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LSEG Response to Central Bank of Ireland Discussion Paper on Exchange Traded Funds (ETFs).

Introduction

- **LSEG welcomes the Central Bank of Ireland Discussion Paper (DP) on ETFs.** We recognise that Ireland is a major location within the EU Single Market for the authorisation of ETFs and therefore we support the objective of the DP to galvanise an exchange of views on ETFs to support IOSCO and EU regulatory discussions. This is particularly important given the rapid growth of the market, including amongst retail investors and the welcome increase of transparency being introduced with MiFID II/R.

- **LSEG is home to over 2500 Exchange Traded Products (ETPs)** across our London and Milan Regulated Markets. All ETFs listed on LSEG markets are UCITS compliant. There are 1378 ETPs (921 ETFs) listed on LSE in London (of which 590 domiciled in Ireland), and 1076 ETPs (763 ETFs) on the ETF Plus market managed by Borsa Italiana in Milan (of which 590 domiciled in Ireland). Across both LSEG platforms combined there is 55% of European ETFs trading (whilst c.70% of the market is OTC). LSEG is also owner of XTF is a provider of U.S. ETF data, analytics and ratings. In the two sections of this paper we provide our overall commentary on the ETF regulatory policy debate (Part 1) and offer responses to specific DP questions (Part 2)

LSEG Key Points

- **More on-exchange trading increases transparency.** The implementation of MiFID II /R will have a major impact on ETFs and substantially increase levels of transparency, through a welcome shift to more on-exchange trading, which will significantly enhance liquidity and allow investors more ready access to funds. It will also deliver efficiencies compared to OTC trading.

- **Clearing and Settlement**. More on-exchange trading of ETFs supports greater access to clearing, removing counterparty risk and creating netting and efficiency possibilities. Clearing helps reduce systemic risk in the market by taking the risks off market makers and liquidity providers, which in turn offers them the opportunity to provide further liquidity to the market. Harmonised settlement and buy-in regimes supported by T2S systems allows more on-exchange trading to benefit from Straight Through Processing (STP) efficiencies.

- **Retail.** ETFs have numerous features which can benefit retail investors, for example improved transparency, enhanced liquidity, lower fees and eligibility for wrappers like ISA and SIPP. We believe there is significantly greater potential for retail participation in ETF markets.

- **US / EU comparison.** We believe that more EU-centric studies should be developed as there are some key differences between the market structure in Europe and US. One of the main data issues faced in European ETF industry is that c. 70% trading volume is outside regulated markets thus not providing full visibility of the ETF market to regulators and industry participants.

- **Collateral.** We believe collateral quality is already sufficiently regulated and disclosed. Under UCITS rules, a fund’s exposure to counterparties may not exceed a total of 10% of the fund’s net asset value.

Part 1: LSEG Overall Commentary on the ETF regulatory policy debate

- **More on-exchange trading increases transparency**. The implementation of MiFID II /R will have a major impact on ETFs and substantially increase levels of transparency. The ETF market is still predominantly wholesale and participants are used to trading large orders in large clips, making use of market markets providing liquidity. On LSEG markets, with a view to increase market efficiency we have introduced the *Request for Quote* (*RFQ*) functionality, for large in scale orders as a MiFID II/R solution to enable institutional customers to use LSEG markets to execute electronically larger sized trades which usually occur OTC. This function enables an intermediary to enter an RFQ regarding a specific financial instrument, to which authorized intermediaries may respond using the "quote response" function. The ETF market is still developing and the RFQ initiative should let agency brokers get involved for the first time. If these brokers in turn offer Direct Market Access ("DMA") to their clients, this will bring in new participants which will help to support market innovation.
- **Clearing and Settlement**. More on-exchange trading supports greater access to clearing, removing counterparty risk and creating netting possibilities. This will benefit the market makers such as banks and propriety trading firms. Harmonised settlement and buy-in regimes supported by T2S systems allows more on-exchange trading to benefit from STP efficiencies
- **Retail.** ETFs have numerous features which can benefit retail investors, for example improved transparency, enhanced liquidity, lower fees and eligibility for wrappers like ISA and SIPP. ETFs are commonly used by pension funds as the costs are low. However compared to the US we believe that there is much greater potential for ETFs to be used by retail investors (particularly fixed income ETFs). The UK market is moving slowly towards US model, where the fee-based (rather than commission-based) compensation covers roughly two thirds of the adviser market and passive assets now account for about 30% of the market.

Part 2: LSEG Responses to Specific DP Questions

Question A. *Is public disclosure of the identity of Authorised Participants (AP) 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?*

- **Transparency should benefit investors.** LSEG publishes the list of registered market makers per security on a daily basis in both London and Milan and we believe that some issuers also publish the list of their APs on their website. We support any transparency around products, that would benefit the investors and this can include list of APs/OLPs. *However, we don't think the disclosure around remuneration models would help investors.*

Question 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?*

- **LSEG fully supports transparency in the ETF market**, our commitment has been underlined by us mandating that all OTC ETF trades by LSE member firms must be reported (in Italy as well the Italian regulator Consob in the context of MIFID I extended post trade requirements in Italy also to ETFs). Post trade transparency ensures the true liquidity of an ETF can be understood. ETFs liquidity also depends on the liquidity of the underlying basket.

- **Electronic order books** provide a transparent view of executable liquidity. This allows market participants to make more informed trading decisions and trade effectively. In Europe, around 70% of ETF trading is OTC and not necessarily visible which doesn't help showcasing the real liquidity of these products. LSEG ETF electronic order book liquidity is supported by over 20 registered market makers in London and13 on Borsa Italiana, and a variety of other liquidity provider who are connected to LSEG markets either through direct membership or Direct Market Access.

- **Question 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?*

- **Secondary Market preferred by investors.** We agree that the provision of giving all investors the possibility to ask for redemption directly from the ETF issuer or APs is a good practice. However, in our experience, this service is rarely used by private investors who instead prefer to close positions in the secondary market rather than by redeeming in the primary market.

- **Question 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?*

- On the LSEG order book registered market makers must maintain a two way quote in each security in which it is registered for at least 90% of continuous trading and the closing auction. Quotes must be within the applicable maximum spread and minimum size. LSEG markets require two way liquidity to ensure investors are able to trade in and out of an ETF throughout the trading day.

- **Question 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?*

No LSEG view

- **Question 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?*

- We note that the DP states in note 81, page 36 that "should an investment funds establish a listed share class it would fall immediately to be categorised as a UCITS ETF". However we believe listed share classes of investment funds already exist and they are not considered ETFs. This depends on the way they are traded. The Open End Fund Segment of Borsa Italiana hosts listed share classes of UCITS funds (incorporated in Ireland, Luxembourg, Italy or France), traded at NAV. As stated at page 8 of this paper "ETFs are investment funds not only admitted to trading on a RM but also actively traded…". Concerning "unlisted" share class established by UCITS ETFs, we only recommend they are not marketed as "ETF".

- **Question 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??*

- We believe that there are some synergies in this kind of concentration and we support the UCITS framework for managing conflicts.

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

- **We believe multiple unaffiliated counterparties for synthetic ETFs could potentially mitigate counterparty risk.** The engagement with multiple counterparties may increase the operational costs and reduce the attractiveness of synthetic ETFs which usually offer lower costs than physical ETFs. Of 921 ETFs listed on LSE, around 240 are synthetic. Of 763 ETFs listed in Borsa Italiana 323 are synthetic.

- **Question 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?*

- **We understand that a higher correlation between the collateral and the ETF index could potentially decrease the possibility of significant loss in the case of default.** However, we believe that it might not be very practical to apply this restriction as correlation threshold would be difficult to quantify and stipulate.

- **Overall, we believe collateral quality is sufficiently regulated and disclosed.** Under UCITS rules, there are certain requirements on counterparty exposure, counterparty risk disclosure and collateral quality etc. To comply with regulations, ETF portfolio managers generally enter into swap agreements that "reset" when counterparty exposure reaches some stated limit. It is important to note that swap-contract terms are not necessarily standardized, are subject to negotiation, and may differ across funds. Generally, swaps reset monthly or quarterly and some ETF providers set the threshold much below 10%.
- **To reduce counterparty risk, best practice for ETF portfolio managers would be to reset swaps daily**, as a few managers have already done. Managers may also reduce counterparty risk by overcollateralizing the swap agreements. All things equal, the higher the level of collateralization and the more frequent the swap resets, the more investors would be protected from losses following a counterparty default (though usually at the cost of a modestly higher swap spread).

- **Question 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)?*

- We believe that ETF structuring, which allows fund managers to streamline many client services and reduce admin costs, is appropriate for active strategies as it can offer investors a relatively cheaper option to access active managers' expertise. There are 3 active ETFs admitted to trade on London Stock Exchange and 11 on Borsa Italian (June 2017). We don't see any reason why an extra limit on strategy should be imposed on active ETFs compared to their mutual funds or ETFs counterparts.

- **Question 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?*

- **Transparency has long been seen as one of the main advantages of ETFs** as most of ETFs disclose their holdings on a daily basis and this improves pricing efficiency as APs knows the portfolios they need to create and redeem shares and the AP arbitrage activities will facilitate the price close to NAV. The ETF structure enables active ETFs to offer a more cost-efficient option compared to mutual funds but the daily portfolio disclosure requirement can cause front-running which is a deterrent to active ETF managers. The daily portfolio disclosure requirement is often cited as one of the primary reasons why active ETFs have not seen greater growth and innovation to date, as investment managers are hesitant to provide full transparency of their trading strategies on a daily basis.

- **LSEG markets require ETFs to disclosure their NAV and number of outstanding shares on a daily basis** and we follow home listing requirements on daily portfolio disclosure which varies among EEA countries. In addition on Borsa Italiana, ETF issuers are required to disclose the iNAV in real time through an information provider (Bloomberg or Reuters) or a web site. *We would like to highlight that Borsa Italiana removed the requirement for portfolio transparency for active ETFs in 2015 (contrary to the information provided on page 33, para 55 of the DP).*

- **In the context of active ETFs, we believe the side effect of front running outweighs the benefits of transparency**. Given the fact that Irish Stock Exchange removed their daily portfolio disclosure requirements for active ETFs and SEC approved non-transparent exchange-traded manged funds in 2014[1], we think the disclosure requirement on active ETFs is worth a further discussion to promote innovation in the asset management industry.

- **Question 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?*

- **We believe that the liquidity rules imposed by UCITS are sufficient.** There are three sources of liquidity: “visible” liquidity on the stock exchange, “hidden” liquidity over the counter and liquidity from underlying securities. The most visible source of ETF liquidity is the trading activities on an exchange, which is facilitated by one or multiple designated market makers to maintain a fair and orderly market. Some OTC trades can also be reported to the exchange to increase visibility. LSE

[1] We understand SEC approved only the so called “Exchange Traded Managed Fund – ETMF” run on a NAV based trading protocol and not on-book trading like those on LSEG markets.

require member firms to report their ETFs/ETPs trades to the Exchange unless the member firm and its counterparty agree to report the trade to a venue with an equivalent or greater level of post trade transparency. Other OTC trading which is not reported to any exchange is the hidden source of liquidity, which constitutes about 70% of overall trading in Europe. Apart from the secondary market activities, an ETF's liquidity also comes from its underlying securities, which is facilitated by APs.

- **We believe that bringing OTC volume on exchange will significantly enhance liquidity**. For this purpose, LSEG markets have introduced Request-for-Quote functionality for ETFs/ETPs to facilitate trading of larger trade sizes on exchange. Since inception (December 2016) Borsa RFQ has registered trades for 1.85 billions in ETFs providing an efficient, secure and transparent way of execution for customers.

- **Costs of OTC trading.** We note the reference in paragraph 20 of the DP to the "efficiencies of trading OTC...[with no] minimum clip sizes in the case of exchange trading". In our view, we believe that OTC trades imply certain costs and risks (counterparty and operational) and Authorities should address them. In addition we do not understand the phrase about the minimum clip size. LSE and Borsa Italiana do not require any minimum trading lot for ETFs that can be traded for a minimum of one share.

- **Question 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?*

- **We believe that ETFs could enhance the informational efficiency of underlying securities in some circumstances.** ETFs could serve as price reference for the underlying assets in some extreme market conditions. For example, during the financial crisis in Greece in 2015, the local equity market was closed from June 29 2015 to August 3 2015. During this time the US-registered Global X FTSE Greece 20 ETF (GREK) continued to trade, gapping down almost 20% when the Greek Stock Exchange was shut. Upon reopening in August, the price of GREK was relatively stable while the underlying benchmark moved down to the ETF's level. This is suggestive that ETFs are important contributors to price discovery. ETF could also improve price discovery when the underlying assets are illiquid. For example, fixed income ETFs are usually more liquid than the underlying fixed income assets and the liquid fixed income ETFs could serve as a price discovery tool. ETFs are also proved to have positive impact on the price discovery in the underlying securities over the short term. *This is consistent with the emerging thinking of the European Commission Expert Group on Corporate Bond Liquidity. We recommend that the Central Bank study its report due in October 2017.*

- We understand there are concerns over impact of (listed or unlisted) passive fund ownership on the underlying markets over the long run. We believe the magnitude of impact should be assessed further. More specifically, the ratio of primary creation/redemption to secondary trading and the ownership percentage in each constitute security should be combined to assess the impact. For example, SPY, the most traded product on NYSE, has comprised an average of approximately 9% of NYSE volume but only an average of about 1% of trades end up constituting

trades in the underlying securities. Assets in SPY, after all, makes up less than 1% of the total market capitalization of S&P 500 companies. Therefore, even as large as SPY, it doesn't seem to have the potential to impact the volume and price of the underlying securities in any big way.[2]

- **Question 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?*

- Some issuers may choose to offer ETF support in stress events to manage their reputational risks but we believe it may not necessarily be compulsory given the resilience of the market. The current ecosystem with a diversity of APs, market makers, trading platforms and regulations is quite resilient and we believe compulsory provider support may not be desirable. Under UCITS requirements, ETF investors can redeem directly with the Fund is already supporting investors in case the stock exchange value of the units or shares of the UCITS ETF significantly varies from its net asset value.

- **Question 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 believe that more Europe-centric materials should be developed** as there are some key differences between the market structure in Europe and US. One of the main data issues faced in European ETF industry is that about 70% trading volume is OTC which is not required to be reported. Hence regulators and industry participants don't have full visibility of the markets. We believe that MIFID II which requires pre-and post trade transparency will help to resolve this data issue. However, LSEG market rules impose transparency requirements for ETFs and ETCs:
  - Order book executions – When trade is executed on-book, a trade report will automatically be generated.
  - Off-book executions – ETF and ETC trades executed away from the order book but considered 'on-exchange' and under the rules of the exchange are required to be reported to the Exchange unless the member firm and its counterparty agree to report the trade to a venue with an equivalent or greater level of post trade transparency. Trades must be reported as soon as possible and not later than 3 minutes after execution.

- ***Question 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?*

No LSEG view

[2] https://www.spdrs.com/library-content/public/Do_ETFs_Have_a_Significant_Impact_on_Equity_Market_Volumes_090716.pdf

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