

16 May 2011

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002 Basel  
Switzerland

Submitted via email to [fsb@bis.org](mailto:fsb@bis.org)

Re: Potential financial stability issues arising from recent trends in Exchange-Traded Funds

Dear Sirs,

Markit<sup>1</sup> is pleased to submit the following comments to the Financial Stability Board's paper *Potential financial stability issues arising from recent trends in Exchange-Traded Funds*.

## Introduction

Markit is a service provider to markets for Exchange-Traded Funds ("ETFs"), working to help increase efficiency and transparency by offering products and services that offer a more comprehensive view of these markets. Markit supports the FSB's examination of recent market developments in the ETF markets and their potential implications for financial market stability.

Global ETF markets have experienced significant growth and innovation in recent years and, with these advancements, new intricacies may make this market vulnerable, especially in respect of products using synthetic replication schemes. We believe that the provision of more frequent and detailed updates of composition and risk characteristics of these products could help address many of the identified regulatory concerns as long as they are appropriately designed.

## Existing Transparency Services in the ETF Markets

We believe that, when analysing risks and transparency in the ETF markets, the FSB may benefit from being aware of the work that Markit has done with ETF providers for many years to enhance transparency for ETFs. In 2010, these efforts resulted in the launch of Markit ETF Services, a service that contains details of ETF providers, daily portfolio composition, net asset value, assets under management and dividend forecasts for all of the ETFs<sup>2</sup> that are currently available worldwide.

Specifically, the service produces the following data sets:

---

<sup>1</sup> Markit is a financial information services company with over 2,000 employees in North America, Europe and Asia Pacific. The company provides independent data and valuations for financial products across all asset classes in order to reduce risk and improve operational efficiency. Please see [www.markit.com](http://www.markit.com) for additional information.

<sup>2</sup> Please note that, in addition to ETFs, Markit ETF Services do also cover Exchange Traded Vehicles (ETVs), Exchange Traded Certificates (ETCs), Exchange Traded Notes (ETNs) and Exchange Traded Products (ETPs). However, for the sake of simplicity, we will reference all of those products as "ETFs" throughout this letter.

- The Markit ETF Encyclopaedia is a reference database of ETFs that are categorised by asset class, type, region and structure. The database which is updated daily for new product launches and cross-listings, includes key ETF data such as authorised participants, key market dates, the tax domicile of funds, swap counterparties, creation and redemption details and fees, and other key data points that have been extracted from filing documents such as prospectuses or annual reports. In relation to some of the FSB's concerns it is worth noting that the database tracks several static fields that enable investors to analyse the structure and the activities of the fund, such as the replication type (i.e., whether it is a cash or a synthetic structure), the swap counterparty (if the fund utilizes swaps), the holdings type (physical or swap based), and the basket holdings (e.g., swap, futures, stocks, bonds, or commodities). Further, the database contains information about the securities lending activities of the fund, e.g. it specifies whether the fund uses securities lending, the lending agent, the stock lending revenue, as well as the stock loan rebate, where such information is available.<sup>3</sup>
- Markit ETF Trade Data provides daily composition data for the creation, redemption and calculation baskets for ETFs. Such information allows authorised participants and market makers to know the exact composition of a fund in order to price the ETF in real-time, make markets, and manage risk accordingly. In addition, the normalization of all ETF composition data allows users to perform a straightforward direct comparison between the cash component and the excluded shares.
- Markit ETF Dividends provides forecasts by utilizing single-stock dividend forecasts which are based on direct company guidance, fundamental analysis, peer group trends, historical patterns, consensus aggregate estimates, and stock exchange guidelines.
- Markit ETF Analytics provides a single source of all key statistics that are required for analyzing ETFs. It includes performance data, risk measures<sup>4</sup>, dividend information, general pricing information, average assets under management, bid-ask spread, asset flows, and premium/discount based on the consolidated close.

While any interested party can subscribe to the service, we provide the above information mostly to ETF providers and to market makers. These ETF providers will then often make the relevant datasets available to their investors and/or the public in order to increase the transparency of their products. As the data relies on a normalized terminology, ETF investors are in a position to perform meaningful comparisons between different ETFs across jurisdictions.

Markit is the primary distribution agent of daily ETF holdings information to Authorized Participants and market makers on behalf of the ETF issuers for the majority of the ETFs listed in the European region<sup>5</sup>. Within our ETF Trade Data module we provide daily compositions of almost every ETF that is available worldwide. For cash-based funds this represents the actual holdings within the structure, while we provide the synthetic holdings for swap-based European funds. We believe the FSB should note that such services have significantly increased the transparency in the ETF marketplace by displaying the composition of the collateral basket in an easily accessible format where such information is available. . However, even where such information is available, it is likely only a starting point for further analysis and measurement of systemic risk.

## The nature of the ETF Market

---

<sup>3</sup> While the stock lending revenue is the amount that the fund earned from securities lending as disclosed in annual report, the stock loan rebate equals the amount of the lending revenue that flows through to holders of the ETF.

<sup>4</sup> These are for example Beta, Alpha, R-Squared, Standard deviation, Sortino Ratio, and the Sharpe Ratio.

<sup>5</sup> In addition, Markit is a premier provider for public post-trade reporting of ETC transactions that occurred in the OTC space via the Markit BOAT platform and ETF Broker Rankings via Markit MSA.

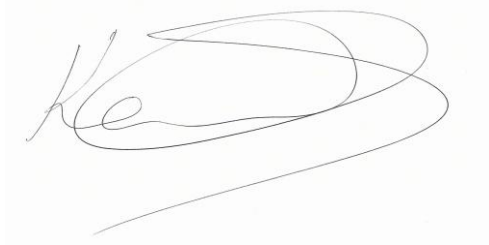
Based on our experience as a transparency provider in the global ETF markets, we believe that several factors should be taken into account when analyzing risks to financial stability that could originate from these markets:

- While a number of existing rules and regulations have relevance for the ETF market, very few of those have been designed specifically for the ETF product. We believe that any potential future rules need to be tailored to the specifics of ETFs in order to enable further growth of this market while reducing risks to market liquidity and financial stability.
- Significant differences exist between the European and the US ETF markets<sup>6</sup> which result in the fact that the US only has cash structures<sup>7</sup> whilst the European ETF market consists of both synthetic and cash ETFs. To address any potential risks that might originate from the lack of transparency about the assets that are backing synthetic ETF structures, we believe the focus therefore needs to be on Europe.

As a provider of transparency services for the ETF markets we are open to working with ETF issuers, investors, and regulatory authorities to ensure that the desired additional transparency of the ETF markets can be made available in an appropriate and timely manner.

We hope that our comments will be of value to you. Please do not hesitate to contact the undersigned or Marcus Schüler at [marcus.schueler@markit.com](mailto:marcus.schueler@markit.com) if you require any additional information or if you want to discuss our comment further.

Sincerely,

A handwritten signature in black ink, appearing to read 'Kevin Gould', written over a light gray rectangular background.

Kevin Gould  
President  
Markit North America, Inc.

---

<sup>6</sup> In Europe, one would typically not distinguish between mutual funds and ETFs, both exchange-traded and over-the-counter derivatives can be held in the fund to meet the investment objectives under the UCITS regulations, and approximately 50% of ETFs can be replicated using a synthetic structure which is frequently used given it is more cost-efficient than physical replication. In contrast, regulations in the United States encourage plain vanilla structures in the ETF markets.

<sup>7</sup> Leveraged and inverse funds which hold swaps in certain cases to achieve desired leverage are exceptions to the cash only structure in the US.