MEMO# 25189

May 17, 2011

ICI Comment Letter on FSB Note on "Potential Financial Stability Issues Arising From Recent Trends in Exchange-Traded Funds"

[25189]

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 14-11
ETF ADVISORY COMMITTEE No. 32-11
INTERNATIONAL MEMBERS No. 15-11
SEC RULES MEMBERS No. 55-11 RE: ICI COMMENT LETTER ON FSB NOTE ON "POTENTIAL FINANCIAL STABILITY ISSUES ARISING FROM RECENT TRENDS IN EXCHANGE-TRADED FUNDS"

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 highlights a number of recent developments in the exchange-traded fund (ETF) market that the FSB believes warrant increased attention by regulators.

On May 16 ICI submitted a comment letter on the Note. The letter is attached and summarized below.

Summary

The letter states that ICI agrees in principle with the FSB's recommendation that authorities and market participants improve their understanding of the potential risks inherent in financial products, the ways financial innovations may interact with one another to amplify negative effects, and the ways in which such risks can be mitigated. The letter expresses ICI's belief that the concerns expressed by the Note primarily relate to one specific ETF structure – what the Note terms a "synthetic" ETF [2] – as well as the practice of securities lending by ETFs more broadly. It urges the FSB to use the utmost care in describing the applicability of perceived risks going forward, explaining that the Note's generalized statements about the "ETF Market" have led to inflammatory media coverage that unfairly paints all ETFs with the same "systemic risk" brush.

The letter then identifies the elements of the "synthetic" ETF described in the Note that appear to be the causes for concern by the FSB, including:

- The potential conflicts of interest arising from a fund sponsor's dual role as a derivatives counterparty;
- The risk of unexpected liquidity demands in the face of illiquid fund holdings;
- The possibility for a bank to create an ETF as a means to raise funding against an illiquid portfolio;
- The risk to fund shareholders of having the entire fund exposed to a single counterparty; and
- The lack of transparency to investors regarding the structure of the fund, counterparty risk, and collateral arrangements in which the fund engages.

The letter explains that the vast majority of ETFs globally, including all ETFs registered under the Investment Company Act of 1940 (ICA), do not share the two features that lead to these concerns, specifically the single-swap portfolio, entered into with an affiliated counterparty. It further explains that the ICA, along with its attendant regulations and guidance, establishes a framework under which such as structure could not operate. After providing some background on the U.S. ETF market, the letter enumerates and discusses the following elements of the ICA framework that address the concerns expressed by the FSB:

- Prohibitions on affiliated transactions;
- Liquidity requirements to meet liabilities and redemptions;
- Practices relating to collateral and counterparty risk; and
- Disclosure and transparency requirements.

Finally, to address the FSB's concerns with respect to securities lending by ETFs, the letter describes the relevant securities lending guidelines for funds regulated under the ICA, which relate to:

- Collateral and counterparty risk;
- Limitations on lending and the ability to recall loaned securities; and
- Conflicts of interest.

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Attachment

endnotes

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

[2] According to the Note, "synthetic" ETFs "obtain the desired return through entering into an asset swap, i.e., an OTC derivative, with a counterparty… They are typically provided by asset management arms of banks. One factor supporting their growth resides in the synergies created within banking groups if the derivative trading desk acts as swap counterparty to the asset management arm providing the ETF."