

## COMMENT LETTER

May 16, 2011

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

May 16, 2011 Secretariat of the Financial Stability Board c/o Bank for International Settlements CH-4002 Basel, Switzerland Re: Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds Dear Sir or Madam: The Investment Company Institute<sup>1</sup> appreciates the opportunity to comment on the Financial Stability Board's Note entitled "Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds" ("Note"). As a general principle, we strongly agree 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.

Fundamental to such an analysis is a comprehensive understanding of the range of financial products available globally,<sup>2</sup> the markets in which they are offered,<sup>3</sup> and the regulatory structures under which they operate. To the extent certain products, practices, or markets are a source of concern, it is 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers.

Members of ICI manage total assets of \$13.1 trillion and serve over 90 million shareholders.

2 For example, we disagree with the statement in the Note that exchange-traded notes ("ETNs") and exchange-traded vehicles are "close substitutes" of ETFs. Unlike ETNs, the shares of ETFs confer voting rights and represent a pro-rata share of the net assets of the fund. In contrast, ETNs are debt instruments that typically represent unsecured, unsubordinated obligations of the issuer. The risks, rights and terms of a note are materially different from those of a share of an ETF. 3 See, e.g., "Liquidity problems hold back European ETFs," Financial Times (Nov. 30, 2010)(suggesting that liquidity in European ETFs is problematic, and attributing liquidity challenges in part to fragmentation across a large number of different exchanges, as well as multiple currency versions of otherwise similar ETFs). Secretariat of the Financial Stability Board May 16, 2011 Page 2 of 14 critical that regulators, market participants, and commentators alike make these distinctions clearly and consistently to avoid confusion and unwarranted negative public perceptions about investment products that do not share the same features or potential risks. Although the Note broadly states that growth and innovations in the ETF market warrant increased

attention by regulatory and supervisory authorities, and that there are “new elements of complexity and opacity,” we believe the concerns expressed by the Note primarily relate to one specific ETF structure – what the Note terms a “synthetic” ETF – as well as the practice of securities lending by ETFs more broadly. As a preliminary matter, we urge the FSB to use the utmost care in describing the applicability of perceived risks going forward. 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.<sup>4</sup> The elements of the “synthetic” ETF described by the Note that are cause for concern are by and large unique to this particular structure. As the Note explains, “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.” The Note raises specific concerns about:

- 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 raise funding against an illiquid portfolio through this type of ETF by designating a portfolio for a fund to hold in exchange for a swap;
- 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 vast majority of ETFs globally do not share the two features that lead to these concerns, specifically the single-swap portfolio, entered into with an affiliated counterparty.<sup>5</sup> Indeed, none of the ETFs registered in the United States under the Investment Company Act of 1940 (“ICA”), which

4 See, e.g., “Blog: Could ETFs Become the Next Toxic Assets?” Wall Street Journal (April 14, 2011); “Super-regulator issues ETF warning,” Ignites Europe (April 13, 2011); “FSB says exchange traded funds merit more scrutiny,” Reuters News (April 12, 2011).

5 As the Note indicates, as of September 2010 assets in synthetic ETFs constituted 45 percent of the European ETF market, which itself constitutes approximately 20 percent of the global market – for a total of less than 10 percent of global ETF assets. Secretariat of the Financial Stability Board May 16, 2011 Page 3 of 14 comprise 68 percent of all global ETF assets,<sup>6</sup> share these features – including those that rely on derivatives to achieve their investment objectives.<sup>7</sup> The ICA, along with its attendant regulations and guidance, establishes a framework under which such a structure could not operate. These include:

- Prohibitions on affiliated transactions and other forms of self-dealing;
- Tight restrictions on leverage;
- Daily valuation of fund shares using mark-to-market valuation;
- A requirement to redeem shares daily (except for closed-end funds);
- Separate custody of fund assets; and
- The most extensive disclosure requirements faced by any U.S. financial product.

Each of these elements of the ICA regulatory framework is discussed in more detail below.<sup>8</sup> We also address the FSB’s concerns with respect to securities lending, which may occur in ETFs that invest primarily in securities as well as those that rely on derivatives to meet their investment objective. We hope that these comments are useful to the FSB as it pursues its critical mission of identifying potential vulnerabilities to global financial stability and the actions that may be needed to address them.

Background: The U.S. ETF Market As of March 2011, ETFs registered under the ICA held \$947 billion in assets under management, or 68 percent of the global ETF market. The vast majority of these assets (96 percent) are held in what the FSB would call “physical” ETFs – funds that seek to track an index by either replicating or sampling the securities in the index. A small portion (0.4 percent) is held in actively- managed ETFs, which also invest primarily in securities but do not seek to track an index. Some of these funds, both index-based and actively managed, may use derivatives such as futures, forwards,

6 Source: ICI and Blackrock data as of March 2011.

7 The Note observes that the U.S. Securities and

Exchange Commission (“SEC”) has taken a more conservative approach to the use of derivatives in ETFs, “limiting de facto the development of synthetic ETFs.” As discussed herein, even notwithstanding the SEC’s temporary deferral of applications for ETFs that make significant use of derivatives, a synthetic ETF as described in the Note could not operate under the ICA framework.<sup>8</sup> Our comments are not meant to suggest that the ICA structure for ETFs is superior to other ETF regulatory structures, either within the U.S. (e.g., commodity-based ETFs, which invest in physical commodities (e.g., precious metals), and are subject to disclosure review by the SEC’s Division of Corporation Finance as well as exchange regulation, or ETF commodity pools, which attempt to track a benchmark index or commodity through commodity futures and/or options, and are regulated by the Commodities Futures Trading Commission (“CFTC”), see, e.g., CFTC, Request for Comment on Options for a Proposed Exemptive Order Relating to the Trading and Clearing of Precious Metal Commodity-Based ETFs; Concept Release, 75 FR 188, 60411 (Sept. 30, 2011)) or beyond our borders. Indeed, we believe that the variety of regulatory structures and product offerings are important to the broad ETF market and offer investors a wide range of ETFs from which to choose. Rather, as the association of U.S. investment companies, we offer these comments simply to ensure that international regulators correctly understand the regulatory structure to which ICI members adhere.

Secretariat of the Financial Stability Board May 16, 2011 Page 4 of 14 options, or swaps, in addition to traditional securities, to meet their investment objectives, subject to the limitations under the ICA and related rules and guidance discussed below. As the FSB report noted, in March 2010 the SEC announced the deferral of new applications for ETFs that make significant use of derivatives,<sup>9</sup> so as a practical matter such usage is limited. Another category of funds that have received a great deal of attention in the U.S. market is leveraged and inverse ETFs. These funds, which comprise 3.5 percent of the U.S. ETF market, also seek to track an index, or more specifically a multiple or an inverse of an index, on a daily basis. They rely to varying degrees on derivative instruments to achieve their objectives. Leveraged funds typically invest a sizeable amount of their assets in the securities of the target index. The remaining assets are invested in cash or cash equivalents, against which the funds enter into derivatives transactions to obtain the remaining targeted exposure. Inverse funds invest primarily in cash or cash equivalents and derivatives to achieve their objective. Despite reliance on derivative instruments to achieve their investment objectives, however, these funds are not “synthetic” ETFs as defined in the Note, because the ICA would not permit the structure the FSB describes. ETFs registered under the ICA – including leveraged and inverse ETFs – typically are not provided by the asset management arms of banks. Moreover, if a bank wished to sponsor ETFs, the ICA’s restrictions on transaction with affiliates, described below, would prohibit the ETF from entering into over-the-counter derivative transactions such as swaps with the bank’s trading desk as counterparty. Additional ICA restrictions on transactions with affiliates even further limit the opportunities for conflicts of interest. Funds registered under the ICA also must maintain sufficient liquid assets to meet potential liabilities stemming from derivatives contracts, as well as to meet shareholder redemption requests within seven days. These liquidity requirements also apply to assets used as collateral. Indeed, the practices related to collateral and counterparty risk are quite different for funds regulated by the ICA than under other structures. Finally, funds must comply with substantial transparency and disclosure requirements. Each of these limitations is discussed further below. We also explain the restrictions imposed by SEC staff guidance on securities lending by funds, much of which addresses concerns similar to those expressed by the FSB.

Regulation of ETFs under the Investment Company Act The ICA was enacted as part of the reforms that grew out of the United States’ financial crisis during the Great Depression of the 1930s. In conjunction with the other securities laws enacted in that era, it established significant protections for fund

investors, including prohibitions on transactions between funds and their affiliates and other forms of self-dealing; tight restrictions on leverage; daily 9 See SEC Press Release: SEC Staff Evaluating the Use of Derivatives by Funds, March 25, 2010, available at <http://www.sec.gov/news/press/2010/2010-45.htm>. Secretariat of the Financial Stability Board May 16, 2011 Page 5 of 14 pricing of fund shares using mark-to-market valuation; a requirement to redeem shares daily (for open- end funds and UITs); separate custody of fund assets; and the most extensive disclosure requirements faced by any U.S. financial product. ETFs typically register as open-end funds (i.e., mutual funds) under the ICA.<sup>10</sup> Because they operate in a manner different from a traditional mutual fund, ETFs must receive exemptive relief from the SEC from specific provisions of the ICA.<sup>11</sup> By and large, however, ETFs are subject to the same regulatory requirements as mutual funds. As noted above, these requirements are designed to address many of the very issues that concern the FSB with respect to synthetic ETFs.

**Prohibitions on Transactions with Affiliates** The ICA contains a number of strong and detailed prohibitions on transactions between an open-end fund and affiliated organizations such as the fund's adviser, a corporate parent of the fund's adviser, or an entity under common control with the fund's adviser. Many of these prohibitions were part of the original statutory text of the Act, enacted in 1940 in response to instances of over-reaching and self-dealing by fund insiders during the 1920s. Among other things, Section 17 of the ICA prohibits transactions between a fund and an affiliate acting for its own account, such as the buying or selling of securities (other than those issued by the fund) or other property, or the lending of money or property by a fund to an affiliate. This section would prohibit an ETF from entering into a swap contract with an affiliate (e.g., a trading desk of a company that owns or is under common control with the fund's adviser) as a counterparty, or lending securities to an affiliate.<sup>12</sup>

<sup>10</sup> There are 8 ETFs in the U.S. registered as UITs, all of which were launched between 1993 and 2002. A UIT is a fixed portfolio of assets – in the context of an ETF, the assets contained in the target index – and does not have an investment adviser. It may only substitute its assets under limited circumstances (e.g., when the index is rebalanced), and may not select or lend securities, utilize derivatives, use a sampling strategy, or otherwise engage in activities that require an investment adviser. Hence, UITs are unlikely to cause the concerns noted by the FSB. This structure has fallen out of favor as the ETF market has developed. Still, because some of the earliest ETFs track the most widely-used indexes, including the SPDR Trust (replicating the S&P 500 Index), the Diamonds Trust (replicating the Dow Jones Industrial Average), and the QQQQ (replicating the Nasdaq-100 Index), there are substantial assets held in this small group of ETFs – approximately \$136 billion, or 14 percent of assets in ETFs registered under the ICA as of March 2011.

<sup>11</sup> This process entails the filing of a detailed application by an ETF's sponsor with the SEC and the granting of an exemptive order that establishes conditions or requirements with which the ETF must comply in exchange for the relief granted. Broadly speaking, the relief sought by ETFs relates to the ability to create and redeem shares, at net asset value ("NAV") and in units of a designated size (a "creation unit"), with a limited number of authorized investors ("Authorized Participants"), while at the same time allowing ETF shares to trade on a secondary market (i.e., an exchange) at negotiated prices rather than at NAV. Mutual funds, by contrast, may only create and redeem shares at NAV and must redeem shares presented by any shareholder.

<sup>12</sup> An exemption to these provisions permits a fund to use an affiliated broker as an agent, i.e., to broker a transaction with a third party, subject to limitations on compensation and oversight by the fund's board of directors. As explained in the Note, Secretariat of the Financial Stability Board May 16, 2011 Page 6 of 14 The ICA framework, in connection with other U.S. securities laws, also addresses the other conflicts of interest mentioned in the Note, i.e., those in which "the ETF provider is also involved in the design and/or calculation of the reference index, or also acts as a liquidity provider on

the secondary market of the ETF.” Because of concerns about potential conflicts of interest, as well the possibilities for misuse of non-public information, very few ETFs in the United States have affiliated index providers. Those that do are required, under the terms of their SEC exemptive relief, to: (i) make publicly available all of the rules governing inclusion and weighting of securities in each index; (ii) limit the ability to change such rules and provide public notice before any changes are made; (iii) impose “firewalls” between the staff responsible for index design and the portfolio management staff; (iv) maintain an unaffiliated “calculation agent” who is responsible for all index maintenance, calculation, dissemination, and reconstitution activities; and (v) specify a limited periodic basis on which the components of the index may be changed.<sup>13</sup> With respect to ETF affiliates acting as liquidity providers in the secondary market, as noted above, the ICA generally prohibits affiliates from buying portfolio securities from or selling them to a fund. Because most ETFs under the ICA create and redeem shares through in-kind exchanges, this prohibition would prevent an affiliate from acting as an Authorized Participant, i.e., exchanging ETF shares for a basket of securities directly with the fund to create liquidity on the secondary market.<sup>14</sup> To the extent an affiliate wished to transact solely in the secondary market for purposes of providing liquidity, i.e., acting as a market maker, the ICA and other U.S. securities laws would not prevent it from doing so; in these circumstances, however, the affiliate would necessarily transact at the same terms as other, non-affiliated entities. Thus, absent the misuse of non-public information, which is strictly prohibited by the U.S. securities laws,<sup>15</sup> an affiliate’s status under such circumstances would not confer any special benefits on either it or the ETF. However, the FSB is specifically concerned with the role of the affiliate as a counterparty, and its ability to take a preferential position vis-à-vis the fund, in such a transaction. This type of transaction is expressly prohibited by U.S. law. <sup>13</sup> See, e.g., WisdomTree Investments, Investment Company Act Release Nos. 27324 (May 18, 2006) (notice) and 27391 (June 12, 2006) (order). <sup>14</sup> The SEC has provided exemptions from this prohibition for entities that are deemed affiliates under the ICA solely by virtue of holding five percent of a fund’s outstanding securities. Absent such an exemption, one could not launch a fund with fewer than 21 Authorized Participants, because in such a case each Authorized Participant would be an affiliate by virtue of ownership. The SEC recognized that because the terms of the creation and redemption transactions would be the same for all Authorized Participants, there is no opportunity for such affiliated persons to engage in a transaction that is detrimental to shareholders. <sup>15</sup> The U.S. securities laws contain strict prohibitions on the misuse of non-public information, and funds, brokers and dealers are all required to maintain policies and procedures to prevent such misuse. Secretariat of the Financial Stability Board May 16, 2011 Page 7 of 14 Liquidity Requirements to Meet Liabilities and Redemptions Under SEC guidance interpreting the ICA, ETFs must comply with a number of liquidity requirements, designed to ensure that the fund is able to meet any obligations resulting from exposure to leverage through derivatives, as well as the fund’s obligation to satisfy redemption requests within seven days. These requirements, taken together with the collateral practices described below, substantially limit the likelihood that an ETF would be unable to meet its obligations to a derivatives counterparty, and thereby potentially trigger a domino effect by causing the counterparty to default on other parties. They also seek to ensure that a fund would not encounter difficulties liquidating its holdings to meet a high level of redemption requests from shareholders. With respect to obligations to counterparties, the ICA imposes substantial limitations on leverage. Under SEC guidance, a fund may engage in derivatives transactions that may include leverage, including futures, options and swaps, only to the extent the fund “covers” its potential future obligation.<sup>16</sup> A fund may cover its obligations by owning the actual instrument underlying the leveraged instrument or an equivalent offsetting position,<sup>17</sup> or setting aside sufficient liquid assets, marked to market daily, to satisfy the fund’s

obligations under the contract.<sup>18</sup> This approach is intended to “function as a practical limit on the amount of leverage which the investment company may undertake and on the potential increase in the speculative nature of its outstanding common stock. Additionally, such accounts will assure the availability of adequate funds to meet the obligations arising from such activities.”<sup>19</sup> <sup>16</sup> See Securities Trading Practices of Registered Investment Companies, SEC Release No. IC-10666 (April 18, 1979). <sup>17</sup> For example, if a fund sells – i.e., takes a short position in – a futures or forward contract, it may cover by owning the instrument underlying the contract, or by holding a call option permitting the purchase of the same contract or the underlying securities at a price no higher than the strike price of the contract it sold. See Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter (June 22, 1987). <sup>18</sup> This practice is commonly known as “asset segregation.” See Merrill Lynch Asset Management, L.P., SEC No-Action Letter (July 2, 1996). For purposes of the ICA, the SEC generally deems a security to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the fund has valued it. It should be noted that under SEC guidance, the amount constituting the fund’s obligations varies by instrument, and the guidance does not cover all possibilities. For example, the SEC staff has taken an informal position that, for futures and forwards that are required to be cash-settled, a fund may set aside only the net amount due on the contract (i.e., the daily marked-to-market amount). By contrast, a physically-settled contract must be segregated for at the full notional amount of the reference asset. The staff has not issued guidance on the appropriate amount to be set aside for swaps, and industry practice varies. See, e.g., Committee on Federal Regulation of Securities, ABA Section of Business Law, Report of the Task Force on Investment Company Use of Derivatives (July 6, 2010), available at <http://apps.americanbar.org/buslaw/blt/content/ibl/2010/08/0002.pdf>. As the Note recognized, the SEC staff is reevaluating its guidance in this area. <sup>19</sup> SEC Release No. IC-10666, *supra* note<sup>16</sup>. Secretariat of the Financial Stability Board May 16, 2011 Page 8 of 14 With respect to meeting redemption requests, the SEC has taken the position that open-end funds (including ETFs) should not invest in illiquid securities if doing so would cause the fund to have less than 85 percent of its assets in liquid securities.<sup>20</sup> Funds must value their portfolio holdings on a daily basis, based on market values if readily available or, if no market quotation is available, at fair value. A fund’s pricing methodologies are established by the fund’s board of directors, a majority of whom typically are independent of the fund’s sponsor. As part of the daily pricing process, liquidity determinations are regularly reevaluated. Many funds adopt a specific policy with respect to investments in illiquid securities; these policies are sometimes more restrictive than the SEC guidelines. While an unexpected market event could potentially cause certain previously liquid securities to become temporarily illiquid, the SEC has determined that the maintenance of 85 percent of a portfolio in liquid securities should satisfactorily ensure a fund’s ability to meet redemptions.<sup>21</sup> These liquidity guidelines would apply equally to any of a fund’s assets that were posted as collateral for derivatives transactions, as they continue to be considered fund assets. Therefore, the scenario posed by the Note in which an ETF holds an illiquid portfolio as collateral for a swap is unlikely to occur. Practices Relating to Collateral and Counterparty Risk While funds registered under the ICA must set aside on their own books liquid assets to meet potential obligations stemming from derivatives transactions, the ICA framework does not dictate the level or type of collateral that must be posted for the benefit of a counterparty for such a transaction.<sup>22</sup> Rather, funds and their counterparties enter into master swap agreements dictating the amount and frequency of movement of collateral. Funds and their counterparties typically agree to both post collateral equal to their daily marked-to-market exposure under a swap, netted across all of the swaps between the two parties. <sup>23</sup> The agreements also set forth the acceptable types of collateral – most often <sup>20</sup> See Revisions of Guidelines to Form N-1A, SEC Release No.

IC-18612 (Mar. 12, 1992). Although as a technical matter the SEC has rescinded the Guidelines to Form N-1A, see Registration Form Used by Open-End Management Investment Companies, SEC Release No. IC-23064 (Mar. 13, 1998), most of the positions taken in the Guidance, including those relating to liquidity, continue to represent the SEC staff's position. As noted above, the SEC generally deems a security to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the fund has valued it. 21 See Revisions of Guidelines to Form N-1A, *supra* note 20 (stating that the standard was "designed to ensure that mutual funds will be ready at all times to meet even remote contingencies"). 22 By contrast, we understand that UCITS III regulation dictates both the amount of collateral required and the types of securities that are eligible. 23 A recent proposal by the CFTC would require swaps dealers to post collateral for uncleared swaps in certain circumstances, and would permit, but not require collateral in other circumstances. Although it did not propose to require collateral from swaps dealers in all circumstances, the CFTC stated in its proposing release that "two way variation margin Secretariat of the Financial Stability Board May 16, 2011 Page 9 of 14 cash and U.S. treasury and agency securities, but other securities such as equities are sometimes permitted – as well as an agreed-upon haircut representing the negotiated relative risk associated with a particular type of collateral. We understand that this can range from four to five percent for high- quality agency securities to forty or fifty percent for equities.24 Notably, under the ICA regulatory structure, collateral posted by a fund must be placed with a third-party custodian.25 As a result, funds typically negotiate tri-party custody arrangements for all collateral posted under a swap agreement, including collateral posted by the counterparty. The benefits of this approach were highlighted following the collapse of Lehman Brothers, as funds with tri-party custody arrangements were able to take control of both their own collateral and the collateral posted by Lehman with far less difficulty than swap market participants who did not require tri-party custody. The recent regulatory movement toward centralized clearing of swaps should further protect funds against counterparty risk with respect to cleared swaps, as central clearinghouses are designed to protect market participants in the event of a counterparty default. Another limitation on counterparty risk is the diversification requirement imposed by the tax framework with which funds registered under the ICA must comply. These regulations require that a fund invest no more than 25 percent of its total assets with a single issuer, and that with respect to 50 percent of the fund's assets, no more than 5 percent of the assets of the fund may be invested in a single issuer.26 Although the application of this framework is somewhat unclear with respect to swaps,27 as a matter of practice funds typically consider the counterparty to be an issuer for purposes of compliance with these regulations. As a result, funds that rely heavily on swaps typically contract with multiple counterparties. This diversification of counterparties, together with bilateral collateral movements, tri- party custody arrangements, asset coverage requirements, and other regulatory restrictions work to mitigate counterparty and systemic risks in ways not contemplated by the Note. has been a keystone of the ability of [Derivatives Clearing Organizations] to manage risk." See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 FR 23732 (April 28, 2011) at 23736. 24 The recent CFTC proposal would not permit equities to be used as collateral except by commercial end users. See *id.* 25 The ICA requires funds to maintain custody of their assets separate from the assets of the adviser. Although other arrangements are permitted subject to specific requirements, the vast majority of funds maintain their assets with an independent bank custodian. The custody requirements extend to collateral held by the fund for the benefit of a counterparty, because such collateral is a fund asset. 26 In other words, the minimum diversification a fund could have is 25 percent of its assets in each of two issuers, and 5 percent of its assets in each of 10 additional issuers. 27 See generally Report of the Task

Force on Investment Company Use of Derivatives, *supra* note 18, for a discussion of possible approaches to counterparty risk under the ICA. Secretariat of the Financial Stability Board May 16, 2011 Page 10 of 14 Finally, as a practical matter, the arrangement described in the Note, in which an ETF would swap the return of a specified collateral basket in exchange for the return of an index, is not likely to occur in an ETF registered under the ICA. Rather, a party seeking to obtain the return of an index through a swap is far more likely to pay a financing fee that is based on LIBOR, as opposed to the returns from a customized basket. Together with the limited collateral posted and the diversification of counterparties for derivatives exposure, this limits the ability and desirability of a swap counterparty to attempt to dictate an ETF's holdings, as implied in the Note.

**Disclosure and Transparency** The Note raises concerns about the availability of certain information to investors, particularly with respect to more complex structures. Under the ICA, mutual funds and ETFs registered as open- end funds<sup>28</sup> are subject to more extensive disclosure requirements than any other comparable financial product. First, open-end funds are required to maintain a current prospectus, updated at least annually, which provides investors with information about the fund and its operations, investment objectives, investment strategies, risks, fees and expenses, and performance, among other things. The prospectus must describe all principal investment strategies and risks of a fund. Thus, to the extent a fund relies on derivatives to achieve its investment strategy, that usage will be described. SEC guidance explains that "any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed... This disclosure also should describe the purpose that the derivatives are intended to serve in the portfolio... and the extent to which derivatives are expected to be used."<sup>29</sup> The prospectus must be provided to investors in connection with a purchase of fund shares.<sup>30</sup> An ETF must also disclose its performance based on market price (in addition to performance based on NAV) and include, either in its prospectus or on its website, a chart displaying the frequency of premiums and discounts of the market price compared to NAV. Fund shareholders also receive audited annual and unaudited semi-annual reports within 60 days after the end and the mid-point of the fund's fiscal year, respectively. These reports must contain updated financial statements, a list of the fund's portfolio securities, management's discussion of

<sup>28</sup> ETFs structured as UITs have somewhat different disclosure obligations. Like open-end funds, they must maintain a current prospectus and provide it to investors in connection with a purchase of fund shares. They also file an annual report with the SEC. Finally, their portfolio holdings are available to the public on an ongoing basis. As noted above, this structure is unlikely to cause the concerns noted by the FSB. See *supra* note 10.

<sup>29</sup> Letter from Barry Miller, Associate Director, Office of Legal and Disclosure, Division of Investment Management, U.S. Securities and Exchange Commission, to Karrie McMillan, General Counsel, Investment Company Institute, July 30, 2010 at 4, available at <http://www.sec.gov/divisions/investment/guidance/ici073010.pdf>.

<sup>30</sup> Additional information must also be made available to investors upon request in a "Statement of Additional Information" ("SAI"). Secretariat of the Financial Stability Board May 16, 2011 Page 11 of 14 financial performance, and other specified information. Following their first and third quarter, funds file an additional form with the SEC, Form N-Q, disclosing their complete portfolio holdings. These quarterly portfolio holdings disclosures include any assets earmarked against derivatives transactions, as well as any assets posted as collateral.<sup>31</sup> They also list open derivatives positions, including terms of the contracts, their notional value and fair value. The SEC staff takes the view that for over-the-counter derivatives such as swaps, "terms" include the identity of the counterparty.<sup>32</sup> In addition, pursuant to the specific terms of their exemptive relief, ETFs must disclose information about their portfolio composition daily. At a minimum, ETFs must disclose the composition of the basket of securities they will accept from an Authorized Participant in exchange for ETF shares; this



“creation basket” may be the fund’s entire portfolio, or a sample of the portfolio designed to mimic the daily performance of the ETF. Most ETFs, however, including all leveraged and inverse ETFs, are required to disclose their complete portfolio holdings daily (including derivatives positions).<sup>33</sup> Securities Lending by ETFs In addition to the FSB’s concerns with the synthetic structure, the Note raises several concerns related to market liquidity and ETF’s securities lending, which can occur in synthetic or physical ETFs, i.e., any ETFs that hold securities for which there is a lending market.<sup>34</sup> In particular, the Note references counterparty and collateral risks, threats to the ETF’s liquidity position in the event of significant unexpected liquidity demands from ETF investors, and the possibility of a market squeeze in the underlying securities if ETF providers recalled loaned securities on a large scale in order to meet redemptions.<sup>35</sup> The Note alludes to concerns both on behalf of shareholders and with respect to the potential for broader market risk. 31 As noted above, funds typically do not post substantial portions of their portfolio as collateral. 32 See Letter from Barry Miller, *supra* note 29. 33 These disclosures are not required to disclose the identity of swaps counterparties. 34 As noted above, ETFs structured as UITs are not permitted to lend securities. See *supra* note 10. Additionally, funds registered under the ICA that rely on derivatives to achieve their investment objectives often hold a sizeable amount of cash and cash equivalents, which are not conducive to securities lending. 35 These issues should be distinguished from concerns about borrowing and lending of ETF shares themselves. A recent paper suggested, incorrectly, that an ETF could collapse as a result of high levels of short interest, i.e., the same ETF shares being sold short multiple times (a practice which requires a short seller to locate shares to borrow). As the ICI explained in a response to this paper, the scenario described is not possible under the current regulatory structure. See ICI Response to Kauffman Foundation Paper, “Choking the Recovery: Why New Growth Companies Aren’t Going Public and Unrecognized Risks of Future Market Disruptions,” November 11, 2010, available at [http://www.ici.org/pressroom/speeches/10\\_etfs\\_kauffman](http://www.ici.org/pressroom/speeches/10_etfs_kauffman). Secretariat of the Financial Stability Board May 16, 2011 Page 12 of 14 As a preliminary matter, we believe the FSB must be cautious in attributing potential systemic or market risks, or risks to shareholders, to the securities lending activities of ETFs. 36 Many types of collective investment vehicles, including mutual funds, hedge funds, pension plans, and collective investment trusts, as well as other market participants, engage in securities lending. Any of these collective investment vehicles could potentially encounter unexpectedly high redemption requests or other types of withdrawals in a time of market stress, and need to recall loaned securities.<sup>37</sup> Indeed, because of the limits and risk protections imposed on funds registered under the ICA, the practice and attendant risks may be far more widespread in other investment vehicles.<sup>38</sup> Thus, to the extent there is concern about the impact of securities lending activities on the broader markets, it should not be approached as an ETF-specific issue. The SEC staff has established guidelines for securities lending activities for funds (other than UITs) regulated under the ICA, which are intended to address some of the same concerns expressed in the Note. Among other things, these guidelines: restrict the types of collateral that are permissible and how that collateral may be treated; impose limitations on the amount of lending; ensure the ability of a fund to recall securities in a timely manner; and police conflicts of interest. Additionally, a fund may engage in securities lending only if permitted by its organizing documents, disclosed to investors in the fund’s prospectus or SAI, and subject to approval and oversight by its board of directors. Collateral and Counterparty Risk SEC guidelines set forth the types of collateral that funds may accept in securities lending transactions. These include cash, U.S. government and agency securities, and, subject to limitations, certain bank guarantees and irrevocable bank letters of credit. Under applicable accounting standards, the loaned securities are reflected in a fund’s financial statements as a fund asset, and reported in the 36 Index-based ETFs tend

to receive more focused media attention with respect to securities lending than other collective investment vehicles, perhaps because the returns for investors can significantly offset the fund's management fee, helping the funds better track their benchmarks and therefore improving their performance records. See, e.g., Tom Lauricella, "Barclays Puts ETF Portfolios to Good Use," *The Wall Street Journal*, Feb. 16, 2007 ("Securities lending isn't new, but it is growing increasingly common in the fund industry. Such lending has particular appeal for ETF providers. The profits can boost an ETF's returns -- and in the world of index funds such as these, a small amount of additional income can make performance appear significantly better."). 37 Securities may also be recalled for other reasons, such as trading by the lender. In this respect, index-based funds and ETFs actually pose less risk and are preferred lenders, because their trading activities are predictable and limited to times of index rebalancing. 38 One survey of securities lending in vehicles available in retirement plans found that the mutual funds surveyed lent between 0.04 percent and 28.3 percent of assets, while the collective investment trusts surveyed lent out between .1 percent and 97 percent of their total assets. See "Securities Lending with Cash Collateral Reinvestment in Retirement Plans: Withdrawal Restrictions and Risk Raise Concerns," Summary of Committee Research, prepared by the Majority Staff of the Special Committee on Aging, U.S. Senate, March 2011, available at <http://aging.senate.gov/events/hr232rpt.pdf>. Secretariat of the Financial Stability Board May 16, 2011 Page 13 of 14 schedule of investments along with disclosure indicating that the securities have been loaned. When a fund has effective control of the collateral received, the collateral is also recorded as a fund asset, with a corresponding liability. In the event the fund does not have effective control, such as if the collateral is in the form of securities (e.g., bonds) and the fund does not have the ability to dispose of such assets except in limited circumstances, the collateral is not recorded as a fund asset. Any securities or instruments purchased with cash collateral are recorded as fund assets.<sup>39</sup> As a practical matter, U.S. funds typically prefer to receive cash collateral. SEC guidelines further require that funds lending securities receive at least 100 percent of the value of the loaned securities as collateral from a borrower. The value of the loaned securities must be marked to market daily and the collateral adjusted so that at least 100 percent is maintained at all times. As a practical matter, securities lending agreements typically establish a somewhat higher collateral amount, usually 102 percent for loaned domestic securities and 105 percent for loaned foreign securities. SEC guidelines also require that the fund's board approve specific borrowers to whom the fund may lend shares. This responsibility may be delegated to the fund's adviser subject to board supervision. In practice, fund advisers and/or their lending agents typically perform a thorough credit review of all potential borrowers and develop a list of "approved borrowers" to whom the lending agent may loan the fund's securities; these borrowers are usually limited to well-established broker-dealers and major banks. Additionally, lending agents typically provide indemnification to the fund in the event of default by a borrower.

**Limitations on Lending and Ability to Recall Loaned Securities** SEC guidelines prohibit a fund from having on loan at any given time securities representing more than one-third of the fund's total asset value. In calculating this limit, the collateral (i.e., the cash or securities required to be returned to the borrower) can be included as part of the lending fund's total assets, meaning a fund can lend up to 50% of its asset value before the securities loan. The guidelines also require funds to be able to terminate a loan at any time and recall loaned securities within the normal and customary settlement time for securities transactions. i.e., the securities must be returned within the settlement cycle for the type of instrument loaned (e.g., T+0 for U.S. government securities, T+2 for U.S. equities). As a practical matter, these requirements limit the likelihood that a fund could not satisfy its redemption obligations within seven days, as required by the ICA. 39 See e.g., Letter from John S. Capone, Assistant Chief Accountant, Division of Investment Management, U.S. Securities

and Exchange Commission, to Frank Maresca, Managing Director, Bear Stearns & Co., Sept. 16, 1997. Secretariat of the Financial Stability Board May 16, 2011 Page 14 of 14 Conflicts of Interest As discussed above with respect to transactions with affiliates, the ICA generally prohibits a fund from lending its securities to an affiliated person or using an affiliate as a securities lending agent. The SEC has granted individual exemptions to this prohibition, subject to a number of conditions designed to ensure that the affiliated person does not take advantage of its relationship with the fund. These conditions include that a majority of the fund's independent directors determine that: the securities lending program is in the best interests of the fund, the services rendered are necessary for the fund's operation, and the fees paid are fair and reasonable under the circumstances. In addition, the fund's board must review the fees paid under the program at least quarterly. Additionally, it is important to note that all profits from securities lending (i.e., revenues less fees paid to a lending agent or other involved parties, as approved by the fund board) accrue to the fund itself, not the adviser.<sup>40</sup> While an adviser may receive fees if it is acting as the lending agent, those fees must be fair and reasonable, as determined by the fund's board of directors. Further, as noted above, the board must approve the fund's securities lending plan – that is, determine that it is in the best interest of the fund's shareholders – and oversee the program. Thus, while in some circumstances an adviser may earn fees for securities lending, in all cases the determination of whether to engage in lending is made by the board on behalf of the fund and its shareholders – not the fund's adviser. \* \* \* \* The ICI strongly supports the FSB's efforts to identify and investigate potential causes of systemic risk, and to encourage regulators and market participants alike to do the same. In pursuing these goals, we urge the FSB to exercise caution in making broad statements about potential risk, and to identify as clearly as possible the sources of its concern, to avoid unwarranted negative public perceptions about investment products that do not share the attributes that are the basis for concern. If you have any questions about our comments or would like additional information, please contact me at 202/326-5815, Susan Olson at 202/326-5813, or Mara Shreck at 202/326-5923. Sincerely, /s/ Karrie McMillan Karrie McMillan General Counsel

<sup>40</sup> The Note states that “thin margins on plain-vanilla physical ETFs create incentives for providers to engage in extensive securities lending in order to boost returns,” suggesting that the adviser itself benefits from securities lending.