HSBC

To whom it may concern
Fund Policy Division
Central Bank of Ireland
New Wapping Street
North Wall Quay
Dublin 1

Date: 11th August 2017

Re: CBI ETF Discussion Paper 2017

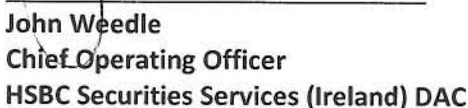
Dear Sir/Madam,

HSBC Securities Services in Ireland welcomes the opportunity to input and provide a response to the Central Bank's Discussion Paper on ETFs. We are hugely encouraged by the quality of the paper and the level of engagement the Central Bank has had with the ETF industry. The paper discusses some of the pertinent topics for ETFs today and in particular covers some of the forward looking developments the products may benefit from.

Please find attached our responses to the Discussion Paper. The central theme to our responses is that ETFs are typically established as UCITS and, as such, it is important to allow them function as UCITS.

We welcome the opportunity to discuss this further with you as our interests are aligned in providing for a robust and functional regulatory framework.

Regards,



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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?

If, as the paper points out in Observation 17, there is a chance that there are possible negative implications due to the inter-connectedness of the AP and the OLP then possibly details of such connection should be made available to the Regulator by the Fund entity. The appointment of a selection of APs & OLPs by an ETF promoter/manager is probably of more importance in ensuring an availability of multiple prices and liquidity sources for an ETF.

Secondary market investors are provided transparency in relation to their transaction costs (by their brokers) and in relation to the ongoing expense ratio for holding an ETF (via a fund's prospectus, KIID, marketing documentation). As such, it is debatable whether disclosure of remuneration models of OLPs and APs would benefit secondary market investors.

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?

Passive ETF products have traditionally had full portfolio transparency for two reasons:
(1) Transparency via a PCF file enables APs to create portfolio baskets either to deliver via in-specie or for directed trading and;
(2) It enables accurate intra-day pricing from iNAV providers for secondary market investors.

The key point is that item (1) is not necessarily needed for an active ETF so the critical requirement is accurate intra-day pricing for the ETF. There are non-transparent ETF models, for example Precidian's Activeshares model, being proposed in the US which are designed to protect an investment manager's intellectual capital but provide sufficient information to authorised participants and maker makers to create an efficient market. We believe that there is merit in the Central Bank reviewing these models. The key point of these models is that they provide secondary market investors with at least as much transparency as existing non-ETF mutual fund products.

In addition to accurate intra-day pricing, competition among APs and OLPs would probably be the single biggest mechanism that will keep the secondary market price tight when compared to the net asset value. In many cases, there will be a lot of parties trading the same ETF and the competition to have the "tightest spread" will lead to the secondary market price being close to the NAV. The Stock Exchange also sets out regulations as to the spreads APs and OLPs may charge when dealing ETFs in the secondary market.

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?

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The ESMA guidance on ETFs provides for scenarios such as market disruption on the secondary market. It should be noted that in such a scenario, a transfer agent could only accept orders from the shareholder of record on the secondary market (for example CREST for domestic UK issuances or Euroclear/Clearstream for international issuances). Such shareholders would have to go through know your customer ("KYC") processes before a trade could be accepted from them. Given the period of time required for such an investor to prove their identification, it is probable that they would have been quicker routing their order via another AP. A potential alternative is exploring whether a mechanism could be established for one or more APs to place redemption trades at NAV in a market disruption scenario. This would ensure that secondary market investors could redeem at NAV and put investors in a similar position to those of a mutual fund.

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?

UCITS mutual funds include multiple risk disclosures in their prospectuses regarding the impact of market conditions. UCITS ETFs include similar risk disclosures in their prospectuses. As with other UCITS, ETFs also disclose the discretion of a fund board to restrict inflows/outflows to 10% of total NAV if required. If there is sufficient liquidity in the portfolio held by an ETF, this discretion should not be required to be invoked. If there is temporarily illiquidity in the portfolio held by an ETF, the board of directors and investment manager of the ETF need to determine whether to adjust the basket trades or, in the worst case scenario, suspend the NAV of the ETF.

By their nature, ETFs have incremental liquidity given that APs & OLPs make a market at secondary market level. Primary market trades are only triggered if there is sufficient volume of subscription or redemption trades being received when there are insufficient sellers or buyers, respectively, at secondary market level.

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 the AP is the conduit for ETF shares reaching the market it is important that the dealing cut offs are structured with regard for their operational concerns. Dealing cut offs closer to market close are better for APs. If the cut off time is earlier than close and a trade is done after that in the secondary market, then the position on the APs books needs to remain open until the following day as they cannot create those shares in the primary market to deliver to the investor in the secondary market. This may result in the bid/offer spread being larger in the secondary market.

However, an earlier cut off point allows the APs to potentially reduce trading cost by having more time to identify counterparties to trade with, thereby reducing the knock on impact on investors in the secondary market. Ensuring that ETFs can be structured to meet APs operational needs can only be a positive for investors in the secondary market; any negative impacts would be passed on the investors in secondary market.

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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?

The paper has focussed on the "fairness" of the comparable dealing in either a listed or unlisted class. A better question would be what price are primary market deals on listed classes executed at versus unlisted classes. In both cases, the trades are executed at NAV so it is debatable whether there is a fairness issue from a fund perspective. Investors may be happy to pay brokerage fees for the ability to trade intra-day and ease of investment. Alternatively, investors may prefer to submit an application form and appropriate KYC documentation in order to invest directly with a fund. It is notable that in the US a product issuer has successfully run ETF classes on their passive mutual fund ranges. We believe there is merit in the Regulator discussing this topic further with the investment management community.

It should also be noted that fairness does not necessarily equate to equal treatment. For example, different share classes of the same mutual fund can hold different economic characteristics such as fees and currency exposure.

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?

Yes, where ETF providers have more than one group entity performing activities for the UCITS ETF they should be able to manage their conflicts of interest once there is an appropriate policy and disclosure of interested parties.

We believe the UCITS Directive provides an appropriate risk mitigation and management framework for conflicts of interest. A separation of legal entities is required between the UCITS Management Company and the swap counterparty (a credit institution is also subject to supervision and compliance with MiFID rules).

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

We do not believe there is a necessity for ETFs to appoint multiple counterparties. If the counterparty risk is properly managed and the disclosure of the investment technique is clear to investors, then the addition of multiple counterparties should not expose ETFs to unintended risks or consequences. This comment is consistent for all investment funds – whether established as a UCITS and/or as a UCITS ETF.

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

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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?

We believe that the ESMA Guidelines in respect of collateral, as detailed in paragraph 103 of the Central Bank paper, are appropriate and there is not necessarily a requirement for collateral to be correlated to the index being tracked once there is sufficient collateral in place. Collateral is closely monitored by all parties and we do not believe further regulation in this regard is required.

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)?

It is worth considering the appropriateness of ETFs for housing active strategies from the point of view of secondary market investors, investment managers and authorised participants/market makers.

From a secondary market investor perspective, such an ETF could have all the benefits of a typical fund but the incremental benefits of ease of investment, intra-day liquidity and potentially lower costs (assuming the ETF was a conduit to scale allowing a manager to reduce fees). Given the buy & hold approach for most investors in most investment funds, it is probable that ease of investment and lower fees could be the key drivers. The key point for investors is that there is sufficient information in the fund's documentation to give them clarity on the investment approach and risk factors. This is no different than any other investment fund.

From a manager perspective, an ETF could broaden and increase the investor base in their fund but this is offset by the knowledge that there is likely to be an expectation of lower fees from investors. They also need to consider whether the transparency (dependant on whether non-transparency is permitted) of an ETF is going to result in front running.

Finally, from an authorised participant or market maker perspective the key point is whether sufficient information is available to enable them to price & hedge ETFs intra-day. Authorised participants and market makers may be agnostic as to whether this information is achieved through portfolio transparency or via another mechanism, for example iNAVs.

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?

As outlined in question B, portfolio transparency is fundamental for passive ETF products for two reasons (1) it enables APs to create portfolio baskets either to deliver via in-specie or for directed trading and (2) it enables accurate intra-day pricing from iNAV providers for secondary market investors. The key point is that (1) is not necessarily needed for an active ETF so the critical requirement is accurate intra-day pricing for the ETF.

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There are non-transparent ETF models, for example Precidian's Activeshares model, being proposed in the US which are designed to protect an investment manager's intellectual capital but provide sufficient information to authorised participants and marktr makers to create an efficient market. We believe that there is merit in the Central Bank reviewing these models. The key point of these models is that they provide secondary market investors with at least as much transparency as existing non-ETF products.

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?

In severe market conditions, similar to the 2008 financial crisis, liquidity concerns of any market are difficult to eliminate. It will not always be sustainable to offer investors instant access to their money especially in a volatile environment with rapidly falling prices and redemption spikes.

In assessing whether UCITS liquidity management rules are sufficient the SEC approved rules referenced in observation 27 should be considered.

ETF managers should be addressing several practical issues, including but not limited to:

- Assessment of current liquidity levels of fund assets;
- Classification of assets into liquidity buckets;
- Determining proper level of minimum liquid asset thresholds;
- Creating liquidity risk management policies and procedures; and
- Considering the use of additional liquidity risk management techniques (e.g., swing pricing, collateral management, committed credit lines, etc.).

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?

On the basis that markets are by nature not perfect (inefficient), it would be extremely difficult to eliminate the decreased informational efficiency of underlying securities as well as increased non-fundamental volatility of underlying securities associated with index-tracking funds.

We also note that ETF investments account for less than 5% of the market capitalisation of listed underlying securities they hold.

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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?

If the assumption was made that ETF promoters would reinforce secondary market trading to prevent its breakdown and offer liquidity support, this would be desirable for an Investor. However, it could be argued that it would be unreasonable for this support to be put in place. Unlike the banking world, where deposits are guaranteed by the government - stocks, bonds and other securities can lose value. There are no guarantees. The principal way for investors to protect the money they put into the securities market is to do research. There should not be a disconnect between investor expectations for securities traded on the secondary market just because the security has "ETF" in its name.

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?

The European ETF market has many similarities with the US market, although structural and operational differences are prevalent between both locations. That is not to say that US centric academic literature cannot be used to aid analysis on the European ETF market, particularly when used in the context of the learning that Europe can learn from the efficiency of the US market.
For example in-specie create redeem processes prevalent in the US market is not a feature in Europe – particularly in the equity strategies. Therefore, it can be argued that the DVP settlement model in Europe puts Europe at a competitive advantage to the US in terms of settlement efficiency.
However, to give another example, the multiple exchange and corresponding settlement systems across Europe put Europe at a disadvantage to the US. This structural inefficiency can lead to additional costs, fragmentation of liquidity and the failure of additional markets to materialise (such as securities lending in European ETFs). As a result, in such circumstances, the US market is not a fair comparison to the specifics in Europe.
With respect to MIFID II, yes this will address some of the inefficiencies of the European market with respect to ETFs such as the requirement to conduct trading on exchange as opposed to OTC.

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?

Harmonisation of settlement systems is not addressed under UCITS or MIFID. Whilst T2S is likely to bring some level of harmonisation although there will still be fragmentation within the European Union. We believe the harmonisation and simplification of ETF settlement in Europe should be explored further in order to ensure the ETF market is as liquid as possible for investors. Simplification of settlement will also lead to cost savings which, ultimately, will benefit investors.
We do not consider that there are risks unique to an ETF which are not already addressed by the UCITS and MiFID frameworks.

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