12 October 2017

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

Re: Exchange Traded Funds, Discussion Paper

Dear Sir/Madam:

JP Morgan ('JPM') is grateful for the opportunity to respond to the Central Bank of Ireland's ('Central Bank') Discussion Paper on Exchange Traded Funds ('ETFs'). We welcome the Central Bank's openness in considering the sector's fundamental issues and commitment to the strength of the ETF industry.

JPM is in agreement with the Irish Fund Association's response to the Central Bank on this topic. In this letter we elaborate on areas that we believe particularly merit the Central Bank's consideration. We focus on the sections of the Discussion Paper relevant to our business as an issuer and investment manager of ETFs and as a provider of administration and custody services.

The nature of ETFs has changed over time. They began as traditional passive products with access to capital weighted indices and have now evolved to cover a much broader range of investment strategies including smart beta, active and commodity strategies. As a preliminary matter, we suggest that regulators should allow ETFs to continue to evolve and not stifle innovation and investor demand through overly constrictive regulation. We were pleased to see the Central Bank's objective of creating a "robust, but enabling, regulatory framework".[1]

While ETFs have distinctive features relative to other investment funds, European ETFs at their core are UCITS products and are regulated as such. Any movement away from common UCITS regulation could cause complications for investors and promoters of European ETFs; and cause damage to the global validity of the UCITS brand through fragmentation.

For this reason, we believe that the Central Bank should start with the presumption that in most cases any ETF related issues are also relevant to other forms of UCITS. This would mirror the approach ESMA has taken in its UCITS Guidelines, ensuring the general consistency of Irish and EU rules. Any steps taken to address ETF issues should be agreed and resolved at the EU level, supporting the ability of the industry to market ETF products across Europe, which will benefit scale and economic competitiveness.

Our comments below support our view regarding the fundamental importance of permitting evolution and ensuring regulatory consistency.

Section I: ETF dealing

The Discussion Paper considers whether the public disclosure of the identity of Authorised Participants (AP) and Ordinary Liquidity Providers (OLP) would result in benefits to investors.[2] We believe that regulators should have knowledge of the liquidity ecosystem for the ETF; however, we are concerned that requiring

[1] Discussion Paper, page 8.
[2] Discussion Paper, question A.

public disclosure in ETF documentation could potentially confuse or mislead investors, because APs change over time (on boarding and off boarding over the life of the product), so fund documentation would not always be accurate. The alternative of requiring fund documentation to be updated each time an AP is added or removed is not sufficiently beneficial to investors to warrant the added cost and complication of doing so.

The Central Bank also asks about possible arrangements should secondary markets or AP arrangements become impaired, including secondary markets dealing directly with an ETF when AP arrangements break down.[3] Generally the market has sufficient mechanisms to ensure the ability for investors to continuously trade on exchange. However, there could be exceptional market events that impact the ETF and the ability to implement UCITS gating.

ETFs are structured to use the primary market creation/redemption mechanism. A solution that opens this primary market mechanism as a vehicle to facilitate the ability of the fund to deal directly with investors is likely to be legally and operationally complex.

Administrators cannot identify the underlying owners within the secondary market for ETF shares. Moreover different European countries have differing rules for KYC, AML and similar requirements. As a result, it is not possible for Administrators to settle directly with ETF unit holders. However, by exception, settlement of the ETF units in-kind with retail investors' broker accounts might be accommodated to ensure that remaining investors are fairly treated. This mechanism would be contingent on the redeeming investors' consent and practical feasibility, based on factors such as investment size.

The Discussion Paper further asks whether ETF share classes should be structured to take account of the operational concerns of APs, for example, dealing deadlines for hedged versus unhedged share classes, cash versus in-kind dealing.[4] We believe that so long as investors interests are advanced through the inclusion of operational considerations in the structure of the ETF, and such processes are sufficiently transparent and carefully assessed for risk, there is no reason that these operational processes should be excluded.

In Europe, where there is fragmentation in markets and currencies (as opposed to the US where there is a single settlement market), there are a number of reasons to allow for different trading cut-offs to ensure that both the AP and manager can complete the operational processes to ensure the best result for the end investor.

In respect of allowing listed and unlisted share classes within the same fund, ETFs are a wrapper within the UCITS framework and any currently permitted UCITS features should also be available to ETFs.[5] We believe that as long as the underlying investors of the individual share classes have an understanding of the features of the share class they have invested into, and that there is no significant variance in the NAV of the share classes, there should be no barrier to this style of product.

Section II: Distinctive ETF risk factors

The Discussion Paper considers whether there is rationale for requiring synthetic ETFs to have sufficient collateral to deliver the performance of the underlying index if a counterparty defaults.[6] Synthetic ETFs can offer access to markets where the underlying assets are illiquid and facilitate more efficient trading for the

[3] Discussion Paper, question C.
[4] Discussion Paper, question E.
[5] Discussion Paper, question D.
[6] Discussion Paper, question G.

investor in times when trading on those underlying assets is more difficult. As such, restricting the ETF collateral to asset classes that are correlated to the index could cause unfair impact to the investor in a time of market stress. The standard UCITS collateral rules, with which synthetic ETFs must comply, are sufficient.

Section III: Particular types and features of ETFs

Active ETFs and product classification

As previously stated ETFs are fundamentally UCITS and should be subject to the same investment eligibility restrictions to which other UCITS are subject.

Contrary to the views expressed by certain market participants, we believe that the categorization of ETFs as "simple and transparent"[7] is not appropriate. While this does not necessarily imply that ETFs are 'complex products', many non-active ETFs do not follow simple investment rules. This could be because they are using synthetic replication of their reference index or because they are using smart beta strategies, a rule-based approach to investing not based simply on replication of a publicly available benchmark. In respect of transparency, an ETF might utilize techniques such as stock lending or the re-hypothecation of collateral that mean that the fund's activities and resulting risks are not obvious. Finally, we note that a categorization of ETFs as "simple and transparent" could hinder the further development of the market by setting limits to structure and strategies that investors might want.

The Central Bank questions whether investors can have a full appreciation of actual exposure delivered and risks associated with purchasing an actively-managed ETF which is a UCITS[8]. We consider that such issues are not particular to ETFs but are common to other forms of UCITS and therefore should be addressed as UCITS issues and not ETF issues, for instance through increased disclosure.

Considering active ETFs, in particular, we broadly agree with the Central Bank's definition but would clarify that these funds are those that do not *aim* to track an underlying index.[9] An active fund might have a resemblance to an underlying index for a number of reasons at any given time. This could be due to structural reasons; for example, an active ETF could invest primarily in large cap, listed businesses. It could be because closely tracking an index could result in the best returns for investors at a given time. Notwithstanding these situations, active ETFs, and those that follow smart beta and similar rule-based strategies, may not track their reference index as an objective of those funds.

Active ETFs and fee transparency

We note that the transparency of active ETF fees is greater than those of non-ETF active funds. The Total Expense Ratio is clearly disclosed and transaction costs for acquiring shares are largely known ex ante. From the perspective of product promoters, one of the primary reasons for launching an active ETF strategy is to gain access to previously unavailable distribution channels, such as platforms, investment banks and tactical ETF buyers. Restrictions like the "simple and transparent" designation will unnecessarily prevent investors from accessing these benefits. Furthermore, we believe it likely that active ETFs will be an area of significant industry development absent of any new restrictions.

[7] Discussion Paper, paragraph 132-133.
[8] Discussion Paper, paragraph 132-133.
[9] Discussion Paper, paragraph 130.

Active ETFs and portfolio transparency

Notwithstanding the transparency of active ETFs fees, disclosure of their portfolio composition is a more complicated area. On the one hand, to attract investors an ETF will seek to offer low spreads and efficient pricing. To achieve this, market makers will typically require full disclosure of portfolio holdings or at least details of the baskets that the fund will accept for in-kind subscriptions. On the other hand, as the Discussion Paper highlights, there are risks to full disclosure because other market participants can 'front-run' those active strategies.[10] This can have a material adverse effect on investors in the fund and also in other products offered by the same manager that pursue the same strategy. Ultimately the development of the market depends on managers being able to protect the investments that they have made in intellectual capital, research and analysis.

The tension between the need for disclosure to ensure efficient markets and the need for managers to protect their investors and themselves from inappropriate market behavior can result in sensible outcomes. In the context of active ETFs, we consider that a pragmatic approach would be to require disclosure of the full portfolio on a daily basis to specific market participants which they need for their market making purposes and to ensure efficient secondary market trading. These market participants, which include APs, market makers, OLPs and INAV providers, are commercial counterparties of the ETFs and are appointed through commercially negotiated legally binding agreements. These agreements provide for protection of the ETFs and their investors from the risks of "front running" through confidentiality requirements and limitations on the use of the information outside the scope of the services provided by the market participant.

As regards the disclosure of portfolio to the general public, we consider that its appropriateness should be determined on a case-by-case basis, based on the distinctive features of a particular ETF and whether or not daily portfolio disclosure creates too great a risk of "front running" and, as a result, may negatively impact investors.[11] In such cases, we believe that disclosure to the general public could be time-lagged or less frequent to avoid negative outcomes for investors in the fund. In addition, retail investors, the group that disclosure rules typically aim to protect, do not necessarily gain any additional benefit beyond the disclosures that ETFs currently make (for example, the ultra-frequent iNAV publication). Arguably the group that is realistically able to gain any benefit from full disclosure are investors that are sophisticated enough to interpret this information. Sophisticated investors would therefore derive an advantage, while there could be detriment to other investors in the strategy.

Consequently, we believe that the Central Bank should permit a greater degree of flexibility in the determination of portfolio holdings disclosure policies, to enable market participants to assess what is appropriate for their particular ETF products. We believe that the Deutsche Börse example in paragraphs 137 and 138 is a good example of how to achieve this. It is noteworthy that a recent ESMA review concluded that full portfolio disclosure for ETFs is not necessary and that the principal exchanges on which ETFs are traded in Europe do not require as much to ensure the integrity of their markets.

Furthermore, contrary to the point made in paragraph 149 of the Discussion Paper, we believe that disclosure of the entirety of ETF holdings cannot in all cases offer full transparency of the fund's strategy. The former is a

[10] Discussion Paper, paragraphs 141-150.

[11] In each case, the Central Bank has the opportunity to review the proposed approach to disclose through review and approval of fund documents.

disclosure at a point in time, while a strategy is dynamic. Transparency of investment strategy can be addressed much more effectively through the offering documents and supporting materials and also through education which issuers provide to investors and other market participants. If transparency of investment strategy is a concern, it should also be one for other UCITS.

Section V: Other considerations

The Central Bank questions whether reliance on US academic literature might pose practical difficulties when applying those studies to Irish and EU markets. We share this concern. The US ETF Primary market differs from the European market in that the former market is much more mature and centralised, and operates in a single currency. In addition, investor behaviour within the US is further driven by the tax treatment of their activity, which can result in retail investor behaviour differing from what might be expected in a European country.

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JPM appreciates the opportunity to comment on the Central Bank's Discussion Paper. We would be pleased to provide any further information or respond to any questions you may have.

Very truly yours,

/s/ Carin Bryans	/s/ Mike O'Brien
Carin Bryans	Mike O'Brien
Senior Country Officer, JP Morgan Bank Ireland	CEO, JP Morgan Asset Management EMEA