



28 August 2017

Central Bank of Ireland
New Wapping Street
North Wall Quay
Dublin 1

Dear Sirs,

Re: Response to Central Bank of Ireland - Exchange Traded Funds Discussion Paper

Fidelity International (Fidelity) is pleased to present herein its comments on the discussion paper on exchange traded funds carried out by the Central Bank of Ireland (CBI).

Fidelity International is a Global and pan-European and global asset manager, with offices in Europe, Asia Pacific, the Middle East and South America. We are a privately owned, independent company, with the commitment and resources to provide the investment expertise, technology and service innovation needed to help our clients achieve their financial goals.

We invest in excess of Euro 275 billion globally on behalf of our clients, who range from pension funds, central banks, sovereign wealth funds, large corporates, financial institutions, insurers and wealth managers, to private individuals. For institutional clients, we also offer tailored investment solutions design and full-service asset management outsourcing.

In addition to asset management, we provide investment administration and guidance services for workplace benefit schemes, advisers and individuals in several countries, with more approx. Euro 80 billion in assets.

Fidelity has since its founding had an investment approach building on active, bottom-up research. We have one of the largest global research capabilities with over 400 investment professionals and research staff around the world, and our portfolio managers and analysts do over the course of a year carry out more than 17,000 company meetings, or one every 10 minutes on average.

Fidelity has recently made the decision to enter ETF market and appreciates this opportunity to contribute to the discussion around ETFs in Ireland. Fidelity is also an active member of Irish Funds (IF) and has contributed to its response to the ETF discussion paper.

We look forward to a continued discussion around this important topic, and do also going forward stand prepared to discuss and contribute if and where this is found to be of value to the CBI.

Best regards,

Sent by email, bears no signature

Nick King
Head of ETFs
Fidelity International

Section I Questions

A. Is public disclosure of the identity of APs and OLPs of an ETF of benefit and should regulators have a clearer view of the interconnectedness of the AP / OLP ecosystem? Should remuneration models of OLPs (and if relevant APs) be disclosed?

Fidelity sees limited value in compulsory disclosure of APs and OLPs. Whilst an ETF umbrella may be supported by a number of APs and liquidity providers, these can (with the exception of the OLP) decide when they wish to be active and may not be active in all sub-funds. Exchange requirements ensure that an OLP is appointed and ETF issuers are motivated to ensure that the commercial arrangements ensure favourable bid-ask spreads are quoted.

B. Transparency is described as the feature which enables a tight secondary market price (by comparison to net asset value) to be maintained. It also provides certainty to investors in terms of exposure achieved through the ETF. It might be the case that there are other mechanisms which achieve the same goal as transparency? If ETFs are not transparent does this have unintended consequences?

Fidelity generally supports transparency, and notes that it is a key aspect of the ETF industry in Europe. It is important that the level of information provided allows liquidity providers to appropriately price and hedge any risk that they are exposed. Any uncertainty or residual risk will be priced in to the spread offered by the liquidity provider and therefore passed onto the end investor.

As ETF issuers look to offer ETF strategies which incorporate an element of intellectual property, it is important to find ways to achieve efficient pricing whilst protecting this intellectual property. This is in the interest of investors in the ETF as it will prevent potential erosion of active returns. Fidelity can thereby see that there are benefits in finding ways to achieve efficient pricing and trading of ETFs without providing full daily portfolio transparency.

As liquidity providers will often use a proxy hedge to cover intra-day exposures, information which allows them to create such a proxy should be sufficient to allow efficient pricing. For example, reporting on a daily basis of portfolio risk exposures, such as country exposures, sector exposures, currency exposures, would allow market participants to effectively price and hedge their exposures.

C. Is the idea of secondary market investors dealing directly with an ETF when the AP arrangements breakdown unworkable in practice or unnecessary? Is there a better way of enabling secondary market investors to dispose of their ETF shares at a price close to the next calculated net asset value when secondary market liquidity is impaired?

Fidelity can see the practical challenges if secondary market investors were to deal directly with an ETF. As it is difficult to predict exactly how market participants will react in case secondary market liquidity is impaired, we do however consider that provisions should be in place to allow secondary market investors to deal directly with the ETF to facilitate redemptions in exceptional circumstances.

D. Should ETFs warn investors that the ETF may temporarily become a closed-ended fund in certain market conditions? Would requiring an ETF to remain open-ended in a stressed market be disadvantageous to existing investors or have other unintended consequences?

Fidelity notes that the ETF market has certain advantages to investors from a liquidity perspective. By way of example, liquidity in ETFs can be provided at times when the underlying markets are closed. This in turn means that a suspension of trading in primary markets should not automatically result in the suspension of ETF trading in secondary markets.

However, as with all open-ended funds, it should however be noted that liquidity cannot be guaranteed in stressed markets and ETF issuers should inform potential investors that they cannot guarantee that an active trading market for ETF shares will develop or be maintained. As with any open-ended fund, it is also important that the ETF issuer has the ability to suspend dealing in the ETF under certain circumstances including stressed market conditions.

E. Is it correct to permit share classes to be structured having regard to the operational concerns of APs and the impact this may have on secondary market pricing? Are there factors (other than those noted above) that could be relevant to ETF structuring?

As noted in paragraph 60 of the discussion paper, it is important that share classes are structured in such a way that any transactions can be executed at (or ahead of) the relevant valuation point. The dealing cut-off should allow sufficient time for the investment manager to instruct the relevant transactions.



As noted in Paragraph 61, in the case of in-kind deals, the investment manager will not need to execute transactions in underlying securities (as these will be delivered by the Authorised Participant) and therefore it is possible to allow a later dealing cut-off without impacting investors.

As noted in Paragraph 70, in the case of currency hedged share classes which use a 4pm fixing for currency valuations/executions, it may be necessary to apply an earlier cut-off where this currency valuation point is before the valuation point of the underlying investment securities.

Whilst the dealing-cut off must be early enough to allow the investment manager to instruct the relevant securities and currency transactions, it is important to balance this with needs of liquidity providers and authorised participants.

As liquidity providers will be facilitating trading throughout the trading day for the relevant exchange, it is important that they are able to create and redeem units in the primary market in response to client demand. If the dealing cut-off is before the end of the trading day for the ETF, then the liquidity provider can be left with some residual risk where units cannot be created or redeemed until the next dealing day. Later dealing cut-off also allows more time for secondary market transactions to be netted which could potentially reduce the size of any primary market transaction. Considering these operational concerns clearly benefits liquidity providers and authorised participants, this should ceteris paribus also result in tighter trading spreads for the ETF and therefore benefit investors.

In summary, in our opinion it makes sense to permit share classes to be structured with specific features (such as dealing cut-offs) which reflect the operational requirements of the specific class. The primary consideration is to ensure that this does not prejudice any investors in the fund. In the case of dealing cut-off times, this primary consideration is that the cut-off should be set at an appropriate time to allow sufficient time for the investment manager to instruct the relevant transactions, which may vary by share class. However, when setting these times, the manager should also consider the needs of the market participants that support secondary market trading.

F. What are the benefits or disadvantages of permitting listed and unlisted share classes within the same investment fund? Do listed and unlisted share classes create unfairness as between investors in the same investment fund and if so, can these be mitigated or addressed?

Fidelity believes that there is no reason why listed and unlisted share classes could not be offered in parallel by an investment fund. While it is important that investors are duly informed and understand how the class they invest in works, Fidelity believes that pooling of assets can allow efficiencies in managing and administering the portfolio which should reduce costs and could allow for better investment outcomes e.g. by reduced tracking error in the case of an index-tracking ETF.

Allowing listed and non-listed share classes has the benefit of allowing investors to choose how they wish to deal with the fund, either directly with the fund at a specific point in time or through a broker at any point during the trading day. Implementing this choice of access through share classes of the same sub-fund prevents the need for separate sub-funds and allows the pooling benefits described above.

This being said, as is noted in paragraphs 74-76 of the discussion paper, there are potential concerns that arise from offering both listed and unlisted share classes in the same sub-fund. The first being that shareholders of a listed class are unable to deal directly with the fund, and the second being that shareholders in unlisted classes are unable to deal on an intra-day basis.

While these concerns are important, we would as noted above suggest that if these points are adequately disclosed and the investor has made a decision to purchase their chosen share class, then this should not itself result in any disadvantage or unfair treatment. We believe that the key consideration here is to ensure that dealing in either the listed or unlisted share class does not impact investors in the other class. The ETF issuer must thereby ensure that appropriate transaction costs are covered by both share classes.

This means that in cases where a listed share class applies a specified spread/charge to cover transaction costs, then such unlisted share class should apply an equivalent charge (subject to potentially different operational costs such as transfer agency or custody settlement charges). In cases where the listed share class applies a 'cost of execution model' for creations and redemptions, where the authorised participant pays the cost of securities purchased for a creation and receives proceeds from sale of securities in the case of a redemption, then the unlisted share class should apply a rate which also ensures that the cost of trading securities is adequately covered.

Section II Questions

G. Are conflicts of interest rules effective for dealing with concentrations of activities within an ETF provider's financial group (e.g. group entities could act as promoter, investment manager, AP and swap counterparty or SFT counterparty)? Are other approaches worthy of consideration?

Conflicts of interest rules are important in this as well as in other financial services activities. It is thus important that ETF providers manage any potential conflicts of interest properly, in accordance with applicable rules. At the same time, it is important that different business models can develop without undue regulatory restrictions.

H. Are multiple counterparties necessary, or appropriate for ETFs? Could they expose ETFs to unintended risks and consequences?

Fidelity can see that the implementation of a multiple counterparty model for synthetic ETFs can offer several benefits. Such models can diversify counterparty exposure and can encourage competitive pricing of the swap agreements. It will also make it possible to continue to offer the desired investment exposure in the case of a counterparty default. In this case, one or more of the alternative counterparties can step in and offer the required notional exposure.

This being said, paragraph 97 of the discussion paper identified a potential scenario in which a multiple counterparty model can lead to the ETF having more counterparty exposure in aggregate. As well-structured synthetic ETFs will collateralise well beyond minimum regulatory requirements this is unlikely to happen in practice, but we agree that it is important to ensure that regulatory requirements deal with and rule-out such scenarios.

I. Some academic research suggests that if a synthetic ETF experiences counterparty default, the synthetic ETF is more likely to be able to deliver the performance of its underlying index if the collateral received is correlated to that index. Should collateral received (where a funded model is used) or securities purchased (where an unfunded model is used) be correlated to the index being tracked? Is this practical, particularly for example where the index tracked by an ETF is comprised of securities which may be relatively expensive to access? Is collateral quality sufficiently regulated and disclosed?

Use of collateral that is well correlated to the benchmark index could certainly reduce the likelihood that collateral is insufficient to cover counterparty exposure in the case of default. In practice, this might be difficult to monitor and enforce in a systematic way.

In addition, it should be noted that long-term asset correlations may not apply over shorter time horizons or in stressed market conditions. It could therefore be more beneficial, if anything and following further more specific consultations, to address this issue through appropriate guidelines on specific eligible collateral, haircuts (where a funded model is used) and frequency of reset.

Section III Questions

J. Are active strategies appropriate for “housing” in an ETF structure and if so, is there a limit to the type of strategy that would be appropriate? If the ETF structure provides opportunities for managers to achieve scale is there a downside to this where the strategy is active (or, if scale is achieved, its potential impact is not otherwise capable of being ascertained)?

Fidelity believes that, as also noted in paragraph 132 of the discussion paper, an ETF is simply a UCITS that is available for trading on exchange. It can therefore, in general as some limitations may exist, be asserted that any investment strategy that can be effectively implemented within a UCITS framework is suitable for delivery within an ETF wrapper.

As noted in paragraph 133, simplicity and transparency are features that are commonly associated with ETFs. This is however because most existing ETFs are fully transparent index-tracking products, not because of any limitations inherent in the ETF per se. With the development of smart-beta and factor based investment strategies, many index-tracking ETFs are also becoming more complex and active in nature. Indeed, these factor indices are designed to systematically capture elements of active strategies and can be as complex as the active strategies they are seeking to replicate.

However, as noted in paragraph 133, particularly complex synthetic strategies, which may involve extensive use of complex derivatives, may not be suitable for implementation within an ETF wrapper. In these cases, the return profile of the product may be less predictable and/or the value of ETF's holdings may be more difficult to value. These features will make it more difficult for liquidity providers to price and hedge the ETF and will therefore result in wider spreads being offered to clients.

The above means that whilst full transparency and simplicity are not a requirement for efficient functioning of the ETF, there is the consideration of investor protection. This can in our view be managed by application of the MiFID II appropriateness test, to avoid complex products becoming available to investors who are unable to understand the exposure delivered and risks associated with the product.

A degree of transparency is also here as elsewhere required for secondary market activity to function efficiently. However, full transparency and simplicity are not a requirement for an efficiently functioning ETF, and we are to conclude of the view that the ETF structure is an appropriate vehicle for delivering certain active strategies.

K. Similar to the question posed in Section I, is portfolio transparency fundamental to the nature of an ETF or are there are other mechanisms which achieve the same goal as transparency? In the context of an active ETF, is transparency essential in order to achieve a liquid market and to facilitate efficiency in pricing?

Please refer to our response to Question B.

Section IV Questions

L. Some commentators are concerned that ETFs are tracking indices of underlying stocks which are not sufficiently liquid to match the intra-day liquidity on the secondary market which the ETF offers. This statement is quite simplistic and does not, for example, reflect that there may be much secondary market activity but very little primary market activity. UCITS, including UCITS ETFs, are subject to general liquidity management rules which should ensure that ETFs track indices of underlying stocks that are sufficiently liquid to allow the ETF to meet creation and redemption requests. Is this sufficient? What liquidity practices do ETFs follow? Are there other practices that might be appropriate for ETFs?

As stated in paragraph 184 of the discussion paper, the liquidity of an ETF should be consistent with the liquidity of its underlying securities as this is the rate at which units in the ETF can be created and redeemed, as is the case for an unlisted UCITS. Therefore, any asset class or security which is considered sufficiently liquid for investment by a UCITS should be suitable for an ETF.

In addition, the presence of secondary market activity can enhance liquidity and potentially reduce the requirement to trade underlying securities. There are also many examples of well-established ETFs that have significant secondary market activity and therefore, in normal market conditions, offer an additional level of liquidity beyond that of the underlying securities.

It may however be a concern if and to the extent that investors believe that an ETF will always maintain its liquidity. This additional level of liquidity may not hold in stressed markets. As noted in paragraph 193, this belief



may also have attracted investors who will leave the asset class if liquidity is not available. If this were to happen, it may lead to price dislocations in the ETFs and ultimately in the underlying securities/asset class.

However, the regulatory framework for ETFs as well as UCITS provides for a number of liquidity management tools that can be used by managers in stressed situations. It is thereby important that supervisors as well as managers discuss how such tools can be used in practice, to manage any potential upcoming situations.

M. One of the potential impacts from greater investment in index-tracking ETFs is decreased informational efficiency of underlying securities as well as increased non-fundamental volatility of underlying securities. However, these may not be risks *per se* or, at any rate, may not be risks that ETF providers or regulators can mitigate, manage or eliminate. Is this assessment correct or could measures be taken to address this impact?

Fidelity notes that ETFs represent a very limited portion of the global equity and fixed income markets, and it is important to have this perspective when discussing any potential risks with ETFs.

Academic studies of the impact of the growth of passive investing on market efficiency has also often led to different conclusions - some concluding that this is decreasing informational efficiency and others asserting that this growth is creating opportunities for skilled managers.

As an example, a recent publication by Citi Research (Passive Aggressive, 23 March 2017) looks at correlations between stocks to assess the impact of passive investing. Indiscriminate buying of stock markets should thus as a starting point increase correlations.

Whilst the research found that pairwise correlations between stocks have risen over the longer term, they have reduced more recently. The research further suggests that the biggest driver of correlation still seems to be market direction. If markets are rising then correlations tend to fall. They rise when markets are falling. There is little indication that the rise of passive funds has (yet) changed this traditional relationship.

N. One of the key issues in the context of support by ETF providers is investor expectation. Investors' views about purchasing ETFs and their ability to sell may be informed by whether or not the ETF provider will support the ETF in the face of stress events. There are, however, divergent views amongst ETF providers as to whether they would support their ETFs. Is provider support a desirable objective?

As noted above it is important that investors are duly informed about what they invest in and regarding any potential support expected to be received from the ETF provider. As is also noted above managers of ETFs and UCITS also manage liquidity and fund redemption risks continuously. If risks are properly handled and tools are properly used the question of provider support should thus in most market conditions not arise.

The broader issue of provider support, not least in extremely stressed situations, should be discussed in a more broad market disruption discussion.

Section V Questions

O. The Central Bank is primarily interested in risks associated with Irish authorised ETFs and European ETFs more generally yet much of the available academic literature, analysis and data relates to US ETFs. The concern is that any analysis of Irish authorised and European ETFs may be adversely affected by our reliance on US-centric materials. Is this valid? Are Stakeholders aware of EU ETF specific information that might lead to different conclusions? Will MIFID II resolve these data issues?

We agree that most academic studies, analysis and data relates to US ETFs, as this has been and is the largest market for ETFs. In addition, analysis of trading within the European ETF market is more difficult due to fragmented trading across multiple exchanges and inconsistent disclosure of over-the-counter trades. Once ETFs are included as MiFID instruments in January 2018 we should be able to form a more accurate view of ETF trading and liquidity, even this date data will continue to be fragmented.

P. Does the nature of an ETF have peculiarities (and therefore risks) that neither the UCITS nor MiFID regulatory frameworks, either in isolation or in conjunction, address and which has not been examined here?

As noted elsewhere most of the potential risks associated with ETFs are equally applicable to UCITS. It is our opinion that most ETF related issues should be seen in that context, and do not at present see that there are any ETF specific risks or peculiarities that ought to be examined.