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Global Regulators Issue ETF Good Practices Report

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TO: ICI Members
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ETF (Exchange-Traded Funds) Committee
ETF Advisory Committee SUBJECTS: Exchange-Traded Funds (ETFs)
Financial Stability
International/Global RE: Global Regulators Issue ETF Good Practices Report

The International Organization of Securities Commissions last month published a report providing a set of good practices to supplement and implement their 2013 principles for the regulation of exchange-traded funds (ETFs) ("ETF Principles").[1] The good practices highlight issues for regulators, responsible entities, and trading venues to consider on how they can employ the ETF Principles in practice. The report consists of three main sections that: (1) provide background on ETFs; (2) highlight major themes and recent developments in the ETF market; and (3) recommend ETF good practices around (i) effective product structuring; (ii) disclosure; (iii) liquidity provision; and (iv) volatility control mechanisms (VCMs). The report also includes several appendices that furnish jurisdictional examples of good practices to consider.

Importantly, IOSCO concludes that the ETF Principles remain relevant and appropriate, and that it has identified no major gaps or regulatory issues as of the date of the report. It adds that the ETF structure generally has remained resilient during historical stress events. This memo provides a brief summary of the report.

1. Background on ETFs

The report describes the general characteristics and operations of all ETFs, including their intraday, secondary market liquidity and their arbitrage mechanism. It contrasts ETFs with unlisted open-end funds and other exchange-traded products (ETPs) (*e.g.,* exchange-traded commodity pools and exchange-traded notes) to highlight their unique features, such as their ability to pass portfolio transaction costs to authorized participants (APs) or AP clients and that ETFs often are subject to diversification and other risk management rules that do not apply to other types of ETPs.

The report also notes that ETFs and their trading activities are subject to robust regulatory frameworks across jurisdictions, but that individual jurisdictions may address potential ETF concerns in varying ways to achieve similar regulatory outcomes. These could include variances in (i) portfolio transparency requirements and the provision of an intraday, indicative net asset value (iNAV); (ii) affiliations among ETFs and service providers; (iii) disclosure requirements relating to the arbitrage mechanism, trading costs, and internal costs; (iv) asset classes and strategies; and (v) VCMs on trading venues. The report observes that there also may be jurisdictional differences in the investor base and the broader markets in which ETFs operate[2] and that jurisdictional variances among specific regulations may impact ETF operations.

2. Major Themes and Recent Developments in the ETF Market

The report next summarizes observations from a group of IOSCO members on major themes and developments in four main areas: (i) the arbitrage mechanism; (ii) ETF product structuring; (iii) volatility control mechanisms (VCMs); and (iv) financial stability.[3]

(i) Arbitrage Mechanism. IOSCO studied different jurisdictional approaches to see what elements may help facilitate effective ETF arbitrage, focusing on valuation information and AP, market maker (MM), and other liquidity provider (LP) participation. It found that different jurisdictions require different valuation information disclosure for effective arbitrage (*e.g.*, differences in portfolio transparency and other information used to value ETFs) but that those differences may be appropriate and that the arbitrage mechanism in each jurisdiction generally has been effective. It also found that AP participation rates were robust and, even when an AP steps away, arbitrage disruptions have been short lived with other APs stepping in. In addition, it found that the arbitrage mechanism is not solely dependent on AP participation, as LPs may engage in arbitrage activity through an AP on an agency basis or through positions in ETF shares or their underlying assets on the secondary market.

To enhance risk disclosures related to the arbitrage mechanism, certain secondary market trading costs, and previous IOSCO guidance,[4] IOSCO identified additional areas where regulators and responsible entities may consider supplementing existing disclosure guidelines. These include:

- providing quantitative data to highlight how an ETF's arbitrage mechanism has performed (*e.g.*, historical trading premium/discount to net asset value (NAV))
- disclosing trading and other internalized costs (*e.g.*, the median bid-ask spread, swap costs, and rebalancing costs); and
- differentiating ETFs from other ETPs and unlisted open-end funds.

(ii) ETF Product Structuring. IOSCO reviewed ETF product design and structure, focusing on (i) facilitating effective arbitrage and efficient secondary market trading, (ii) ETFs with novel asset classes and complex strategies, and (iii) management of conflicts of interest between ETFs and service providers. For facilitating effective arbitrage and secondary market trading, IOSCO highlights good practices on ETF managers' selection and oversight of APs and LPs; primary market arrangements; open AP/LP architecture; contingency planning; and mitigating operational risks to support APs and LPs that seek to engage in arbitrage. On novel asset classes and more complex strategies, it notes that some jurisdictions impose specific obligations on managers to consider the characteristics of target investors (*e.g.,* their knowledge, investment objectives, and needs), while others principally focus on disclosure about the risks associated with investing in an ETF and may impose other regulatory limits (e.g., on liquidity and diversification). IOSCO also considered areas where conflicts could arise in addition to the ones listed in the ETF Principles. It highlighted the conflicts related to the construction of creation/redemption baskets that are negotiated bilaterally between an affiliated AP and an ETF, but it noted that many jurisdictions that permit such affiliations have established policies and requirements to mitigate such potential conflicts.

(iii) Volatility Control Mechanisms (VCMs). IOSCO notes that many jurisdictions and trading venues have imposed VCMs to address risks to orderly markets from extreme volatility events. For example, it notes that many jurisdictions have VCMs based on historical secondary market price movements, while some European trading venues link ETF circuit breakers to iNAVs.

(iv) Financial Stability. IOSCO highlights its significant engagement with the Financial Stability Board (FSB) to explore issues related to ETF liquidity and the activities of ETFs during the COVID-19 volatility.

ETF and Liquidity Risk. IOSCO concludes that the ETF structure has remained relatively resilient and that neither the FSB nor IOSCO observed significant information indicating that ETFs negatively impact underlying markets or that ETFs would contribute to a liquidity shock or crisis. Instead, observers noted that the structural features of ETFs and their tools could mitigate potential liquidity risk through secondary market liquidity or in-kind redemptions.[5] Observers also noted that the ETF structure can provide additional liquidity because investors can adjust their market exposures by trading ETF shares on the secondary market without directly impacting the ETF or underlying markets. This secondary market liquidity compared to certain underlying markets also can provide an additional source of pricing information for the underlying portfolio assets.

Nevertheless, during stressed periods, some fixed-income ETFs may display more significant or persistent discounts and spreads. In addition, it observed that certain derivative-based ETFs and ETPs, representing a small portion of the ETF/ETP market, experienced more significant volatility and operational challenges.

COVID-19 Market Volatility. IOSCO reviewed the activities of ETFs during the COVID-19 volatility and found that most ETFs remained resilient during March 2020, despite significant volatility in the underlying markets. Discounts and spreads for most ETFs temporarily increased before generally normalizing. Similarly, primary and secondary market activities generally functioned as intended and neither IOSCO nor the FSB identified any major risks associated with the ETF structure.

Nevertheless, certain fixed-income ETFs briefly experienced discounts between their ETF share price and NAV. Some observers suggested that these fixed-income ETFs, which generally are more liquid than their underlying fixed-income holdings, may have played a role in providing additional pricing information for the underlying markets, as some ETF valuation inputs (*e.g.,* the last traded prices of bonds) were comparably staler than the ETF's secondary market price. In addition, some derivatives-based ETFs and ETPs (*e.g.,* with oil futures and/or leveraged/inverse strategies) experienced significant volatilities and operational difficulties. The report notes that, while these derivatives-based products constitute a small portion of the space, if not properly mitigated, the risks could impair the viability of ETFs and ETPs.

3. ETF Good Practices

Based on IOSCO's reviews, IOSCO recommends 11 good practices in four categories: (i) effective product structuring; (ii) disclosure; (iii) liquidity provision; and (iv) volatility control mechanisms (VCMs). Each of the good practices ties to certain of the ETF Principles and is listed below.

(i) Effective Product Structuring – Relevant ETF Principles #4, 7, 8, and 9

Measure 1. Regulators and responsible entities are encouraged to consider the range of asset classes and investment strategies that may be appropriate for the ETF structure, taking into account their nature, novelty, and complexity, and the effectiveness of the arbitrage mechanism for such assets and strategies.[6]

Measure 2. Regulators are encouraged to consider requirements regarding the transparency of an ETF's portfolio and/or other appropriate information provided to market participants so as to facilitate effective arbitrage.

Measure 3. For jurisdictions that mandate the provision of iNAV, regulators and/or trading venues are encouraged to consider means to enhance the accuracy and usefulness of iNAV.

Measure 4. Responsible entities are encouraged to:

(i) conduct due diligence on APs and MMs when onboarding them to the ETF, with a view towards having those that are capable of facilitating an effective arbitrage mechanism and providing liquidity;

(ii) conduct ongoing monitoring on APs and MMs for the ETF regarding, amongst others, the functioning of the arbitrage mechanism and liquidity provision;[7] and

(iii) avoid exclusive arrangements with APs and MMs if they may unduly affect the effectiveness of the arbitrage mechanism.

Measure 5. Responsible entities are encouraged to put in place appropriate arrangements to facilitate an effective arbitrage mechanism, including contingency plans to address the circumstances where the arbitrage mechanism of the ETF is impaired.[8]

Measure 6. Regulators are encouraged to consider whether the securities laws and applicable rules of securities exchanges within their remit and jurisdictions appropriately address potential conflicts of interest raised by ETFs.

(ii) Disclosure – Relevant ETF Principles #1, 2, 5, 6, and 7

Measure 7. For ETFs, in particular those that invest in more complex or novel asset classes, or use more complex investment strategies, regulators are encouraged to consider appropriate requirements for the adequacy and appropriateness of the disclosures regarding ETF-specific aspects, including whether certain disclosures are presented in an understandable manner and whether they address the nature of risks associated with the ETFs' strategies.

Measure 8. Regulators are encouraged to consider appropriate requirements for the disclosures of fees and expenses for investing in ETFs (including secondary market trading costs) 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.

Measure 9. Regulators and responsible entities are encouraged to consider appropriate disclosure requirements or disclosures to help investors to clearly differentiate ETFs from other ETPs / collective investment schemes, as well as appropriate disclosures for index-based and non-index-based ETFs.[9]

(iii) Liquidity Provision – Relevant ETF Principle #9

Measure 10. Regulators and/or trading venues, where applicable, are encouraged to monitor secondary market trading and market-making activities of ETFs and have rules governing the orderly trading of ETF shares.

(iv) Volatility Control Mechanisms – Relevant VCM Recommendations #2 and 8

Measure 11. Regulators and/or trading venues, where applicable, are encouraged to appropriately calibrate VCMs applicable to ETFs, considering factors including their liquidity profile and volatility profile. Where an ETF is listed or traded on a number of trading venues, those trading venues are encouraged to consider communicating with one another as appropriate when VCMs are triggered.

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Notes

[1] See IOSCO, Good Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds (May 2023), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD733.pdf. The 9 ETF Principles cover a wide range of topics, including disclosure, portfolio transparency, costs, risks, strategies, and structuring issues related to counterparties and conflicts of interest. See IOSCO, Final Report on Principles for the Regulation of Exchange Traded Funds (June 2013), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD414.pdf. We attach a list of IOSCO's ETF Principles as Appendix A.

[2] For example, in Europe, ETFs are mainly traded in the over-the-counter market or on multilateral trading facilities by institutional investors. In comparison, ETF trading generally takes place on exchanges in the US and Asia and there is greater retail participation in the US.

[3] The group of IOSCO members consisted of regulators from: Autoriteit Financiële Markten (AFM, Netherlands), Autorité des Marchés Financiers (AMF, France), Central Bank of Ireland (CBI, Ireland), European Securities and Markets Authority (ESMA), Financial Conduct Authority (FCA, UK), Securities and Futures Commission (SFC, Hong Kong) and Securities and Exchange Commission (SEC, US). These regulators reviewed academic literature and surveys from regulators and industry participants; engaged with industry stakeholders, academics, other IOSCO subcommittees, and, through IOSCO, engaged with international bodies such as the Financial Stability Board; and evaluated lessons learned from major market events affecting ETFs (e.g., the COVID-19 volatility).

[4] See, e.g., ETF Principles; IOSCO, Good Practice for Fees and Expenses of Collective Investment Schemes (Aug. 2016), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD543.pdf.

[5] Some jurisdictions also may impose redemption gates or suspend primary market transactions, which IOSCO notes may help mitigate potential liquidity/run risk and the potential risk transmission between ETFs and their underlying markets.

[6] The report suggests that, when making these considerations, responsible entities could consider: (a) the nature, novelty, and complexity of the asset class or strategy; (b) the effectiveness of the arbitrage mechanism; (c) whether there is orderly secondary market trading; (d) the capacity or liquidity of the asset in its underlying market and local circumstances (e.g., relative investor familiarity with ETFs); and (e) the availability and capability of the service providers (including, index providers, APs, LPs, and swap counterparties).

[7] The report provides considerations for responsible entities to consider when onboarding and continuing to monitor APs and MMs, including: (a) whether the APs/MMs have sound financials, a clear ownership structure, good reputation and clean regulatory history; (b) whether the operational structure of the APs/MMs can also facilitate trading in overseas markets (where appropriate) and for overseas investors; (c) whether APs can facilitate in-cash, in-kind, and custom basket formats to provide more flexibility for primary market transactions; (d) whether the APs/MMs can hedge their exposure in an ETF and have flexibility in its inventory management to facilitate arbitrage or liquidity provision; (e) whether APs/MMs participate in clearing or have other features to help facilitate settlement; (f) whether APs/MMs can support the arbitrage mechanism and liquidity provision both in normal times and under stressed market conditions, particularly for ETFs invested in novel asset classes or implementing more complex investment strategies; and (g) whether there is an adequate number of and diversified set of APs/MMs, which can help maintain competitive bid-offer spreads and tight pricing relative to NAV or fair value.

[8] Based on an IOSCO survey, the report identified the following practices that may facilitate effective arbitrage: (a) a clear and cost-quantifiable creation/redemption mechanism; (b) enabling custom baskets which can facilitate creation/redemption of, in particular, fixed-income ETFs by allowing APs to deliver/receive a subset of the portfolio according to credit, duration, sector, country and issuer metrics; (c) having multiple APs per ETF available to step-in in the event that any particular AP is not able to carry out creations/redemptions for any reason; (d) facilitating an open AP architecture to promote competition; (e) widening the availability of APs/MMs by allowing appropriate / qualified firms from outside an ETF's jurisdiction to act as APs/MMs; and (f) smaller minimum creation / redemption basket sizes where possible. In addition, the report suggests that, for jurisdictions that do not require full daily portfolio transparency, responsible entities should consider providing additional information about the ETF portfolio than what otherwise may be required. Further, the report suggests that responsible entities diversify an ETF's key service providers to mitigate the risks of operational disruption.

[9] The report notes, that it generally is good practice that a given jurisdiction impose disclosure requirements that help (a) differentiate ETFs from other ETPs and other collective investment schemes; and (b) understand an ETF's investment strategy. Where appropriate, however, the report suggests that responsible entities also consider additional investor outreach to help provide greater clarity for investors.