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IOSCO

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AFG's response to the IOSCO's consultation report on "Principles for the Regulation of Exchange Traded Funds"

The Association Française de la Gestion financière (AFG)[1] welcomes the opportunity given by the IOSCO to express the French asset management's opinion on the ETF topic. Our ETF industry represents €34.3 Bn as of May 2012.

I. General comments

Scope

Most of the issues listed in this report are not specific to ETFs but also concern other funds or CIS (Collective Investment Schemes), including other ETPs (Exchanged Traded Products).

[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

We believe that is not appropriate to regulate specifically ETF, to the extent that they are only CIS. We may however understand that IOSCO looks at regulating what is really specific in ETFs, for example market making and everything that relates to the secondary market.

Only the proposed principles 1, part of principle 2, principle 6, principle 13 and maybe principle 15 are applicable only to ETFs.

All the other principles are applicable to a broader CIS world than only ETFs. They concern disclosures and transparency of the assets of the fund (principles 3, 4, 5 and 7), securities lending, collateral and derivatives (principles 8 and 14) and marketing (principles 9, 10, 11 and 12). They are not ETF-specific at all. There are actually regulations in many countries that already deal with these issues. As a general rule, they are applicable to all CISs. We are not aware of any case where they would be applicable to ETFs only.

It would therefore be inefficient and incoherent to regulate specifically ETFs as regards such issues. It seems to us that regulations are better when they have a broader and general application.

We therefore suggest that IOSCO:

- either restrict these guidelines to what is specifically linked to ETFs: principle 1, 2, 6, 13 and 16;
- or make clear that these guidelines do not concern specifically ETFs but all CISs, except the few principles that are ETF-specific.

Distinction between “traditional” and “non-traditional” ETFs

We believe the distinction established between “traditional” and “non-traditional” ETFs including all synthetic ETFs, without any distinction within the second category (between vanilla indices and leveraged/inverse strategies), should be reconsidered.

It seems there is a strong confusion between “traditional” (“physical ETFs”) and the “non-traditional” (“synthetic ETFs”) suggesting that synthetic ETFs (no matter the investment strategies of the ETFs) are highly speculative and risky. This is totally misleading. All European ETFs are UCITS funds. Amongst those UCITS ETFs, only a small proportion of synthetic ETFs are based on complex strategies such as leveraged or short strategies. It seems that this confusion relies on a certain degree of “US bias” in the analysis and the comparison of ETFs linked to US historical structuring techniques.

Thus, we would like IOSCO not to make the traditional / non traditional distinction in the way it does in the paper (implicitly US type physical ETFs versus European type synthetic ETFs), but rather to base it on the fund’s objective (vanilla index ETFs versus leveraged/short ETFs).

Also, a clear distinction should be made between synthetic UCITS ETFs and synthetic US ETFs: they do not have the same investment strategies and therefore the same risks. Another distinction should also be made between European ETFs (that are not actively-managed ETFs until now) and US ETFs that can be active funds.

In Europe, UCITS ETFs are highly regulated products and are amongst the most transparent type of funds by the means of regulation combined with voluntary practices in the European environment which is highly competitive.

In this respect, we more than welcome the general approach of the consultation which is to avoid any discrimination against what the consultation has named “non-traditional” ETFs. Such discrimination would not make sense because physical replication and synthetic replication ETFs are identical in terms of risks, and so-called "synthetic replication" does not use a technique which is more "complex" than securities lending.

Such a distinction is all the more surprising if we consider that the market event of May 2010 which raised concerns about the link between ETFs and systemic risk did not involve UCITS ETFs (such as synthetic/“swap-based” ETFs) but rather US ETFs structured with physical replication. At this stage, it is worth remembering that after its first consultation on ETFs as of April 2011, the FSB did not retain ETFs within its main areas of scrutiny for the systemic risk.

We disagree with the weird proposal of a market participant to classify ETFs in their names

We also fully support the consultation refusal to classify ETFs in their names (following the proposal of one market participant) depending on the inner workings of a fund (the replication techniques used).

Conflicts of interest

The report points out various sources of conflict of interests that do not exist, especially under the European UCITS framework.

ETFs proposed definition lacks the replication objective

Our members feel that less place is given to European ETFs and to UCITS CIS. For example, UCITS ETFs are defined before all as index tracking funds. No reference to this aspect is done in Box 1. In Europe, the vast majority of ETFs are index based and thus they have an objective of replication. We believe that the definition which is given (related particularly to the secondary market specificities) should be amended to specify the replication objective.

Regulatory approach vs best practices

On a more general plan, we believe it should be distinguished between best practices and regulatory issues. Not all best practices are meant to be carved in stone through mandatory regulation.

II. Comments on the proposed principles for the regulation of ETFs

Comments on Chapter 1 - Executive Summary

It does make sense for the IOSCO's Technical Committee to focus its analysis on ETFs, ignoring ETNs, ETIs or ETVs as IOSCO has a strong expertise in the field of CIS. However CIS, and UCITS in particular in Europe, are already subject to strong and accurate regulation in most countries. The great majority of European ETFs being UCITS, they are already regulated and therefore they already deal with many of the issues raised in the report. From our point of view, it is far more urgent to cope with certain regulatory loopholes which may exist with other ETPs (ETNs, ETIs or ETVs).

The footnote n°7 on page 2 should be completed with a US example specifying that US 3 times levered ETFs or some US low-diversified commodity ETFs may not be regulated as UCITS in Europe.

The footnote n°9 at the bottom of page 2 which distinguishes the so-called "traditional" ("physical ETFs") and the "non-traditional" ("synthetic ETFs") is very detrimental for the second category of products. Indeed, the use of the "non-traditional" qualification suggests that synthetic ETFs (no matter the investment strategies of the ETFs) are highly speculative and risky (cf. page 5, point 2; page 6, Box 2). This is totally misleading. All European ETFs are UCITS funds. Amongst those UCITS ETFs, only a tiny proportion of synthetic ETFs are based on complex strategies such as leveraged or short strategies. Almost 95% of swap-based ETFs are based on vanilla indices (using market capitalization weights). Using mainly the same category of indices as physical ETFs, UCITS swap-based ETFs are not riskier than the physical ones and they are not a source of systemic risk. On the opposite, US ETFs are "traditionally" physical (because of US regulation) and in the US the "new generation" of ETFs (that are based on more complex strategies) is swap-based indeed. These US swap-based ETFs are almost all based on complex strategies since they use derivatives instruments to achieve their leverage/inverse strategies. They use swaps because the implementation of their strategy requires so and because they cannot be structured like the so-called "traditional" US ETFs. It seems that the confusion made in the report relies on a bias linked to US historical structuring techniques.

As a result, a clear distinction must be made between swap-based UCITS ETFs and swap-based US ETFs: they do not have the same investment strategies and therefore the same risks. Another distinction should also be made between European ETFs (that are not actively-managed ETFs until now) and US ETFs that can be active funds.

The market event mentioned at the end of this chapter occurred in the US market and only concerned the so-called "traditional ETFs". At this stage, it is worth mentioning that out of the global ETF assets of US$ 1,525 mentioned in note 8, the US AUMs were over $ 1 trillion at the end of 2011. Some analysis of the 2010 market event concluded that some US ETFs suffered with this event as brokers involved in their market making could not face the sudden breakdown of the market. The size of some of those US ETFs gave way to what has been seen as a systemic threat.

Comments on Chapter 2 – Principles related to ETF Classification and Disclosure

Comments on 1. Disclosure regarding ETF classification

The description of the ETF creation process given in Box 1 provides a clear understanding to ETFs unit holders. It is of interest giving a similar description for synthetic ETFs.

First, it is extremely important to distinguish between ETFs and other ETPs (Exchanged Traded Products that are not CIS) as the risk of confusion between each category is currently very high. Although they appear similar from a financial point of view (all are listed on an exchange), they are different in terms of legal structure (UCITS funds versus investment banks' Notes or Certificates) and underlying risks. These Notes and Certificates are far more risky than UCITS ETFs for example: issuer risk, lack of independent valuation, no diversification requirements nor counterparty risk limit, no depositary nor auditor. Therefore we strongly encourage regulators to clarify the situation and make appropriate and clear distinctions between ETFs and ETPs, in terms of both regulatory frameworks and distribution among retail investors. This is a key point in terms of investors' protection and should be given priority.

We strongly believe that the definition ETFs should be clearly completed with the information that they are **index funds with a replication objective and limit**. In France, index funds are constrained by a Tracking Error (TE) limit, which ensures investors of the quality of replication. Actively managed ETFs are a different type of ETFs, which should be clearly distinguished from an index ETF whose objective is to accurately replicate the index. The vast majority of ETFs are index replicating and the common perception is to associate ETFs with index tracking.

Principle 1 Regulators should encourage disclosure that helps retail investors to clearly differentiate ETFs from other ETPs.

We agree that ETFs that are regulated CISs, to the extent that such regulation is protective of investors, like UCITS regulations in Europe, should be distinguished from other ETPs. This distinction should be given priority, as highly protective for investors. We also agree with the consultation that there should be no further classification scheme in the name of ETFs.

In addition, we do believe that a distinction has to be made between the financial product structure (i.e. portfolio management technique) and its payoff. From a retail point of view, complexity is linked to the risks borne by investors and the degree of protection offered. Therefore, it is much more closely linked to the CIS payoff than to its financial structure,

especially as the CIS structure is well regulated under UCITS rules. Products' complexity should not be linked to the portfolio management technique (nor the financial instruments used in the portfolio) but to the products' payoff itself (for example, hedge fund UCITS or leveraged/short UCITS could be 'complex' while other UCITS tracking 'vanilla' market indices would not). Investors have to understand both the CIS return objectives and risk factors, they are not asked to understand the techniques employed. It is the investment manager's duty to select appropriate techniques to achieve the risk-return objectives of the ETF.

In reference to the classification of products, the proposal of one market participant (note 15) to classify ETFs in their name, with an identifier distinguishing between physically-replicating and derivatives replicating ETFs is completely irrelevant if "simple" refers to the way products are structured. The investment strategy of a synthetic ETF based on a vanilla index is equivalent to the investment strategy of a physical ETF, and this is what really matters to the investors as well as the ability of a synthetic ETF to track its underlying index. It is of regulators' concern to assess whether the product has been structured in a sound and secure manner. For instance, UCITS funds are highly constrained and protective.

The consultation refuses to follow this isolated and weird proposal and we fully support the consultation on this. Indeed, we believe that this would be misleading. It supposes that the notions of "synthetic" and "physical" are easy to understand, ie they designate a finite and well known concept, or this is false:

- The information given through such a prominent distinction would be incomplete (mixed and evolving/switching strategies, physical using sampling and/or securities lending, etc.). If we want to add all relevant information in the name, we will soon arrive at the conclusion that the name of the fund will have the size of the KIID.

- Also, putting forward this distinction and not, for instance, the fact that it is either a tracker or an actively managed fund, or the index that is replicated (piece of information which constitutes the objective of the fund) would be meaningless.

- Funds are usually classified according to their strategy, not according to how they replicate this strategy.

- In addition, classifying funds in the name is not consistent with UCITS regulations. The European system of fund classification by EFAMA, has never proposed to put such classification in the name. The issue of understanding the fund and how it is managed has been addressed by UCITS4. The UCITS4 solution to this problem is the Key Investors Information Document (KIID). The fundamental idea is to have for each fund a two-pages document, the KIID, written in simple language, that explains the fundamental characteristics of the fund. We do not see why we should depart from the UCITS4 construction, which has not even been fully implemented yet (the KIID will completely be in place only in July 2012). If such a requirement were applicable to ETFs, why not applying it to all UCITS? The logic behind such proposition would be to have a system of classification of all UCITS in their names. That is very unlikely to be effective. It is already difficult to explain the fundamental characteristics of a fund with two pages, so in the name this is clearly impossible.

- What about mixed situations? If an ETF replicates an index by purchasing the constituents of the index, for 60%, and with some swaps for 40% of the index, is it physical or synthetic replication?

Principle 2 Regulators should seek to ensure a clear differentiation between ETFs and traditional CIS, as well as between index-based and non index-based ETFs through appropriate disclosure requirements.

We do not believe that there should be a clear differentiation between ETFs and traditional CIS. In Europe, ETFs are only CIS that are listed on a stock exchange. Their listing on a stock exchange does not create some characteristics that are so fundamental that a clear differentiation should be achieved. The word ETF, however, should clearly be reserved to those CIS that have a real and liquid secondary market, in order to avoid misleading investors with some understanding that they could purchase them on the secondary market at low trading cost.

ETFs are UCITS funds in Europe, thus they are very similar to any simple, traditional CIS. Maybe the distinction between ETFs and traditional CIS refers to the US market where ETFs are not considered as mutual funds? For all these reasons, a global/universal IOSCO principle should better be rephrased as follows: *Principle 2 Regulators should seek to ensure a clear differentiation between index-based and non index-based ETFs through appropriate disclosure requirements.*

ETFs are often confused with other ETPs (such as ETNs, ETCs and ETVs) yet the features of these products and the underlying risks for investors are different. We strongly encourage clear distinctions between these products, in terms of both regulatory frameworks and distribution among retail investors. Notes and Certificates are far more risky than UCITS ETFs for example: issuer risk, lack of independent valuation, no diversification requirements nor counterparty risk limit, no depositary nor auditor. Investors should naturally understand that a higher level of protection is achieved with an ETF rather than with other ETPs.

Additionally, index-tracking ETFs should be defined with a clear investment objective as well as with a tracking error objective. This requirement already applies in France. We encourage regulators to establish and publish a clear tracking error formula (i.e. the mathematical formula) applicable to all index-tracking ETFs so as to:

- harmonize tracking error calculations across Europe (some asset managers calculate the tracking error using the data on one specific weekday while other use a weekly average)
- allow a comparison of tracking error between European index-tracking funds.

As we have said earlier, we do not agree with the idea to use an identifier in the ETFs name that would distinguish between synthetic and physical ETFs for the following reasons:

- In Europe under the UCITS rules physical and synthetic ETFs are CIS that must comply with the same regulatory constraints. Adding an identifier would be misleading in terms of risks communicated to investors.
- An identifier in the ETF name would not add any relevant information in terms of exposure, performance, tracking error or risks compared with the information stated in the CIS legal documentation. Investors may have different constraints or expectations and should therefore be able to make their own investment analysis and choose ETFs with full knowledge of the performance and underlying risks.

- An identifier would widen the ETF name; the main objective of the ETF name is to quickly identify the index tracked rather than the ETF replication method. Given that ETF names are already quite long enough, one can imagine that in order to comply with CIS database constraints, ETFs providers would have to remove some current relevant information from the name to keep it within an acceptable length. Adding the identifier would be at the expense of overall product clarity.
- If an identifier is required for synthetic ETFs, a similar identifier should also be required for physical ETFs that carry risks: counterparty risk through securities lending and tracking error risk through sampling replication, for example. We could therefore submit the following identifiers: 'swap-based ETF' (for synthetic ETF) and 'full -or sampling-replication with share lending ETF'.

Synthetic UCITS ETFs do not generate systemic risks and a clear distinction has to be done between these CIS and other "non-traditional" products. Almost 95% of synthetic ETFs are based on vanilla indices (using market capitalization weights). Using mainly the same category of indices as physical ETFs, UCITS swap-based ETFs are not riskier than the physical ones and they are not a source of systemic risk. On the opposite, US ETFs are "traditionally" physical (because of US regulation) and in the US the "new generation" of ETFs (that are based on more complex strategies) is swap-based indeed. These US swap-based ETFs are almost all based on complex strategies since they use derivatives instruments to achieve their leverage/inverse strategies. They use swaps because the implementation of their strategy requires so and because they cannot be structured like the so-called "traditional" US ETFs. It seems that the confusion made in the report relies on a bias linked to US historical structuring techniques.

<u>Comments on 2. Disclosure regarding ETF strategy</u>

As mentioned above, we consider that a detrimental amalgam is done in this part of IOSCO consultation between synthetic ETFs and other "non-traditional" ETFs. All non-traditional ETFs described in Box 2 (leveraged ETF, inverse ETF, ultra short ETF) have more complex investment strategies than the vast majority of ETFs based on "simple" or "vanilla" indices.

Most of the leverage/short strategies described in Box 2 do not apply to synthetic UCITS ETFs because they are constrained by the UCITS regulation. Therefore, the following conclusion: *"Furthermore, derivatives are necessary for certain ETFs (i.e. synthetic ETFs) to pursue their replication strategies. The use of more complex investment strategies and replication methods may result in confusion for investors and may raise additional risks"* is confusing.

In the European UCITS framework, leverage is strictly regulated with a detailed precise methodology and a limit of 2.

Principle 3 Regulators should encourage all ETFs, in particular those that use or intend to use more complex strategies, or other complex techniques, to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with such strategies or techniques.

We strongly believe that the principle should not make reference to complex techniques (we propose to erase “or other complex techniques”). Indeed, any CIS is intrinsically using more or less sophisticated techniques to achieve its investment objective. All CIS use techniques and structures, more or less sophisticated, and with more or less permanency, related to the investment objective of the fund and how markets behave. There is no scission between “simple” techniques on one side and “complicated” on the other. From the portfolio construction point of view, there is a continuum between the “simplest” products and the more sophisticated ones and, as a matter of principle, we do not believe it would make sense to require the investors to be able to reproduce themselves what a professional asset manager performs. CIS are funds and funds use techniques and structures. Investors buy the fund, ie the result of the combination of what is inside the fund. By definition, a fund is a package; it is not a single instrument. When buying a fund, the client decides to pay for an expertise he/she most of the time does not possess.

Thus, we agree with such a Principle, provided that "or other complex techniques" is deleted. We believe that this expression may lead to some confusion between "complex strategies" and "complex techniques".

"Complex strategies" are investment strategies that have a direct impact on the risk/ return of the fund for investors. One typical example of such investment strategy is a leverage strategy. The "pay-off" of the fund is becoming more complex and it is important that investors be able to understand them.

"Complex techniques" may mean techniques, like securities lending or the use of delta-one derivatives that are not in themselves changing the investment strategy of the fund. From the standpoint of an investors, and provided that their risks are appropriately controlled (for example in Europe, the UCITS Directive is limiting the counterparty risks linked to the use of such techniques), they do not create added complexity for the investors. Furthermore, focusing investors attention too much on the “techniques” used instead on what the fund offers may somewhat prove to be misleading as simple does not always add value, nor permit an efficient management of the portfolio.

We believe a clear distinction has to be made between the investment objective of the CIS and the way the CIS is managed or structured; in this matter a clarification is needed in Principle 3.

Also, we believe that such principle should be applicable to all CIS, not only ETFs.

The additional counterparty risk pointed out at the end of §2 will be mitigated through the EMIR Directive (or through Dodd Frank).

<u>Comments on 3. Disclosure regarding an ETF portfolio</u>

Principle 4 Regulators should consider imposing disclosure requirements with respect to the way in which an ETF will replicate the index (or the asset basket or the reference

portfolio) it tracks (e.g., physically holding a sample or full basket of the securities composing the index (or the asset basket or the reference portfolio) or synthetically).

In general, we believe that all CISs should disclose their Strategy and how they intend to implement their Strategy. This principle 4 is about the implementation of a Strategy.

We therefore agree with such disclosures. They should be made in the documents of the fund, like the prospectus. As mentioned before, we believe that such disclosure should not be part of the name of the fund.

We also don't understand why such requirement would be applicable only to ETFs and not to other CISs that replicate an index. The European Securities Market Authority (ESMA), in its consultation on "ETFs and other UCITS", rightly proposed to apply such regulations to all UCITS, not only to ETFs.

There is also no real reason to limit this principle to indexed funds. Actively managed funds, ETFs or not, should also be required to disclose how they implement their Strategy.

It is also important to require the same transparency and disclosure rules for both synthetic ETFs (disclosure of the CIS assets) and physical ETFs that do securities lending (disclosure of the CIS collateral) because the function of assets and collateral is the same for both types of structures in terms of investors' protection if a counterparty fails.

In the first paragraph, the sentence *"[in physical ETFs] The transparency of the underlying index results in a high degree of transparency in the ETF's investment operations"* must be balanced because those assets are bought by the CIS but also lent out and a collateral is received: securities lending contributes to the CIS's economic profile and the instruments used in the implementation of the investment strategy. This remark can also be applied regarding Principle 6.

Principle 5 Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio or other appropriate measures in order to provide adequate information to investors concerning: i) the index (or the asset basket or the reference portfolio) tracked and its composition; and ii) the operation of performance tracking in an understandable form.

We fully agree with the consultation. We however don't understand why such requirement would be applicable only to ETFs and not to other CISs that replicate an index.

We especially welcome the definitions given by the Consultation, in box 3, of Tracking Error and Tracking Difference. We believe that both concepts are important and that both performances should be disclosed to investors in the fund reports.

AFG believes that the harmonization of stock exchange listing rules should be beneficial and should improve investor information and protection.

Principle 6 Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio or other appropriate measures in order to facilitate arbitrage activity in ETF shares.

We agree that there should be some requirements of this kind for actively managed ETFs. To the extent that an ETF is indexed, the transparency of the index itself is good enough to allow a liquid secondary market.

If the ETF is not indexed, there is some requirement of transparency of the portfolio in order to allow the secondary trading of their shares in a manner that would allow a quality trading, with low bid-offer spreads, and would also avoid insider trading possibilities.

Principle 7 Regulators should encourage the disclosure of fees and expenses for investing in ETFs in a way that allows investors to make informed decisions about whether they wish to invest in an ETF and thereby accept a particular level of costs.

In general, we believe that all CISs should disclose their fees and expenses, as provided, in Europe by the Key Investors Information Document (KIID).

Again, there is no reason to limit such requirement to ETFs. That should be applicable to all CISs in an identical way. All products distributed to retail investors (through the future PRIPs Directive in Europe for example) should disclose this information. It would be quite a paradox to require such disclosure for ETFs and not for other CISs, when ETFs have on average lower fees and expenses than other CISs.

However, the information required should not be too detailed: what really matters for the investor is the global costs of the product and excessive information has to be avoided.

Principle 8 Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities.

We agree and again that should be applicable to all CISs, not only ETFs.

Revenues linked to material lending and borrowing of securities have to be disclosed to investors. The fee sharing arrangement (i.e. the sharing rule between the ETF and the asset manager) should be disclosed on legal documentation (both CIS prospectus and annual reports). Nevertheless, monitoring of technical aspects related to this activity is a subject for regulators, not for investors.

Costs borne by the CIS when implementing the strategy are data difficult to disclose ex-ante. They depend on the number of operations dealt by the asset manager, instruments used, operational costs when trading those instruments, legal constraints as well as tax issues (changing over the time under some jurisdictions). Furthermore, costs are often off-set by revenues, what makes the distinction revenues/costs very difficult. The issue is not specific to

ETFs. As of today, the best way to assess ETF costs and analyze the quality of the ETF index replication is to compare the ETF performance with the index performance. This difference of performance (called "Tracking Difference" above) is a key indicator in terms of costs and revenues.

We disagree with the idea of explaining ex post the performance "bp per bp". We do not understand this requirement, as in practice it would be very difficult to do (for instance because of relying on complex concepts such as dividend optimization processes or income generation etc.). It is also unclear how it could be comprehensible and useful information for retail investors.

Comments on Chapter 3 – Principles related to Marketing and Sale of ETF shares

As a preliminary remark on Principles 9 to 12, our members fail to understand the reasons for which IOSCO believes there is a need to discuss marketing and sales standards specifically in relation to ETFs. In our opinion, provisions for marketing and sale of ETFs should be part of a global distribution framework for financial products in general and not differentiated from the requirements applicable to other CIS and other types of competing financial products.

In addition, vanilla synthetic ETFs as described above should not be considered as complex products. Above all, the complexity of a product has to be considered with respect to its investment strategy or objective and its level of risk.

Finally, most ETFs units purchases are pursued through execution only services. In Europe, in the context of the MiFID revision, it is important for all vanilla ETFs to be considered as non-complex products.

In our view, the paper should remind that ETF investors are autonomous. It is the case for retail investors as well as for professionals. So, it is not frequent for retail investors to look for advice before investing in such funds.

As the consultation makes a reference to another IOSCO consultation on Suitability Requirements with respect to Transactions involving Complex Financial Products, we want to echo the joint response of IIF, IBF and JAC and their concern about the IOSCO's approach on complex products.

In any case, we would stress on the fact that vanilla synthetic ETFs as described above should not be considered as complex products. Above all, the complexity of a product has to be considered with respect to its investment strategy or objective, its characteristics and its level of risk. In fact most synthetic ETFs have a simple investment objective and their structuring does not involve any special risk for the investor.

Principle 9 All sales materials and oral presentations used by intermediaries regarding ETFs should present a fair and balanced picture of both the risks and benefits of such products, and should not omit any material fact or qualification that would cause such a communication to be misleading.

We agree with Principles 9 and 10 and with the distinction to be made between issuers and distributors obligations and responsibilities in terms of disclosure, in case of distribution intermediation. We believe that it should be applicable to all CISs, not only ETFs and, beyond CISs, to all financial products.

Principle 10 In evaluating an intermediary's disclosure obligations, regulators should consider who has control over the information that is to be disclosed.

We agree with Principles 9 and 10 and with the distinction to be made between issuers and distributors obligations and responsibilities in terms of disclosure, in case of distribution intermediation. We believe that it should be applicable to all CISs, not only ETFs and, beyond CISs, to all financial products.

Principle 11 Before recommending the purchase, sale or exchange of an ETF, particularly a non-traditional ETF, an intermediary should be required to take reasonable steps to ensure that recommendation is based upon a reasonable assessment that the product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.

AFG agrees with this principle which is already consistent with the rules on financial intermediation in the EU (MiFID Directive) through the suitability test in relation with the provision of investment advice. Principle 11 is already in place in Europe through the MiFID Directive, and especially with the suitability test whose aim is to check that recommendations of intermediaries are based on a reasonable assessment that the product is consistent with the investor's profile, experience, knowledge, risk/return expectations.

However, we believe the expression *"particularly a non-traditional ETF"* should be changed. It is clear that introducing a distinction in the mode of distribution between types of replication (which represent the inner workings of a fund) would make no sense. We guess that this remark follows the confusion between US and European ETFs.

We understand that "Non-traditional ETF" is defined by the consultation, on page 17, as meaning "Synthetic ETFs". We believe that it would not be appropriate to create some specific marketing rules or some specific requirement for synthetic ETFs.

Synthetic ETFs are not necessarily more complex or more risky than so-called "physical ETFs" that use securities lending. Depending on how their counterparty risk is controlled, a synthetic ETF can be safer than a so-called physical one. It would therefore be unfair to treat them differently.

We believe that the expression is correct to the extent that a "non-traditional ETF" would mean an ETF that is using non-traditional Strategies, for example a leveraged ETF or a short ETF. Such Strategies may be complex to understand for a retail investor. They therefore deserve some higher degree of scrutiny in respect of their marketing.

We therefore propose to replace *"particularly a non-traditional ETF"* by "***particularly an ETF that uses complex Strategies".***

Regarding the means of implementation for Principle 11: as for any other investment product, we agree with the general principle that *"The intermediary should explain to the retail investor the basis for its recommendation (...)"*. This principle pertains to good practices; but is should not be the basis for any regulatory obligation for intermediaries to provide a written justification of their advice because such an obligation would lead to abuses from non-scrupulous customers. This principle is already in place in Europe through the MiFID Directive, and especially with the suitability test whose aim is to check that recommendations of intermediaries are based on a reasonable assessment that the product is consistent with the investor's profile, experience, knowledge, risk/return expectations.

Our members believe that the fact of taking into account the tax status of the investor is a good practice which could never be introduced in a regulatory framework.

Principle 12 Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations when recommending any ETF.

We believe that the principle is applicable to all CISs, not only ETFs and, beyond CISs, to all financial products.

We strongly disagree with the proposal to give tax advice to investors (based on each investor's tax status).

<u>Comments on Chapter 4 – Principles related to the Structuring of ETFs</u>

Principle 13 Regulators should assess whether the securities laws and applicable rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interests raised by ETFs.

We believe that such principle should be applicable to all CISs, not only ETFs. We have some major reservations regarding Principle 13.

The report underlines that there are various sources of potential conflicts of interest in ETF businesses especially when ETF providers are affiliated with index providers or APs or swap counterparties or securities lending agents. The word "affiliations" appears several times in the paper and would probably need to be defined precisely because it relies on a complex concept. To what extent is an entity considered as "affiliated" to another? What would be the minimum holdings threshold to have such "affiliation"?

In the European UCITS framework the fund manager is subject to detailed requirements regarding the management of conflicts of interest. The UCITS Directive provides a strong risk mitigation and risk management framework for conflicts of interest, particularly with the modifications included in UCITS IV.

As a result, we fully disagree with the propositions that:

- A swap-counterparty should not be affiliated with the ETF provider
- The primary AP should not be affiliated with the ETF provider
- A custom index provider should not be affiliated with the ETF provider
- A security lending counterparty should not be affiliated with the ETF provider

First of all, a separation of legal entities is required between the UCITS Management Company and the swap counterparty or a securities lending counterparty (a credit institution also subject to supervision and to MiFID rules).

Conflicts of interest rules apply to the choice of counterparties for the CIS, and the risk management process must be submitted to regulators for approval. Above all, UCITS Management Companies have the fiduciary duty to act in the best interest of the UCITS and its unit holders, and the senior management must ensure compliance in this respect.

The Eligible Assets Directive lays down rules for the valuation of OTC derivatives, and the depositary must ensure that the value of units is calculated in accordance with the applicable national law and the CIS rules, adding an oversight role to the activities of the Management Company.

Second, regarding indices it must be reminded that in Europe under the UCITS framework all indices must be disclosed to investors in accordance with a clear and understandable methodology (in Europe there is no 'actively managed CIS' since indices must be systematic, non-discretionary and published on a daily basis). We believe there is no need for further firewalls between entities under the European rules.

We clearly do not agree that there is an inherent conflict of interest between the index provider and the asset manager. On the contrary, we even believe that an asset manager should be allowed to create its own index and track it. There is no inherent conflict of interest.

We don't see any conflict of interest when the index provider is an affiliated firm of the management company or even the management company itself. Management companies have the right to manage discretionary funds. So in a worst case scenario, if we assume that an asset manager manages the index without following its rules, the fund will simply be an actively-managed fund. Provided that the prospectus is clear about what the manager is doing, we don't see any issue.

In fact we strongly believe the opposite. Asset Management companies should have the right and be encouraged to manage indices themselves. Index providers are, to some extent, Asset Managers, because they actually determine investments. It would be very paradoxical to propose that regulated Asset Managers cannot sponsor indices and track them, whereas index providers, that are not regulated, could sponsor any index.

On APs side, the issue of conflict of interests is even more irrelevant. European stock exchanges require a contract to be signed between the AP and the exchange. There are many APs operating at the same time on ETFs and arbitrager activities also contribute for a fair market making.

Indeed, we do not agree with the idea that the "primary AP" should not be affiliated with the ETF. We are against the prohibition of intra-group dealing. We rather favour the European approach. In general, European regulations do not discriminate against affiliated entities and there is no proof that they have failed to protect investors appropriately in this respect. European regulations of conflict of interests rely on standards, policies and controls, not on regulations linked to affiliation. We believe that regulators should make sure that conflict of interest regulations are properly implemented. But they should not altogether prohibit or restrict intra-group transactions or agreements.

Instead of prohibiting activities by avoiding “affiliated entities” to work together, we firmly believe that regulators should address conflicts of interest properly by setting a robust legal framework between entities and acting for greater transparency on the underlying businesses, as it is already the case in Europe.

Regarding the number of market makers there are many advantages in having more than one market maker because this can improve liquidity and spreads on the exchange. There is no need for stricter requirements on the minimum number of market makers since most of the time ETFs have a large number of active market makers. Both “independent” market makers and affiliated entity market makers have the same requirement rules (minimum size, max spread, minimum time of presence) to respect on the exchange. Given that having a market maker in an affiliated entity of the ETF promoter is not an issue.

The cases where there is a small number of market makers are those where the underlying basket is specific (e.g. commodities) and innovative. Therefore requiring more than one market maker would make the listing difficult to achieve in these specific niche markets. Instead of looking to impose a regulatory requirement on this issue, it would be preferable maybe to ask the ETF industry to set best practices and harmonize ETF listing rules in Europe in terms of maximum spreads, offered size, minimum time of presence and iNAV policy. European ETFs structured as UCITS offer their investors also direct redemption opportunities in addition to secondary trading.

Principle 14 Regulators should consider imposing requirements to ensure that ETFs appropriately address risks raised by counterparty exposure and collateral management.

We agree with this principle but we believe that it should apply to all types of CIS, not only ETFs.

The Consultation rightly shows that counterparty risks exist in many structures. It is therefore important that regulators treat all these structures equally in terms of risk mitigation.

In Europe, virtually all measures suggested by IOSCO for risk management by synthetic and physical ETFs are already in place under EU law.

All ETFs are subject to a potential counterparty risk: counterparty risk derives mainly from the use of swap for synthetic ETFs and from the securities lending activities for physical ETFs. In the UCITS framework counterparty risk is limited to 10% of the fund’s total net

asset value per counterparty. It should be specified that individual players may go stricter than the rule. For instance, our members that provide synthetic ETFs may target currently zero counterparty risk (in practice, the marked-to-market of the swap that measures the counterparty risk is close to zero). Thus, in the case of these ETF players, the counterparty risk is maintained significantly below the 10% maximum per counterparty stipulated by the UCITS rule.

In addition, European regulations are reinforcing on the counterparty risk with the EMIR[2] new regulation to come that will require collateralization for non-cleared OTC instruments and the regulation to come on securities lending.

Collateral requirements for OTC derivative instruments (that may be soon extended to repos and securities lending) are detailed under the Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. The strengths of the Box 26 Guidelines are the constraints on collateral liquidity, valuation and issuer quality, as well as qualitative requirements on collateral concentration.

Under UCITS regulation, collateral is kept on a segregated account at the custodian, with appropriate conflict of interest firewalls. This is a safety for the investor in case of a counterparty default.

Transparency on counterparty risk is an important issue but it seems that European Regulators are working on improvements on this matter. Transparency should be required on funds' legal documentation as well as on annual reports.

We consider that at this stage there is no need to limit the amount of a UCITS portfolio that can be lent as part of securities lending transactions. It would be detrimental to investors as it could reduce the fund's performance.

We would prefer a more precise wordingfor the Principle, as in Europe we clearly make reference to the notion of "counterparty risk": "*Principle 14 Regulators should consider imposing requirements to ensure that ETFs appropriately address counterparty risks and collateral management."*

<u>Comments on Chapter 5 – Issues broader than ETFs</u>

Principle 15 ETF exchanges should consider adopting rules to mitigate the occurrence of liquidity shocks and transmission across correlated markets (e.g. automatic trading interruption mechanisms)

We agree with Principle 15, although we really think that the so-called "liquidity shocks" are related to all capital markets and not specific to ETFs.

[2] European Market Infrastructure Regulation

Indeed, the issue of "liquidity shocks" seems to us related to capital markets in general more than to ETFs in particular. Liquidity shocks may appear on any market and they will materialize through the financial instrument that is leading the concerned market. In some markets, US-based ETFs have reached this status of leading financial instrument.

III. Comments on specific concerns raised by TCSC5 in the Consultation Report

Question for the consultation: Are there particular financial stability concerns raised by ETFs that are not addressed by this paper?

No, we believe that all possible risks have been identified. We tend to believe that the advantages of ETFs for investors, but also for financial stability, have not necessarily been properly taken into account. ETFs are simple products and they have reached, at least in Europe, a degree of transparency that is unprecedented. Not only do they offer, at low cost, a transparent exposure to markets, but European providers provide to the public, on their web site, an abundance of information about the counterparty risks, the collateral etc. All this transparency benefits the public and, ultimately, the broader financial system.

Another way to say it is that the risks of ETFs have been analyzed, but the relative context of ETFs compared to other products, at least in Europe, has not been properly analyzed. For example, if ETFs replace financial products that are less transparent, the overall transparency of the financial system should be very much improved.

Question for the consultation: Are there particular counterparty risks raised by ETFs? If so, should the FSB or the Joint Forum carry out further work to address counterparty risks?

No, we believe there are no particular counterparty risks raised by ETFs. Regulators are already targeting/addressing counterparty risks linked to techniques such as derivatives or securities lending.

Question for the consultation [regarding the financing of Banks by ETFs]: Should the FSB or the Joint Forum, acting on the basis of their broader mandates, further study these concerns?

We agree with the consultation that the issue is linked to the quality of collateral.

Theoretically, a bank can gain a financing advantage by borrowing from funds some liquid securities, which can be re-used in financing operation, and providing as collateral illiquid securities. Any securities lending operation can therefore provide a financing to the bank. In the synthetic replication world, Total Return Swaps provide an equivalent variant of securities

lending operations. They can also provide the same advantage to a bank, if the direct portfolio is less liquid than the index portfolio.

We therefore agree with the consultation that requirements on the ***quality*** of collateral address these concerns.

If you need any further information, please don't hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr) or myself at +33.1.44.94.94.29 (p.bollon@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre Bollon