How Will Regulation Affect ETFs?

EXPLORER SERIES

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How Are ETFs Currently Regulated Under UCITS?

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UCITS Restrictions

- General Diversification Requirements i.e. 5/10/40 Rule etc.
- More flexible risk spreading rules for index replicating funds, i.e. 20% / 35% rule provided index meets certain criteria:

  (a) its composition is sufficiently diversified;
  (b) the index represents an adequate benchmark for the market to which it refers; and
  (c) it is published in an appropriate manner.

- UCITS ETFs physically replicating an index would need to comply with above rule.

UCITS and Use of Derivatives

- According to UCITS Commission Directive 2007/16/EC, the reference to replicating the composition of an index shall be understood as a reference to replication of the composition of the underlying assets of the index, including the use of derivatives or other techniques and instruments.

- UCITS ETFs replicating an index are therefore allowed the use of derivatives.

- Use of derivatives by a UCITS are subject to the following conditions:

  (a) the underlying must be UCITS eligible investments, financial indices, interest rates, foreign exchange rates or currencies;

  (b) the counterparties to OTC derivative transactions must be institutions subject to prudential supervision, and belong to the categories approved by the competent authorities of the UCITS home Member State;

  (c) the OTC derivatives must be subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the UCITS' initiative.

UCITS and Financial Indices

- Financial indices are indices which fulfil the following criteria:

  (a) they are sufficiently diversified;
  (b) they represent an adequate benchmark for the market to which they refer;
  (c) they are published in an appropriate manner.

- Indices based on financial derivatives on commodities or indices on property may be eligible provided they comply with the criteria set down for financial indices.

- In Ireland, financial indices must be cleared in advance by the Central Bank unless constituents are UCITS eligible and exposure by the UCITS to each constituent will comply with the 5/10/40 rule.

- If a financial index does not meet the above criteria, the UCITS can only seek exposure to that financial index if it comprises UCITS eligible assets and the exposure to the constituents meets the UCITS 5/10/40 when combined with direct investments, i.e. a look through approach must be adopted.

UCITS Global Exposure Restriction

- Global exposure as a result of the use of derivatives cannot exceed 100% of the NAV.
- Global exposure is a measure designed to limit either (a) the incremental exposure and leverage generated by a UCITS through the use of derivatives utilising the commitment approach or (b) the market risk of the UCITS through the use of derivatives utilising the VaR approach.
- For UCITS utilising the commitment approach, total exposure cannot exceed 200% of NAV and leverage cannot exceed 100% of NAV.
- For UCITS utilising the Relative VaR approach, VaR on the UCITS portfolio cannot exceed twice the VaR on a comparable benchmark portfolio.
- For UCITS utilising the Absolute approach, VaR on the UCITS portfolio cannot exceed 20% of NAV.
- The creation of leveraged exposure to an index via derivatives or the inclusion of a leveraged feature in an index must also be taken into account in the global exposure calculation.

UCITS Global Exposure Restriction (cont.)

- The calculation of the Absolute and Relative VaR must be carried out in accordance with the following parameters:

  (a) one-tailed confidence interval of 99%;

  (b) holding period equivalent to 1 month (20 business days);

  (c) effective observation period (history) of risk factors of at least 1 year (250 business days) unless a shorter observation period is justified by a significant increase in price volatility (for instance extreme market conditions);

  (d) quarterly data set updates, or more frequent when market prices are subject to material changes;

  (e) at least daily calculation.

Other Derivative Restrictions

- Position / Concentration Rule, i.e. look through derivatives to ensure position exposure when combined with direct investments do not exceed the UCITS concentration rules (i.e. 5/10/40, etc.);

- Cover Requirement, i.e. sufficient liquid assets to meet commitments;

- OTC Counterparty Requirement, i.e. OTC counterparty exposure cannot exceed 10% in the case of credit institutions and 5% in other cases.

Collateral Posted by OTC Counterparty

- Collateral may be used to reduce counterparty risk exposure provided it complies with the following set of high-level principles at all times:

  - Liquidity
  - Valuation
  - Issuer credit quality
  - Correlation
  - Collateral diversification (asset concentration)
  - Operational and legal risks

- Collateral must be held by a third party custodian which is subject to prudential supervision, and which is either unrelated to the provider or is legally secured from the consequences of a failure of a related party.

Collateral Posted by OTC Counterparty (cont.)

- Collateral must be fully enforced by the UCITS at any time without reference to or approval from the counterparty.

- Non-cash collateral cannot be sold, re-invested or pledged.

- Cash collateral can only be invested in risk-free assets, i.e. assets with a return of short-dated (generally 3-month) high quality government bonds, for example 3-month US T-bills.

- For the valuation of collateral presenting a significant risk of value fluctuation, a UCITS should apply prudent discount rates.

UCITS and Securities Lending

- Securities lending may be permitted by Member States subject to conditions and limits set down by the Member State provided that such techniques and instruments are employed for the purpose of EPM, i.e.:

  (a) they are economically appropriate in that they are realised in a cost-effective way;

  (b) they are entered into for one or more of the following specific aims:

    (i) reduction of risk;

    (ii) reduction of cost;

    (iii) generation of additional capital or income for the UCITS with a level of risk which is consistent with the risk profile of the UCITS and the risk diversification rules laid down in the UCITS Directive;

  (c) their risks are adequately captured by the risk management process of the UCITS.

UCITS and Securities Lending (cont.)

- If UCITS are authorised to undertake securities lending transactions in order to generate additional leverage through the reinvestment of collateral, these transactions must be taken into consideration for the determination of the global exposure.

- UCITS that reinvest collateral in financial assets that provide a return in excess of the risk-free return, must include in their global exposure calculations:

  (a) The amount received if cash collateral is held; and

  (b) The market value of the instrument concerned if non-cash collateral is held.

UCITS and Securities Lending / Irish Regulatory Position

- Securities lending counterparty must have a credit rating of A-2 by S&P (or equivalent) or be deemed by UCITS to have an implied rating of A-2 by S&P or equivalent. Unrated counterparty is acceptable in certain circumstances.
- UCITS must have right to terminate at any time.
- Collateral obtained must meet with following criteria:

  (i) Liquidity;
  (ii) Valuation;
  (iii) Issuer Credit Quality.

- Collateral must equal or exceed in value the value of the amount of securities loaned.
- Collateral must be immediately available to UCITS without recourse to counterparty in the event of default.

UCITS and Securities Lending / Irish Regulatory Position (cont.)

- Non-cash collateral:

  (i) cannot be sold, pledged or re-invested;
  (ii) must be held at risk of counterparty;
  (iii) must be issued by an entity independent of the counterparty;
  (iv) must be diversified to avoid concentration in one issue section or country.

- Cash collateral cannot be invested other than in the following:

  (i) deposits with relevant institutions;
  (ii) government or other public securities;
  (iii) certificates of deposit issued by relevant institutions;
  (iv) letters of credit with a residual maturity of 3 months or less (unconditional and irrevocable) and which are issued by relevant institutions;
  (v) repurchase agreements provided collateral received falls into these rules;
  (vi) daily dealing money market funds with an AAA credit rating by S&P or equivalent .

UCITS and Securities Lending / Irish Regulatory Position (cont.)

- Invested cash collateral held at risk of UCITS must be diversified (exception being government or other public securities or money market funds).

- Invested cash collateral may not be placed on deposit with or invested in securities issued by the counterparty or a related entity.

ETF Regulation – What's Next?

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Regulators’ ETF Warnings

Date	Regulator	Warning About
June 2009	Finra	Inverse/Leveraged ETFs
August 2009	Finra/SEC	Inverse/Leveraged ETFs
March 2010	SEC	Use of Derivatives by Funds (including ETFs)
November 2010	SFC (Hong Kong)	Synthetic ETFs
Jan 2011	FSA	Leveraged ETFs
March 2011	FSA	ETF Complexity
March 2011	Reserve Bank of Australia	ETF Complexity
April 2011	G20 Financial Stability Board	Conflicts of Interest, Securities Lending, Transparency
April 2011	IMF	Derivatives, Collateral, Commodities, Legal Risks, Liquidity
April 2011	BIS	Regulatory Arbitrage, Mismatched Incentives, Systemic Risks
June 2011	Bank of England	Complexity, Opacity, Interconnectedness
June 2011	FSA	Marketing of ETFs
July 2011	UK Serious Fraud Office	Potential Threats from ETFs
July 2011	ESMA	ETF Structure, Transparency, Liquidity

Common Themes in Regulators' Warnings

- Inverse/Leveraged ETFs
- Use of Derivatives/Counterparty risks
- Securities Lending
- Systemic Risks
- ETF Liquidity

Inverse/Leveraged ETFs

- Path-dependency of returns
- Impact of Leverage
- Impact of Index Volatility

Use of Derivatives/Counterparty Risks

- Europe's UCITS rules allow derivatives-based funds
  - 2/3 of European ETFs are "synthetic"
- Compare SEC stance
- Counterparty exposures and collateral
- Unfunded/funded swap structures
- Single/multi-counterparty models

Securities Lending

- Questions over transparency
- Fee split/incentives
- Collateral policy
- Counterparty exposures
- Cash reinvestment risks

Systemic Risks

- ETF as a source of bank financing
- Regulatory arbitrage/Basel III
- Underpricing of liquidity option
- Commingling of index tracking risk/bank trading book risk

ETF Liquidity

- Focus of recent warnings
- Flash Crash/depth of order book
- Gap risk/trading away from NAV
- Levels of exchange protection

ESMA Proposals

- Identifying Funds
  - Possible split into “complex”/”non-complex” and restrictions on retail sales of complex funds? Naming rules for synthetic/physical/active ETFs?
- Indices
  - Clearer definition of index rules and ETFs’ tracking ability. Strategy indices to be diversified and have clear objectives
- Synthetic ETF Risks
  - Disclose underlying exposures, counterparty and collateral at least annually. Collateral must meet CESR guidelines and be enforceable. Effect of counterparty default to be explained.
- Securities Lending
  - Declare intention to lend securities and explain risks. Collateral to comply with CESR guidelines for OTC derivatives. Disclose lending agent relationship and fee split. No disclosure of collateral?
- Actively Managed UCITS ETFs
  - Clearly mark as active fund, alert investors to risks, describe portfolio transparency policy
- Leveraged ETFs
  - Disclose leverage policy, explain how daily application of leverage can affect investment
- Secondary market policy
  - Risk warning on restricted redemption rights/possible right to request direct redemption from issuer?

Question and Answer Session

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