administrator
Depositary
Register and transfer agent
Distributor
Independent market conformity checks, e.g. on swaps
Valuation of securities and collateral
ETF 1
ETF 2
ETF n etc.
Swap
Swap
Swap
ISDA Master Agreement
Potential Swap Counterparty in case of synthetic ETFs
Typically independent third parties