

ASSET MANAGEMENT AND INVESTORS COUNCIL

26th September 2011

Sent by email

To whom it may concern,

ICMA Asset Management and Investors Council – ETF Working Group Report

The ICMA Asset Management and Investors Council ('AMIC' or 'the Council') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC set up following its December quarterly meeting an ETF working group to highlight issues related to the evolution of the product. The Council ETF working group notes the increased interest from the official sector and regulatory authorities in the ETF space, and supports efforts to increase understanding of ETFs and other exchange-traded products, including notes, partnerships, grantor trusts, commodity pools and other non-fund structures.

This note has three main parts. Part 1 is a descriptive section, with 4 sub-sections A-D which set out the current state of the ETF market; Part 2 is an assessment section, with 3 sub-sections E-G which look at the trends and assess how the ETF market is likely to continue to develop, and considers the consequences for markets, investors and regulators alike; and Part 3 is a concluding section with conclusions and recommendations.

1: Description of the current state of the ETF market

A: Description of ETFs

ETFs (“Exchange Traded Funds”) are typically open-end index funds that provide daily portfolio transparency, are listed and traded on exchanges like stocks on a secondary trading basis, and use a unique creation and redemption process for primary transactions. The fact that an ETF is traded like a stock means that ETFs have real-time pricing (as opposed, say, to the position of some other investment vehicles which have one daily trade price for all activities into and out of the vehicle). This can aid liquidity and real-time asset allocation decision-making. Trading on exchanges also means that ETFs can be bought or sold using a wide variety of order types and can be sold short, subject to the rules of the respective regulated market venues.

The creation and redemption process is designed to ensure that the value of the ETF shares does not deviate far from the value of the underlying investments in the fund, thus offering investors a greater certainty of the value of their investment relative to the market index. The natural arbitrage between the shares of the ETF itself and the basket of securities that comprise the ETF keeps the two valuations in line. This is different from a closed-end fund (for example, a UK Investment Trust) where the fund or investment trust can move to a significant premium or discount to the underlying assets for extended periods of time.

This report distinguishes ETFs from ETPs (“Exchange Traded Products”) which are products that have similarities to ETFs in the way they trade and settle but they do not use a mutual fund structure. The use of other structures including grantor trusts, partnerships, notes and commodity pools by ETPs can create different tax and regulatory implications for investors when compared to ETFs which are funds. Note however that there is no official body that controls the designation “ETF” or authorises managers of investment structures to label their offerings: as a result the term “ETF” is not precisely and officially defined and in different parts of the world what is and is not considered an ETF may differ slightly.

In Europe, ETFs are generally UCITs funds and the primary ETP structures that are broadly listed on European Exchanges are ETNs (Exchange Traded Notes) and ETCs (“Exchange Traded Certificates, Commodities or Currencies”). All of these products are similarly listed and traded on regulated exchange venues, but the legal, structures, investment objectives, techniques used, and risks can differ between, and within, the three main categories of European products ETFs, ETNs, and ETCs .

Table: Summary of characteristics of different exchange traded funds and products

Characteristic	Physical ETF	Swap-based ETF	Physical ETC	Synthetic ETN
Investment strategy	Replicate the index by holding index constituents	Swap agreement (funded or unfunded) to receive index exposure	ETCs are debt securities (possibly undated) backed by physical asset Broader investment vs UCITS	Debt obligation whereby issuing entity replicates the index return through synthetic exposure Broader investment vs UCITS
Vehicle/Issuer risk	Assets held in ring-fenced segregated accounts or a ring-fenced fund company	Assets held in ring-fenced segregated accounts or a ring-fenced fund company	Unregulated- private contractual arrangement None-assets held in ring-fenced segregated accounts with a ring-fenced SPV	Unregulated – private contractual arrangement Credit exposure to the issuer of the ETN or derivative contract – reduced if notes collateralised
Counterparty Risk Exposure	Minimal counterparty risk exposure Possible exposure within securities lending (can be reduced through OC)	Credit exposure diversified with multi-swap counterparties Risk exposure restricted to 10% (UCITs) – can be reduced through collateralisation	Minimal counterparty risk exposure – trustee has charge over physical, ring fenced assets No lending takes place	Investors have full exposure to the risk of issuer default Can be reduced by collateral or guarantees
Fee structure	Transparent all fees included in TER Total cost of ownership reduced by tighter spreads and securities lending revenue	Swap spread and TER are deduced from the fund performance Swap spread can be positive or negative	Transparent – all fees included in TER	Transparent – fees included within the TER and benchmark replication fee
Performance	Tracking difference result from trading and rebalance costs associated with holding the index constituents Optimisation may result in tracking difference	Swap counterparty guarantees the index return – investor receives the index performance less TER and swap spread	The certificates/ notes provide exposure to the spot price of the physical asset less the TER	Return the index exposure less TER & benchmark replication fee plus any return from collateral
Transparency	Holdings published daily	Transparency of holdings, fees, risk exposure and collateralisation varies	Holdings (physical asset entitlement) provided daily	Generally less transparent regarding SPV holdings
Listing & Cross Listing Process	Can be registered & cross-listed across the EU under the UCITS III directive	Passportable across the EU under UCITS III	Passportable across EU under Prospectus Directive	Passportable across the EU under the Prospectus directive

The table below is looking in greater detail at the main differences between ETFs and ETNs, the most common alternative to ETFs.

Table: Main differences between ETFs and ETNs

	Exchange Traded Fund (ETF)		Exchange Traded Note (ETN)
Exchange listed	Yes		Yes
Low Tracking Error	Yes		Yes
Low costs	Yes		Partly
Exposure to market risk of asset class/index	Yes		Yes
Structure	Mutual Fund		Senior Secured Note
UCITS	Yes		No
Underlying Holdings	replication-based: Index securities (constituents)	Swap-based: basked of non- index securities plus Index swap	n/a
Issuer Risk	No		Yes, full exposure to credit of note issuer
Swap counterparty risk	No	Yes, limited to 10% of fund assets under UCITS	n/a
Other counterparty risk considerations	Securities lending and dividend enhancement activity		Some notes are backed by physical assets or guarantee to decrease issuer risk
Transparency	Full holdings disclosed	Limited	Limited
Competitive multi dealer model to trade on and off exchange	Yes	Limited	Limited

B: The different types of ETFs

Broadly speaking, there are two different types of ETFs: “physical” ETFs and “synthetic” ETFs. Physical ETFs were the original ETF concept: they aim to replicate the index they are linked to by owning the basket of physical securities underlying the index. The resulting fluctuation in the value of the basket shares reflects, at least to a close approximation, the changes in the overall index. All the early ETFs followed the physical replication methodology. Synthetic ETFs are a development from the original ETF concept and work through entering into a swap transaction with a third party counterparty or using other financial derivative instruments, rather than

physically replicating the underlying securities in the index they are aiming to track. Synthetic ETFs allow ETFs to enter into a greater variety of transactions and present the twin possibilities of firstly providing exposure to assets where physical holding of the asset is not possible, and secondly employing leverage (both positive and negative: it is possible to construct synthetic ETFs that provide returns corresponding to a multiple or inverse of the movement in an index).

Physical ETFs generally use either a replication or optimisation approach in purchasing underlying securities that are represented by the benchmark index. The full replication approach involves the manager purchasing all securities in the same weight as the underlying index. Over time, the manager then tracks changes in the index, handles subscriptions and redemptions, and manages cash flow from dividends. This strategy will therefore likely provide very close tracking with the underlying index. In an optimisation, or representative sampling, approach to physical replication the investment manager selects and purchases a portfolio of stocks that closely resembles that of the underlying index. The manager's objective remains to track the index but they have greater freedom in the selection of which securities to own in order to achieve the investment objective. The rationale for doing this is to control trading costs and promote liquidity, but the investment technique can introduce a higher level of tracking error.

There are two synthetic replication methods used by UCITS-compliant ETFs the unfunded swap and the funded swap. According to the unfunded swap replication method, the ETF owns: at least 90% [of the fund's NAV] securities plus maximum 10% total return swap exposure. The securities are owned directly by the fund, they are maintained by a fund custodian, just like any other type of mutual fund. As the fund has outright ownership of securities, collateral does not necessarily apply here. In the case of the funded swap replication method, the ETF owns a claim on the TRS counterparty, at a value which is equal to the benchmark market value. The collateral securities are not owned directly by the fund, they are pledged by the counterparty to the fund. The funded swap replication method carries more risk as investors do not get automatic access to the collateral in the event of an adverse credit event. These structures are usually over-collateralised in order to compensate for this risk.

Synthetic ETFs enable investors to gain exposure to markets that cannot be accessed through physical-based funds (such as commodities and some hard to access emerging markets countries). Furthermore, ETFs that gain their full exposure via a swap typically have lower tracking error, since the performance does not hinge on the provider's ability to track the index. However the trade off of using a swap to deliver the return of the index is the introduction into the ETF product of the added risk of a default by the swap counterparty (ies).

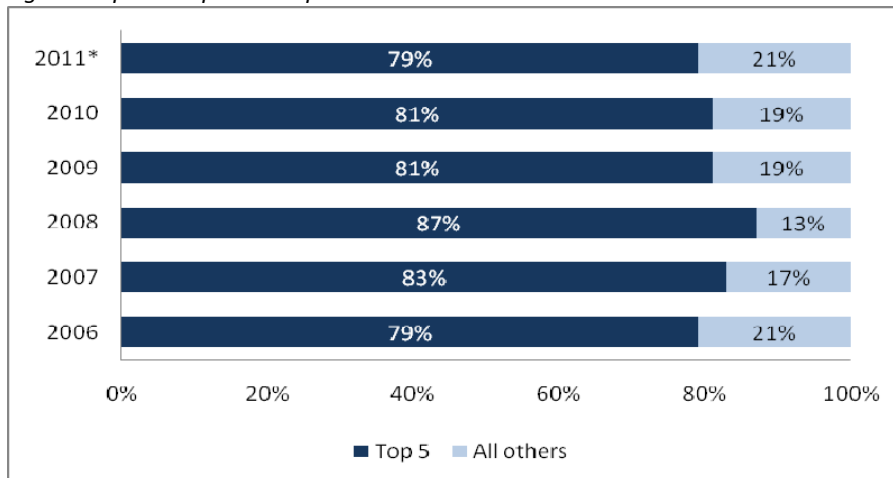
While the majority of the original providers of ETFs were investment management firms, and while they continue to play a leading role in the provision of plain vanilla ETFs to this day, synthetic ETFs are a natural product for investment banks to offer. With their derivative trading desks acting as the swap counterparty to the bank's own asset management arm, it has been efficient and cost effective for investment banks to produce synthetic ETFs.

Dealers have a number of incentives to become swap providers for synthetic ETFs. By signing up, they gain the opportunity to generate revenues from management fees, stock lending and any beneficial tax treatment that the ETF may receive. In addition, synthetic ETF structures allow swap providers to fund assets they hold that meet the conditions of the substitution basket/collateral

basket. In these ways, synthetic ETFs allow swap providers to optimize their collateral from a cost and liquidity perspectives.

There are currently 35 active providers in the European ETF market, but the largest 5 providers manage close to 80% of the region's assets as of 24/01/11. The top 5 providers' market share has been remarkably stable over the past 6 years, despite a steady increase in market entrants.

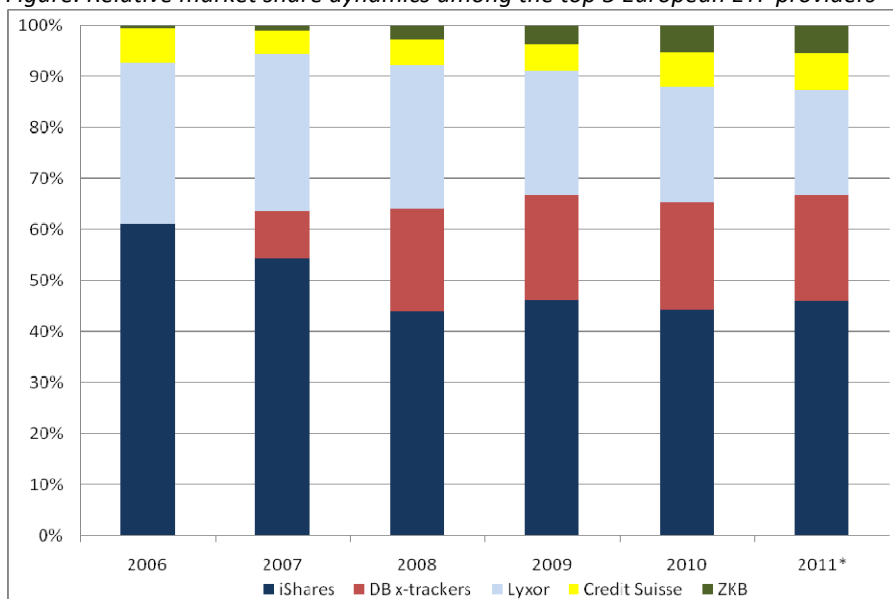
Figure: Top 5 European ETF providers market share



Source: Deutsche Bank- July 2011 report
*As of 24/06/2011

What has changed significantly however over the past 6 years is the market share that the top 5 providers share among themselves.

Figure: Relative market share dynamics among the top 5 European ETF providers



Source: Deutsche Bank- July 2011 report
*As of 24/06/2011

The majority of synthetic ETFs exist outside of the United States, both in numbers of funds and especially in terms of AUM. In Europe, a preference for ETFs which are open-end index funds regulated by the Undertaking for Collective Investment in Transferable Securities Directive (UCITS) has emerged, and the attractiveness and ready acceptance of the UCITS brand has for some time facilitated a growth in the creation and use of ETFs. The growth of European ETFs is also aided by the fact that the UCITS regulations has allowed structures such as ETFs to gain exposure using derivatives and still qualify as a UCITS-compatible vehicle. Despite this, even in Europe, physical based ETFs have the greater share of assets: at the end of Q1 2011 in Europe, there were 714 synthetic based ETFs with US\$138.0 Bn in AUM, compared to 405 physical based ETFs with US\$169.1 Bn in AUM¹.

As previously noted, there is also a growing array of notes, partnerships, grantor trusts, and commodity pools (ETNs, ETCs, ETVs, and ETPs) that are often confused with ETFs. These products often carry very different counterparty, regulatory and tax implications for investors. As the landscape becomes increasingly varied and increasingly crowded, there is a growing realisation that consistency in definitions, clarity and transparency on these products is of increasing importance for regulators and investors alike.

The assets in an exchange traded fund are separate and distinct from the assets of the various service providers such as asset managers, index providers, custodians, etc. Generally, the ETF is not directly subject to the credit risk of a service provider. This is a major strength of the ETF product and an attraction for investors.

Table: Main reasons for the success of ETFs

Transparency	<ul style="list-style-type: none"> Investors know the index methodology and composition ETF holdings, price and costs
Liquidity	<ul style="list-style-type: none"> May be transacted throughout the trading day at negotiated prices like a stock Creation and redemption process allows for liquidity in the markets for the underlying securities to build the liquidity of the ETF
Diversification	<ul style="list-style-type: none"> ETFs provide immediate exposure to a basket or group of securities for instant diversification Broad range of asset classes including equities, bonds, commodities, investment themes, etc
Flexibility	<ul style="list-style-type: none"> ETFs are listed on exchanges and can be traded at any time the market is open Pricing is continuous throughout the day
Cost effectiveness	<ul style="list-style-type: none"> ETFs offer a cost-effective route to diversified market exposure The average Total Expense Ratio (TER) for Equity ETFs in Europe is 40 bps versus 91 bps (per annum) for the average index tracking fund and 180 bps (per annum) for the average active fund²

¹ Blackrock, April 2011 report.

² Source: Morningstar, Global ETF Research and Implementation Strategy Team, BlackRock.

As at end February 2010.

Note: the TER numbers are calculated as simple averages

C: Data on the ETF market and ETF providers

At the end of April 2011, the global ETF industry had 2,670 ETFs with 6,021 listings and assets of US\$1,469.8 Bn, from 140 providers on 48 exchanges around the world. This compares to 2,189 ETFs with 4,354 listings and assets of US\$1,113.1 Bn from 122 providers on 42 exchanges at the end of April 2010³.

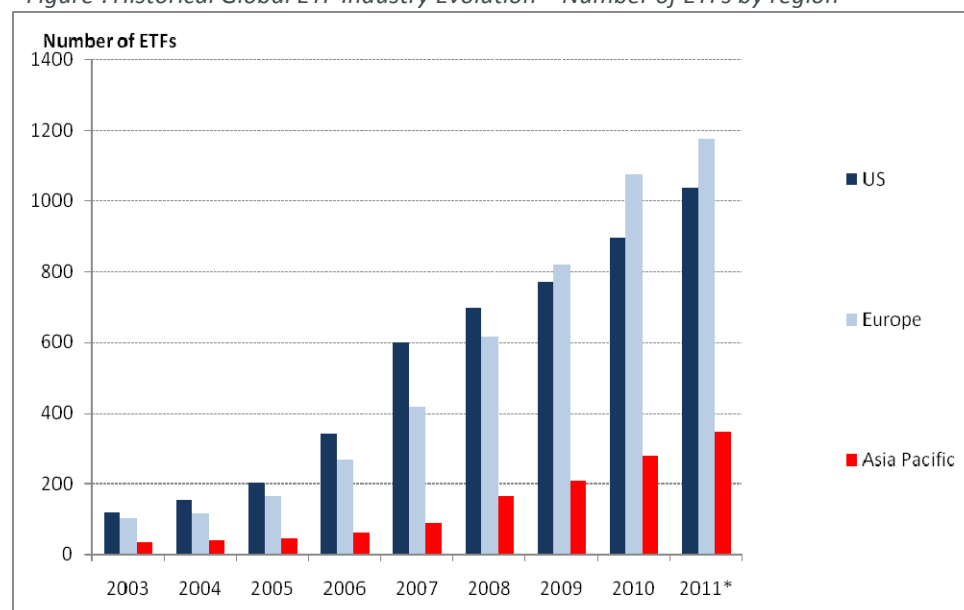
The number of ETFs listed in Europe surpassed the United States in April 2009. At the end of April 2011, Europe had 1,128 ETFs listed, compared to 972 ETFs listed in the United States. There are currently at the time of writing (July 2011) plans to launch 1,055 new ETFs globally compared to 872 at the end of April 2011.

Table: Summary of compound annual growth rates, as at year end 2010

	Global			United States			Europe		
	1 year	5 year	10 year	1 year	5 year	10 year	1 year	5 year	10 year
ETF AUM	26.6%	26.1%	33.2%	26.3%	24.4%	29.8%	25.2%	38.9%	83.0
ETP Assets	46.2%	60.7%	42.2%	36.4%	52.8%	37.4%	99.5%	95.3%	N/A
Total Assets	28.2%	28.2%	34.0%	27.4%	26.4%	30.5%	30.0%	41.3%	84.9%
ETF providers	25.9%	29.7%	32.8%	-3.4%	28.5%	25.0%	14.7%	15.5%	34.6%
ETF providers	42.1%	43.1%	39.0%	17.6%	82.1%	34.9%	125%	35.1%	N/A
Total providers	27.3%	26.4%	32.6%	4.8%	37.4%	27.1%	25.7%	15.9%	36.2%

Source: Global ETF Research and Implementation Strategy Team, BlackRock, Bloomberg.

Figure : Historical Global ETF Industry Evolution – Number of ETFs by region

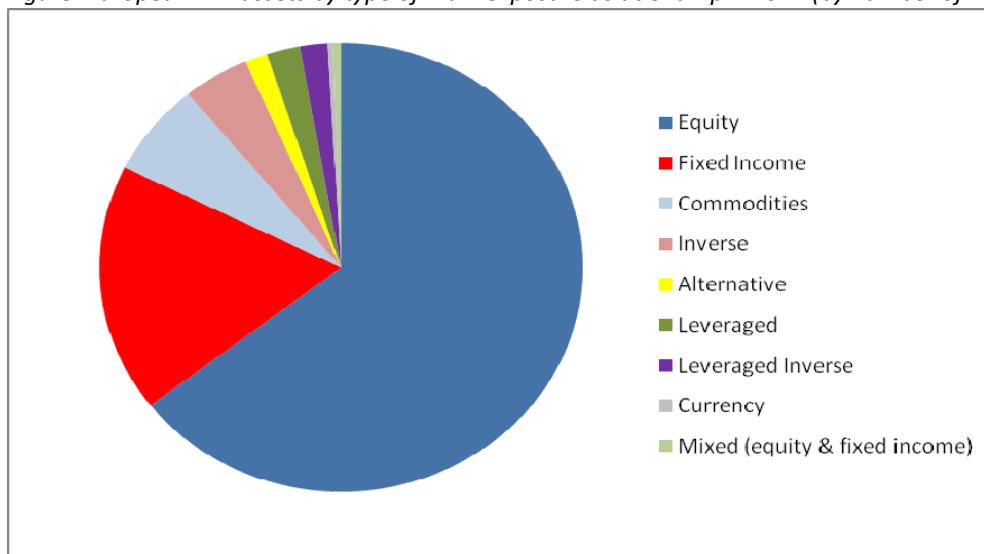


Source: Deutsche Bank- July 2011 report

**As of 24/06/2011*

The landscape will continue to evolve during 2011 and beyond as more products from traditional active asset managers and alternative asset class exposures are becoming available to ‘mainstream’ retail and institutional investors through standardised and regulated fund structures under UCITS in Europe.

Figure: European ETF assets by type of main exposure as at end April 2011 (by number of ETFs)



Source : Global ETF research and Implementation Strategy Team, BlackRock, Bloomberg

ETF providers have continued to expand their product ranges in more specialised areas to cater for the growing number of professional and retail investors using ETFs as advanced portfolio construction tools. The increasing availability of these highly-specialised ETFs across the full spectrum of equities, fixed income and alternative investments now ensures that investors can use ETFs to instantly reallocate capital to take advantage of new investment opportunities.

D: The regulatory landscape for ETFs in the EU and elsewhere

After UCITS III introduced greater flexibility in the ability to use derivatives in the way funds and ETFs are managed, many ETF providers along with mutual funds in Europe embraced the use of listed and OTC derivatives as the way they run their funds. As noted, this provided a major boost to the creation of synthetic ETFs (see section A).

Many regulators around the world are currently looking at general rules regarding short selling, the use of derivatives, the use of commodity futures, and transparency of fees to name a few of the current regulatory concerns. These reviews are typically part of the regulatory authorities’ overall investigation of how markets work and how they responded to the financial crisis, and the various reviews are usually not specifically into the operation of ETFs, and in addition, many of these documents are in the consultation phase and/or the specific guidelines for implementation have not yet been defined. Nevertheless it is clear that these developments will impact the use of derivatives by UCITS funds, including ETFs, in due course.

This regulatory interest is only part of the growing awareness of ETFs, which is causing more

people in all types of firms and regulators alike to look more closely at ETFs. Initially, ETFs were embraced because of a ‘back to basics’ environment where they provide transparency on the fund’s holdings, offer daily real-time creation/redemption, have multiple market-makers, and have real-time indicative NAVs, etc. The introduction of synthetic ETFs has on the one hand built upon and extended this interest and appeal, but on the other hand introduced the possibility of moving away from the initial simplicity of the plain vanilla ETF product.

As an example of this trend to a more nuanced approach, the US Financial Industry Regulatory Authority (FINRA) issued a regulatory notice in June 2009 to provide guidance on leveraged and inverse ETFs. The notice 09-31 stated that “...inverse and leveraged ETFs that are reset daily typically are unsuitable for retail investors who plan to hold them for longer than one trading session, particularly in volatile markets...”

Many investors have understandably expressed concerns over the increased counterparty risk, and the reduced transparency and liquidity when using structured products, swaps, certificates, and notes. Indeed there is evidence among some investors for a preference for ETFs where the structure is a fund, and often, more specifically for ETFs which invest exclusively in physical securities.

2: Assessment

E: Assessment of market trends in ETF development and usage

The AMIC Working Group firmly believes that the growth of the ETF market is directly linked to and in response to investors’ needs and demands. We see strong evidence that there is a real demand for the newer ETF products and that providers are meeting that demand rather than creating it.

To support this, a brief description is helpful in order to analyse the growth potential of the market. The motivations for using ETFs have expanded, beyond the ever-relevant issues of cost advantage and broad market access. Examples of strategies being implemented include managing asset allocation, taking tactical positions, and increasing diversification. Investors are also using ETFs to take negative positions in asset classes, either to remove existing unwanted exposure or to express a negative view.

There are no specific statistics for the European ETF market according to client type, but market players agree that the greatest contributor to volumes in the market is the trading community [fund managers and hedge funds], while the wealth management clients form the largest portion of the assets under management. The majority of the business, 60% to 80%, currently sits with investors such as fund managers and insurers. This is because, in Europe, ETFs are widely used for asset allocation and the largest asset allocators are fund managers. However it is expected that the wealth management will be a large driver for growth. Insurance companies will also be a client segment of growing importance for ETF providers, as it is more efficient for them to manage money on a top-down basis and make use of instruments like ETFs to implement their asset allocation decisions.

This expansion has been fuelled by the increase in the range of asset classes accessible through

ETFs. Therefore, the introduction of ETFs covering emerging markets, commodities and property has allowed investors to access some of the best performing asset classes of the past few years.

Depending on the specific requirements of the client, and at the early stage of selecting a defined asset class, it is usually discussed if active or passive strategies should be included in the investment solution proposed. In many cases this depends on the alpha potential of the targeted asset classes.

On top of greater asset breadth, the range of instruments has also grown. This expansion in usage, breadth and product flexibility has driven steady growth in the use of ETFs over the past decade.

Many surveys, and anecdotal evidence, show that liquidity is the most important factor for both asset managers and institutional funds when it comes to selecting an ETF provider. After liquidity, as far as quantitative considerations are concerned, institutional funds and asset managers focus mainly on providers' tracking error⁴ and total expense ratios⁵, followed by the performance of the fund⁶ and the track record⁷ of the fund itself. Finally valuation of the fund⁸ will be considered. Other qualitative information about products and strategies can be used for further filtering. For the qualitative assessment, questions regarding the ETF sponsor⁹ will be considered, the replication techniques used¹⁰, counterparty risks; use of securities lending¹¹; conditions for eligibility for the underlying assets and index construction; transparency¹²; creation and redemption process; availability of iNAV¹³; liquidity and size of the fund; Domicile of the fund and UCITS compliance; and client services. Finally for an ETF investor, another question is whether the distribution policy, the different replication techniques, and the fund volume amongst other factors have a systematic influence on the deviance between fair values and traded ETF prices.

A critical component to understanding the risks inherent in an ETF is the ability to assess counterparty risk. Ultimately, investors need to ask themselves whether the ability to turn their ETF investment into cash at or near NAV is achievable in a stress scenario. This is both a question of the likely outcome of an event of default by a swap counterparty and the potential lack of pricing liquidity in a stress scenario.

4 The lower the tracking error on the targeted index the better

5 Lower is better, but one has to bear in mind that for swap-based ETFs costs can be hidden in the swap structure. This would not be included in the TER.

6 A good ETF is expected to replicate the net return of the targeted index plus X where X stands for some basis points showing additional performance.

7 Normally a track record of at least three years is expected before considering the fund in a strategy.

8 Is the ETF in average over- or undervalued?

9 What is the company structure and setup? How is the relation of the issuer to his main swap counterparties, if total return swaps are used to replicate the index? Often the parent bank of the sponsor is also swap counterpart; Operational due diligence.

10 Full replication; Partial replication; Sampling Techniques; Unfunded swap-based; Funded swap-based.

11 Process, redemption and termination policy, how does the investor participate in these gains

12 What grade of disclosure does the ETF-manager have? Especially with regards to swaps: will the swap margin be disclosed? This margin will be re-negotiated with every reset and leave room to make gains without participation of the investor.

¹³ Indicative Net Asset Value - a measure of the intraday net asset value (NAV) of an investment.

In order to assess the impact and events of a counterparty default, an investor needs to be able to understand a number of aspects:

1. The credit quality of the swap counterparties that ETF providers are dealing with.
2. The type of collateral or substitute securities that are being provided to mitigate counterparty risk.
3. The haircuts applied to each collateral type.
4. The ability for the collateral policy to change.
5. The rights over the collateral / substitute basket and the ability to liquidate under a default event. The security interest held by the ETF fund will both impact their ability to control collateral movements and determine how quickly they will be able to access collateral in a default.

In terms of these 5 considerations, each ETF provider has a slightly different profile with varying levels of transparency. The differences in collateralisation between providers ultimately mean that different ETFs entail different counterparty credit risk. It was noted that major efforts have been made by many of the large providers recently to address some of these issues of transparency.

F: Assessment of the future development of the ETF market

ETFs will undoubtedly continue to be one of the preferred investment vehicles for low cost beta exposure. A number of factors are driving this growth. Firstly there is an increase in the number of institutional and retail investors who use ETFs and view them as useful tools. This will be driven further by moves to fee-based advisory by financial advisors which in some cases are based on requirements under regulatory changes. For instance, in the United Kingdom, ETFs have been cited by the FSA as one of the packaged products that advisers that consider themselves as independent should become educated on, as part of the Retail Distribution Review to be implemented in 2013. This will enable them to consider ETFs in their reviews prior to recommending products to their clients.

ETFs have been acknowledged as an investment tool which can be suitable for retail investment products as they can be a cost-efficient and transparent way to access the market. In addition on-line brokers are developing enhanced capabilities to assist retail investors and IFAs to firstly foster education on ETFs/ETPs and secondly facilitate the evaluation and comparison of specific products and execute trades. Furthermore, many on-line brokers are running no-commission marketing campaigns for ETFs in an effort to win new accounts and cross-sell other products. Fund platforms are also embracing ETFs, a move which is often driven by current clients asking for ETFs to be included.

It is also expected that regulatory changes in Europe will allow funds to make larger allocations to ETFs. In Germany, the rules were recently changed to allow insurance companies to hold up to 5% in commodities. Therefore, they will now be able to invest in products that directly track commodities indices. A new European directive targeting Independent Financial Advisors will come into effect, and will require IFAs to expand their range of products in areas such as ETFs. The number and types of equity, fixed income, commodity and other indices covered are increasing. And the number of exchanges which plan to launch new ETF trading segments is

growing.

Hedge funds, too, have shown an increased interest in the ETF space. Hedge funds have historically been difficult for many investors to access, with high minimum subscription levels and maximum investor limits, and for many funds, the ease of access and wide distribution networks of ETFs offer an attractive alternative way to provide their services to investors. As a result, there is a growing interest among the Hedge Fund community in creating ETFs with their own funds as the underlying exposure, in an effort to broaden their distribution capabilities. This will give more investors access to the asset class and the ability to do so in small sizes, with daily liquidity. The entry of Hedge Funds into the ETF universe does create some challenges, not least that of ensuring that investors fully understand what they are investing in: compared to the traditional index-based ETFs, ETFs based on underlying hedge funds may be less immediately transparent. But this is a challenge of providing suitable explanation and information, rather than one of the fundamental suitability of hedge funds as the underlying basis for the construction of ETFs.

G: Assessment of the value of the ETF “brand”

To succeed, any financial product has to satisfy a number of conditions. First and foremost, the product has to meet a real need, and satisfy a real demand from investors. A new financial product can indeed grow for a time without there being a real end-user demand for it, but without solid end-user demand, any growth in the usage of the product will almost certainly prove to be temporary and is unlikely to be sustained.

Secondly, the product has to be an efficient and robust solution to the needs of investors. A product that is expensive or carries unnecessary risks may succeed for a time while there is nothing better available, but it will always be at risk of being superseded by a better-engineered solution – one that carries reduced costs or reduces risks to end investors.

Lastly, for a product to succeed it should be easy to understand. Over-complexity and unnecessary opaqueness in financial structures and products reduces their acceptability, and especially following the experiences of many market participants in recent years, as the financial crisis exposed flaws and shortcomings in over-elaborate financial engineering, there is a considerable drive in the investor community back to products that are transparent and easily understood.

Any financial product that fulfils all three of these conditions – that is, it meets a real need, it does so efficiently and robustly, and it is transparent and easily understood – is very likely to succeed and be well received by the financial community and regulators alike.

The AMIC Working Group considers that the early ETFs (ie, version 1.0 or plain vanilla ETFs) clearly did and still do meet all three of these conditions, and moreover do so in a way that is unmatched by other competing products. Plain vanilla ETFs meet a genuine end-investor need, do so in a robust and efficient manner, and have a structure which is transparent and easy to understand. It is no surprise therefore that the ETF market has grown rapidly, or that the plain vanilla ETF product remains very popular and retains the confidence of investors.

The AMIC Working Group considers that the latter, more structured ETFs (ie, version 2.0 or synthetic ETFs) also clearly meet an investor need. The growth of the market, both in the number of ETF products and in the total assets under management that they represent, is strong evidence that there is a real demand for these products. The Working Group does not consider that the rate of growth that the synthetic ETF market has experienced is consistent with an artificial product created by providers for which there is no real demand.

The AMIC Working Group does however have reservations about the other two conditions identified for a product to be long-lasting and successful. The move to a more derivatives-based structure for version 2.0 ETFs has inevitably increased the complexity of the product and reduced their transparency, to the point that it is arguably no longer so easy for end investors to be confident they understand all the details of their operation.

Furthermore, while the case for synthetic ETFs to be “an efficient and robust solution” can be made, and many providers make claims for their products that they are indeed both efficient and robust, the product as a whole is as yet untried in more volatile markets and there remain issues of counterparty exposure and liquidity in times of market stress.

Both of these two concerns have led to increased regulatory interest in the ETF market: for regulators, the first (complexity and lack of transparency) raises issues of investor protection and suitability, and the second (efficiency and robustness) raises issues of systemic risk. The AMIC Working Group understands these concerns, and is keen to contribute to the process of addressing and resolving them.

The AMIC Working Group identifies, however, a challenge of ownership. The success of the ETF product, and the enthusiastic reception from investors for ETF offerings, has brought many new providers into the marketplace, and whereas the creation, provision and management of the early plain vanilla ETFs was concentrated in the hands of a few major players, the current ETF universe is characterised by a very wide and diverse range of offerings and providers. While this has the advantage of diversity, it carries with it the disadvantage that the ETF industry is without a central agreed authority or spokesman, to the extent that different providers’ definitions of what is an ETF and what qualifies to carry the ETF label can vary considerably.

Indeed, the AMIC Working Group observes that there is a risk that if left unchecked, this could cause the definition of what is an ETF (ie, what qualifies to use the ETF “brand”) to be stretched beyond what is useful, either for investors or regulators. The ETF brand is at the moment valuable – investors like and trust it – and the lack of an agreed formal definition of what qualifies as an ETF could lead to a situation where providers claim “ETF status” for products which differ in significant ways from what the investor community generally understand by the term.

The AMIC Working Group would see this as a retrograde step, reducing clarity for investors, and bringing the risk that a malfunction (for example a fund default or liquidity stop, or a counterparty event) in one product that claimed to be an ETF could adversely affect the reputation of the whole ETF market, including other products that are significantly different from the defaulting product.

3: Conclusions

The AMIC ETF Working Group believes that the growth of the ETF market is linked to genuine end-investor demand. The product is understood by investors and to a very great extent retains their confidence and trust, and the Working Group expects the recent growth in the number of ETFs to continue and the assets under management in ETFs to continue to rise. Indeed it is very possible that the growth of the market will encourage even more providers to enter the market, so that the outlook could be for the ETF sector to play an increasingly important part in both retail and institutional investment.

It is against this backdrop of a growing role for the ETF market that regulatory interest in the market has increased. Indeed in a real sense the official interest in the ETF market marks the importance of its position in the universe of investment vehicles today. The Working Group welcomes the increased scrutiny of regulators towards the ETF market and their willingness to work with providers to improve the functioning of the market.

Nevertheless the Working Group feels that it is important that ETFs are seen as part of the general investment landscape rather than unique and distinct from other forms of investment. Rules and regulations applied to ETFs should therefore not be out of line with those applied to other investment vehicles. On a practical note, and as this report has observed, the definition of what is and is not an ETF is not a hard or clean criterion: the lack of ownership of the ETF “brand” means that no single body – official or industry association – “owns” the ETF name or therefore can grant or withhold it (unlike, for example, the UCITS appellation, which is owned by the European Union and entirely within their control). It follows that any legislation aimed at ETFs per se risks being based on a weak and informal appellation: if the regulatory environment for ETFs becomes too onerous, providers will simply call their products something else.

This is unlikely to change: it is clear that there is no consensus between regulators and providers at the global level of what precisely constitutes an ETF or which funds can claim to be ETFs. Therefore the Working Group urges regulators to ensure a level playing-field between ETFs and other investment products: the industry will not be served well by restrictions and conditions applied to ETFs (or rather, funds which claim to be ETFs) which are not paralleled elsewhere, and indeed any regulations based on such an approach may prove insecure and not well-defined. In particular, any regulatory provisions that will affect UCITS-compliant ETFs need to be consistent with other regulatory provisions affecting UCITS funds.

Furthermore, Working Group members urge regulators to consider commensurate and proportionate measures in line with the risks posed by the ETF product. The emphasis should be on more transparency rather than the implementation of restrictive practices affecting ETFs products. Members of the Working Group feel strongly that the risks inherent in an ETF structure should be clearly explained; but this call for increased and understandable transparency is in fact a general principle which should apply to all investments, not specifically or uniquely to ETFs. (It is acknowledged that in fact the biggest providers already provide relevant and easily accessible information on their website – which could constitute best practice).

In conclusion, the ICMA AMIC Working Group welcomes the growth of the ETF market and recognises this as a positive and investor-led development. In firstly creating the ETF product and

more latterly developing it into the now wide range of derivatives-based ETFs that are available, the investment industry is responding well to investors' needs and concerns, and has so far met with end-user approval for their initiatives. The Working Group recognises that the increased size, importance and role of the ETF market demands and requires the interest and close attention of the regulatory community, and is committed to working with regulators in their endeavours. But the Working Group also believes strongly that the regulation of ETFs should be commensurate with the risks they pose, and should be in line with the regulation of other investment vehicles and not subject to a "special regime".