

MEMO# 26249

June 20, 2012

Draft Comment Letter on IOSCO Consultation on ETFs

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TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 20-12
ETF ADVISORY COMMITTEE No. 18-12
INTERNATIONAL COMMITTEE No. 18-12 RE: DRAFT COMMENT LETTER ON IOSCO
CONSULTATION ON ETFs

In March 2012, the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) issued a consultation report, Principles for the Regulation of Exchange Traded Funds (the “Report”). [1] The Institute has prepared a draft comment letter. We express our general support for the principles but provide some specific comments. Comments are due to IOSCO no later than June 27, 2012.

Please provide comments to Mara Shreck (mshreck@ici.org; 202-326-5923) or Susan Olson (solson@ici.org; 202-326-5813) by June 25, 2012.

In the Report, IOSCO states that it has developed 15 proposed common investor-protection principles on ETFs to guide regulators and markets. [2] The principles are intended to be adaptable to different regulatory frameworks. IOSCO states that some principles may be better suited to industry best practice rather than regulation. The Report also states that IOSCO work with respect to other areas of CIS regulation are applicable to the operation and management of ETFs. Therefore, IOSCO states that the Report chiefly identifies proposed principles that address unique issues, or concerns, posed by ETFs or adapts existing IOSCO principles to the specifics of ETFs and makes general recommendations when issues are not exclusive to ETFs or to securities markets regulation. [3] The Report groups the principles into four categories: (1) principles related to ETF classification and disclosure; (2) principles related to marketing and sale of ETF shares; (3) principles related to the structuring of ETFs; and (4) issues broader than ETFs (which focuses on market integrity). The Report sets forth the following principles:

Principle 1: Regulators should encourage disclosure that helps retail investors to clearly differentiate ETFs from other ETPs.

Principle 2: Regulators should seek to ensure a clear differentiation between ETFs and traditional CIS, as well as between index-based and non index-based ETFs through

appropriate disclosure requirements.

Principle 3: Regulators should encourage all ETFs, in particular those that use or intend to use more complex strategies, or other complex techniques, to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with such strategies or techniques.

Principle 4: Regulators should consider imposing disclosure requirements with respect to the way in which an ETF will replicate the index (or the asset basket or the reference portfolio) it tracks (e.g., physically holding a sample or full basket of the securities composing the index (or the asset basket or the reference portfolio) or synthetically).

Principle 5: Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio or other appropriate measures in order to provide adequate information to investors concerning: i) the index (or the asset basket or the reference portfolio) tracked and its composition; and ii) the operation of performance tracking in an understandable form.

Principle 6: Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio or other appropriate measures in order to facilitate arbitrage activity in ETF shares.

Principle 7: Regulators should encourage the disclosure of fees and expenses for investing in ETFs in a way that allows investors to make informed decisions about whether they wish to invest in an ETF and thereby accept a particular level of costs.

Principle 8: Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities.

Principle 9: All sales materials and oral presentations used by intermediaries regarding ETFs should present a fair and balanced picture of both the risks and benefits of such products, and should not omit any material fact or qualification that would cause such a communication to be misleading.

Principle 10: In evaluating an intermediary's disclosure obligations, regulators should consider who has control over the information that is to be disclosed.

Principle 11: Before recommending the purchase, sale or exchange of an ETF, particularly a non-traditional ETF, an intermediary should be required to take reasonable steps to ensure that recommendation is based upon a reasonable assessment that the product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.

Principle 12: Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations when recommending any ETF.

Principle 13: Regulators should assess whether the securities laws and applicable rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interests raised by ETFs.

Principle 14: Regulators should consider imposing requirements to ensure that ETFs appropriately address risks raised by counterparty exposure and collateral management.

Principle 15: ETF exchanges should consider adopting rules to mitigate the occurrence of liquidity shocks and transmission across correlated markets (e.g. automatic trading interruption mechanisms).

Susan Olson
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[Attachment](#)

endnotes

[\[1\]](#) See IOSCO CRO5/12, Principles for the Regulation of Exchange Traded Funds, Consultation Report, March 2012, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD376.pdf>.

[\[2\]](#) IOSCO states that the term “ETF” refers only to ETFs organized as collective investment schemes (“CIS”) and, for the United States, only ETFs regulated under the ICA. Report at 2 and footnote 7.

[\[3\]](#) Report at 3.