STATE STREET GLOBAL ADVISORS.

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Submitted via email: **fundspolicy@centralbank.ie**

Re: CBI 2017 Discussion Paper on Exchange Traded Funds

Dear Sir/Madam

State Street Global Advisors (SSGA) appreciates the opportunity to comment on the Central Bank of Ireland's discussion paper on exchange-traded funds (ETFs). State Street is widely recognized as an industry pioneer, creating the first listed exchange-traded fund in the United States in 1993 (the "SPDR S&P 500"), which has grown into one of world's largest ETFs in terms of assets under management. Since then, State Street has remained at the forefront of developing responsible and innovative investment products, as evidenced by the introduction of many ground-breaking products, including first-to-market launches with gold, international fixed income, and most recently based on gender diversity.

Aside from the numerous, well publicized benefits of ETFs, such as transparency, liquidity and cost-effectiveness, we identify in our response some potential areas for improvement or clarification that would further enhance the attractiveness of ETF structures for investors and promoters alike.

Again, SSGA appreciates the opportunity to comment on the discussion paper. Should you have any aspect that you would like to discuss further, please do not hesitate to contact me.

Yours sincerely,

Rory Tobin
Executive Vice President & Co-Head of Global SPDR Business

Section I ETF dealing

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?

Response: We believe that knowing the identity of OLPs and APs in the ecosystem helps to educate investors on the sources of liquidity for ETFs. A list of APs in the SPDR UCITS range is published on our website, as are the names of firms that have official market making or OLP arrangements with the exchanges. The interconnectedness between the parties is of fundamental importance to the resilience of the secondary market in the ETF. Having an efficient primary market process to support trading allows APs to release inventory through redemptions. Remuneration arrangements with OLPs for the provision of liquidity in the secondary market are commercially confidential, but the intention is to ensure that the OLP provides continuous liquidity in the secondary market for a specific range of ETFs under all market conditions.

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?

Response: We strongly believe in the transparency features of ETFs. Visibility into fund holdings and constituents provides investors with an enhanced level of information about their underlying investments. A lack of transparency of detailed fund level data could create greater uncertainty for OLPs which could in turn be reflected in wider bid-offer spreads and greater volatility.

It is our experience that during the financial crisis investors took comfort from the fact that certain ETFs provided them with composition transparency. This enabled investors to look through to the individual security level, detailing the exact positions held and relevant weightings. The ability to look through to constituent level data contrasted ETFs favourably with other investment products available at the time where in certain instances investors were surprised as to the liquidity characteristics of certain underlying securities held within these products.

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?

Response: The SPDR UCITS range currently operates with over 30 APs and market makers facilitating secondary market liquidity in various capacities. Given the breadth of

these arrangements, we do not foresee a breakdown of our AP agreements leading to secondary market liquidity disruptions. In the event some AP arrangements do break down, other APs would remain active in supporting the primary market liquidity and secondary market investors should still have the ability to trade.

However, in exceptional circumstances (as determined by the SPDR UCITS' board of directors), whether as a result of disruptions in the secondary market or otherwise, secondary market investors may be able to apply to the ETF provider to have ETF Shares registered in their own name and potentially access the primary market redemption facility. To date SPDR has not received such requests from secondary market investors. We consider this a positive indication of the resilience of the multiple AP model in supporting secondary market liquidity under various market conditions. Given secondary market investors do not have a direct relationship with the ETF, supporting requests to deal with the ETF directly could give rise to short to mid-term practical challenges.

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?

Response: In certain exceptional market conditions, an investment manager may not be able to liquidate assets: this holds true for both mutual funds and ETFs. For example, primary market subscriptions and redemptions were suspended during the closure of the Cairo stock exchange in 2011, the closure of the Greek stock exchange in June 2015 and the circuit breaker restrictions leading to China A-shares suspension in July 2015. Depending on the market conditions, a fund closed to creations may remain open to redemptions and vice versa. Investors in all such funds should be made aware of these possibilities.

However, unlike mutual funds, ETFs may continue to be priced and traded on exchange depending on the market conditions. As a result, ETFs can serve as a price discovery tool and offer an option for investors to trade in or out of the fund in such market conditions. While the underlying share prices remain stale due to the closure of the underlying market, the secondary market price of an ETF can reflect the real time market price and liquidity of the underlying.

Forcing ETFs to remain open-ended in a stressed market could disadvantage investors who choose to remain in the fund, if the situation is not managed properly. In order to remain open, investment managers may be forced to sell the only liquid part of the portfolio instead of according to the PCF - leading to significant tracking error of the fund. UCITS may gate redemptions where requests on any given dealing day exceed 10% of issued shares – the ability to do this and the mechanism for applying gates is typically made clear to investors in the prospectus.

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?

Response: We believe that in certain scenarios, there is merit in applying different operational considerations to different share classes. For instance we consider it would be beneficial if different primary market cut-off times were permitted for hedged versus unhedged share classes.

Typically, the cut-off time of an unhedged share class is determined by the trading hours of the underlying markets.

For hedged share classes, the timing of FX trading is also taken into account. In order to tighten the tracking of the currency hedged ETF, the investment managers typically place FX trades at, or as close as possible to the time reflected in the benchmark. As most of the benchmarks apply the 4pm currency fixing price, the investment managers are required to trade the FX forward around 4pm, hence the cut-off of the share class would ideally be brought forward.

If the unhedged share class is required to have the same earlier cut-off as the hedged share classes, investors of unhedged share classes are likely to suffer from reduced trading flexibility.

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?

Response: The European SPDR business does not currently offer listed and unlisted share classes within the same fund, nor do we have any immediate plans to do so. However, we believe that there may be instances where investors can potentially benefit from the choice between listed and unlisted share classes in the same fund. Any unlisted share class should be required to meet the same transparency requirements as listed share classes in order to provide investors with a full understanding of the value of the whole fund.

Section II Distinctive ETF risk factors

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?

Response: The conflicts of interest framework applicable to ETFs and UCITS more broadly, requires management companies to maintain an effective conflicts of interest policy. Where the management company is a member of a group, conflicts arising from group activities must be taken into account in the policy. This provides an appropriate framework for monitoring and managing potential conflicts arising from activities undertaken for an ETF by group entities. The rules also require ETFs to

provide detailed disclosures to investors regarding counterparty risk and potential conflicts of interest that may arise. Where it is envisaged that a UCITS and connected persons may enter into transactions with each other, the prospectus must disclose this fact. While this raises investors' awareness of the risks, a more direct approach to mitigate the risk would be to encourage or require the use of multiple/unconnected counterparties.

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

Response: For physical ETFs, multiple APs and OLPs help ensure an efficient and competitive secondary market environment that strengthens an ETF's liquidity provision, leading to product and market resilience.

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?

Response: The SPDR business does not offer or promote synthetic ETFs, so we are not in a position to give an answer to this question based on any practical experience or recent evidence. If we were to offer such products in the future, we would need to ensure that careful consideration is given to MiFID II product governance requirements to identify the appropriate target market and distribution strategy for such a fund.

Section III Particular types and features of ETFs

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)?

Response: We consider that not all active strategies are compatible for use within an ETF framework. Some active managers might have concerns about transparency facilitating analysis of the signals they use and potentially eroding their competitive advantage. Also, strategies focusing on illiquid parts of the market can be difficult to deliver in an ETF structure. However, some active strategies can be combined with exchange traded features to serve the investment purposes of certain investors. The open-ended and multiple market maker features of ETFs help reduce the deviation

from the NAV and provide investors with opportunities to trade in and out of the fund during the day without having to wait for the end of day price.

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?

Response: To date, both we and ETF investors generally have valued portfolio transparency as a key differentiator and core attribute of the ETF product category. Transparency underpins pricing efficiency and enables informed decisions on both the investment and the risk profile of a fund. In general, this principle holds true for both active and passive ETFs and whenever possible, greater transparency should be the goal.

Section IV ETFs and market liquidity

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?

Response: We consider and monitor liquidity impacts throughout the whole product lifecycle.

Additional stress-testing and analysis is performed on the less liquid parts of the equity and fixed income universe, such as emerging market and credit securities. This ensures that both the index and investment processes to be used for a fund are sufficiently robust in all market cycles. We engage with index providers to ensure that the benchmarks selected are investable and sufficiently liquid.

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?

Response: We believe the growth of investments in index-tracking ETFs has minimal impact on informational efficiency and non-fundamental volatility of underlying securities for the following reasons:

- ETF secondary market trading activity represents approximately 10% of secondary market trading activity in cash equities in Europe
- The size of the ETF market is less than 5% of the mutual fund market in Europe

The above-mentioned risks are also mitigated by the selection of indices which are investable and sufficiently liquid.

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?

Response: Unless explicitly stated and as is the case with the majority of other investment products, investors should not have an expectation that the provider will underwrite the value of ETFs or provide some form of direct support. Generating an expectation that ETF providers will make investors whole should they suffer losses introduces an element of moral hazard to investment decision making.

Investor expectation and understanding of the risks of investing should be appropriately managed by clear and comprehensive risk disclosures in prospectuses and KIIDs.

As a leading ETF issuer we take our oversight role very seriously. AP oversight and engagement with stock exchanges and other institutions in the capital markets ecosystem is a core part of our business. This includes monitoring of an AP and OLP firms financial strength as well as monitoring their trading activities across the SPDR ETF range to ensure optimal access to liquidity for investors.

Section V Other considerations

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?

Response: The harmonised infrastructure supporting the US ETF market does certainly allow for deeper data discovery and analysis. In Europe however, there is a greater level of fragmentation of both securities trading and post trade activities. This also means that trading data for individual ETFs can be opaque and less easy to analyse for patterns or insights. Some of the new requirements that relate to pre and post trade transparency within MiFID II will certainly help to address such issues.

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?

Response: The UCITS and MiFID regulatory frameworks, in addition to applicable listing rules are comprehensive and provide the required structure and protection for the market. We would be mindful that layering additional policy endeavours may merely add complexity rather than mitigating perceived product specific risks.

Given ETFs key characteristic as exchange-traded securities, the lack of harmonised listing rules across exchanges give rise to a lack of consistency in the product's ability to reach investors. Fragmentation in the market, lack of harmonisation in listing procedures, the conditions to which a fund/sponsor must adhere and operational support required to comply add potential costs for investors. Diverse tax treatments and rates can also affect accessibility.