INVESTMENT COMPANY INSTITUTE

MEMO# 25128

April 20, 2011

FSB Issues Note on "Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds"; Conference Call April 25 to Discuss Possible ICI Comment Letter

[25128]

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 10-11
ETF ADVISORY COMMITTEE No. 26-11
INTERNATIONAL COMMITTEE No. 8-11
SEC RULES COMMITTEE No. 36-11 RE: FSB ISSUES NOTE ON "POTENTIAL FINANCIAL STABILITY ISSUES ARISING FROM RECENT TRENDS IN EXCHANGE-TRADED FUNDS"; CONFERENCE CALL APRIL 25 TO DISCUSS POSSIBLE ICI COMMENT LETTER

On April 12, the Financial Stability Board (FSB) issued a Note entitled "Potential financial stability issues arising from recent trends in exchange-traded funds." [1] The Note, which is briefly summarized below, highlights a number of recent developments in the exchange-traded fund (ETF) market that it believes warrant increased attention by regulators. The FSB has invited feedback from the public on the Note. [2] Comments are due May 16.

We will hold a conference call on Monday April 25 at 2:00 pm eastern time to discuss a comment letter from the ICI. The dial-in number is 800-369-1968 (int'l: 312-470-0189) and the passcode is 61203. Please let Jennifer Odom (jodom@ici.org or 202/326-5833) know if you will participate on the call. You may also provide comments directly to Mara Shreck (mshreck@ici.org or 202/326-5923).

Summary

The Note begins by noting the speed and breadth of financial innovation in the ETF market over the last five years. It divides ETFs into two main structures: "physical ETFs," which it describes as "'plain vanilla' products that replicate the index… by simply reconstituting the basket of physical securities underlying the index," and "synthetic ETFs," which "obtain the desired return through entering into an asset swap, i.e. an OTC derivative, with a counterparty." The Note explains that physical ETFs are the dominant form of ETF, especially in the US, while synthetic ETFs are growing rapidly in Europe and some Asian markets.

The Note then raises several concerns regarding risks to financial stability in "some corners of the ETF market." It explains that the impact of certain innovations on market liquidity and on financial institutions servicing the fund is not yet fully understood by market participants, especially during periods of severe market stress. It states that one trend warranting closer scrutiny is the acceleration in the growth of synthetic ETFs on some European and Asian markets, noting that because the swap counterparty to these funds it typically the bank also acting as the ETF provider, investors may be exposed if the bank defaults, and problems at such banks may constitute "a powerful source of contagion and systemic risk." The Note further suggests that conflicts of interest can arise from the dual role of banks in these situations, and that liberal collateral requirements raise the possibility that if it faced high redemptions, an ETF could have difficulty liquidating the collateral.

The Note next addresses concerns relating to disruptions in market liquidity. It states that further study would be useful with respect to the exit strategies and liquidity risk of ETF providers and swap counterparties in the event of a market sell-off or unwind in an individual ETF, particularly where the ETF permits cash redemptions. It also recommends further study on the potential impact of heavy ETF trading on the liquidity and price dynamics of the referenced securities, particularly where those securities do not have an active secondary market. Finally, it describes a potential liquidity risk from extensive securities lending in physical ETFs, positing that if an ETF experiences unexpected liquidity demands and must recall lent securities on a large scale, it could potentially cause a market squeeze in the underlying securities; it also notes potential operational risks if ETF shares are used as collateral in a long chain of secured lending.

The Note concludes by stating that there are significant benefits for authorities and ETF market participants alike in improving their understanding of the potential risks of collateralized structured operations in the contexts of both synthetic ETFs and ETF-based securities lending. It states that higher disclosure and reporting requirements, among other regulatory requirements, could help to alleviate certain risks, and it recommends that ETF providers consider enhancing the level of transparency they offer to investors.

Mara Shreck
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endnotes

[1] The Note is available at http://www.financialstabilityboard.org/publications/r_110412b.pdf.

[2] Press Release: Financial Stability Board publishes a note on financial stability issues from exchange-traded funds (ETFs), April 12, 2011, available at http://www.financialstabilityboard.org/press/pr_110412b.pdf.