EFAMA

European Fund and Asset Management Association

EFAMA RESPONSE TO THE IOSCO (COMMITTEE 5) QUESTIONNAIRE ON ETFs FOR INDUSTRY PARTICIPANTS

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IOSCO Committee 5 Questionnaire on ETFs

Part A: Questions for ETF issuers

INTRODUCTION

As the European trade association representing numerous ETF issuers, EFAMA welcomes the opportunity of this questionnaire to submit a few high-level considerations to the attention of Committee 5 member supervisors. Our inputs are intended to accompany the more detailed submissions of the several European ETF issuers our association represents, in view of informing the Committee's future work around a possible review of IOSCO's 2013 *Principles for the Regulation of Exchange Traded Funds*. Since then, the evolution of the European ETF landscape has largely mirrored that of the larger global market for these products, reaching a total of USD 7.8 trillion in asset under management by the end of January 2021, of which Europe accounted for USD 1.2 trillion[1].

Our submission is limited to the first main title included under Part A of the Questionnaire, pertaining to the stresses observed for specific types of ETFs during March/April 2020. Here we draw out a number of important "lessons learned" from the most recent and significant volatility episodes of last year, while leaving the answers to the remaining sections of the Questionnaire - related to product structuring, disclosure aspects and liquidity provision - to the more exhaustive responses of our Members and individual ETF issuers.

Stresses in March/April 2020

The global financial market volatility induced by the Covid-19 pandemic in early 2020 represented another key "litmus test" for ETFs, for their issuers, for their broader ecosystem, made up of authorised participants (APs), market makers, exchanges and other alternative trading venues, and ultimately, for their investors. The severity of the market disruption experienced as a result of a rapidly worsening public health crisis, and consequent economic and social lockdown measures introduced by governments worldwide, has tested the resilience of the ETF product structure in ways unprecedented until then. Nevertheless, ETFs across all main asset classes have not only passed this test, but have continued to inspire investor confidence by attracting even greater inflows over the remainder of 2020[2].

I. Visible discounts

Despite their resilience, certain ETFs did understandably experience and show evidence of stress. Of these, the prolonged discounts that became apparent between certain ETFs' share value and their net asset value (NAV) - particularly acute for corporate investment and high-yield debt ETFs – should not be understood as a product-specific anomaly. Instead, these discounts were the by-product of a very volatile and contingent trading environment, compounded by the general market uncertainty, including in relation to possible central bank policy actions, as well as a severe deterioration of market liquidity. As with other types of securities, these conditions were thus largely responsible for the widening of bid-offer spreads investors faced when looking to trade their exposure using ETFs in their respective secondary market. Moreover, such discounts should be studied by considering the functioning the ETF ecosystem as a whole, including the incentives and constraints of other significant market actors.

Among these, are the large dealer institutions, commonly known as authorised participants or "APs", in their essential role as arbitrageurs between a secondary market for an ETF's shares and a primary one that involves direct transactions with the ETF issuer (either settled in-kind or in-cash)[3]. More specifically,

[1] Source: ETFGI

[2] According to data from ETFGI, ETFs saw net USD 1.5 trillion in new inflows globally in the course of 2020, despite the market volatility recorded in March.

[3] Depending on the settlement model chosen, APs will either exchange ETF shares for a "basket" of securities (reflecting the composition of the index) or cash with the issuer. Such process (known also as a "primary creation") leads to the issuance of new ETF shares which are then traded on the secondary market. When such mechanism works in reverse order - where ETF shares are withdrawn from the secondary market by the AP and exchanged against the underlying "basket" or alternatively cash from the issuer – one speaks of a "primary redemption". Underpinning this mechanism is an evident opportunity for APs to arbitrage

the prevailing conditions of March complicated APs' tasks to efficiently hedge their exposure to the underlying basket for specific fixed income ETFs, when access to the basket's single components and their tradability became difficult, with potential negative repercussions from a cost impact on APs' own balance sheets. When setting the price for an ETF's shares, an AP will among other factors consider the estimated transaction costs related to the bid-offer spread for the underlying securities, often adding a "liquidity risk premium" to offset the risk that the actual transaction cost is greater than anticipated. Specialist market-makers - in their role of rapidly matching ETF investors by offering two-way quotes in the secondary market – were also compelled to widen their bid-offers in light of the challenging market conditions. During the volatile weeks of March, both estimated transaction costs and liquidity risk premiums were elevated for virtually all types of fixed income securities. By comparison, NAV calculations varied far less as they are usually calculated once a day based on third-party valuation models that seek to extrapolate the value of the individual securities comprising the ETF's basket.

Another no less important driver behind the large temporary discounts observed in the fixed income ETF space derived from the mere nature of fixed income securities, compounded by a very fragmented trading environment in Europe. It is for instance well recognised that bonds are less-standardised, do not trade frequently and that vast swathes of European market transactions are OTC by nature. The volatile market conditions observed in March 2020 only made bond trading more difficult and naturally, with fewer observable trades, deriving the value of a bond ETF's NAV - compounded by the greater probability for valuation errors/discrepancies in AP/market-maker pricing models – only became more challenging. This resulted in an ETF's NAV becoming "stale" and the inevitable "gap" between the "live", real-time secondary market price of the ETF *versus* the derived and indicative value of its underlying bond basket soon widened and became increasingly apparent.

Unlike the U.S., Europe still exhibits a fragmented trading landscape, including competing national exchanges and alternative multi-lateral trading facilities (MTFs), where one same product can be easily cross-listed across several venues, often with their own listing requirements, operating rules, circuit-breakers, etc. According to trading volumes for the fifty largest fixed income and fifty largest equity UCITS ETFs in January 2020, approximately 70% of trading took place away from the continent's main exchanges. This contrasts to the approximate 64% of secondary market trading occurs on an exchange in the U.S.

For all these reasons and compounded by the absence of a consolidated tape for equity-like instruments as ETFs[4], one can easily appreciate why, for instance, certain corporate bond UCITS ETFs were observed trading at deep discounts (even in excess of 6% of their NAV) over a couple of weeks. Yet, when compared to the trading spreads observed for an ETF's underlying cash bonds, the latter were by no surprise far less liquid.

II. ETFs as "price discovery" mechanisms

Another recurring effect of heightened market uncertainty became the significant increase in trading volumes in the secondary market - including on exchanges, MTFs and OTC - compared to the volumes dealt by APs through primary market orders via creations/redemptions. Surges in daily secondary market volumes acted *de facto* as "safety valves", by allowing traders and investors to transfer their exposures swiftly (albeit at a marginally higher cost compared to normal market conditions due to widening bid-offer spreads), with little or no impact on the price of the underlying securities. In this respect, especially under volatile market conditions, it has often been rightly noticed that ETFs – by virtue of their enhanced secondary market liquidity - also act as an efficient "price discovery" mechanism, i.e. allowing not only for investors to be readily matched, but also for market actors to derive a more accurate proxy of underlying asset values compared to their actual "cash" market price, especially when the latter proves stale (as typically for bonds) or is simply not available. On such occasions, various market participants, as well as pricing service providers, have used ETFs to more

away any differential between the value of an ETF's share and that of its underlying portfolio (NAV), thus also ensuring that the ETF is effectively able to track its chosen index as closely as possible.

[4] In this regard, it is of paramount importance for the European Commission to adopt a legislative proposal to complement its recent MiFID II reforms by introducing a real time consolidate tape for post-trade data, beginning with equity and equity-like instruments, and followed by fixed-income ones.

reliably estimate the price for the underlying securities in the heat of volatile trading sessions. These findings have been valuably also echoed in recent publications from some national and EU supervisory bodies[5].

We would stress that these effects have been observed on several earlier occasions, from the closure of the Greek stock exchange in June 2015 at the height of the Eurozone crisis, to the Chinese A-share trading suspensions in the following month; from the volatile opening of the NYSE trading session in August 2015, to the volatility experienced in the immediate aftermath of the U.K. "Brexit" referendum in June 2016.

III. APs & market-makers remain engaged

A final point worth noting in the context of the March/April 2020 volatility is that – contrary to some beliefs – APs and market-makers remained engaged to support ETF liquidity. As a reminder, there are very clear economic incentives for APs to honor their arrangement with the ETF issuer, offered by the arbitrage opportunities inherent in the creation/redemption mechanism, especially during bouts of market volatility as those observed in March 2020. Moreover, given the surges in ETF average daily secondary market volumes relative to those of the underlying "cash" market precisely around the time of significant market events, there is a clear decorrelation to be observed between secondary-to-primary market orders. This proves that APs do not usually deal primary market orders in concomitance with large demand or supply imbalances observed in the secondary markets (which result respectively in ETF inflows or outflows). Where they do, the resulting primary orders also typically occur with a notable lag relative to the date of a volatility spike, suggesting that APs maintain discretion as to when they choose to deal creations/redemptions, based on the size of their respective stock inventories, available market prices for the underlying securities, as well as on their hedging capabilities[6]. Lastly, as a good practice and one dating well before the March/April 2020 events, the large majority of European ETF issuers can rely on a network of multiple active APs. To the best of EFAMA's knowledge, there have been no cases of APs, nor of market-makers, withdrawing from serving any European ETF issuer in the course of last year.

Conclusion

The events of March/April 2020, along with our three key "lessons learned" to be drawn from them, offer valuable inputs for Committee 5 to develop its work and possibly guide the review of the existing 2013 *Principles*. In conclusion, as last year's volatility episode has amply demonstrated, we stress the fact that there is no compelling evidence to suggest that ETFs, by their intrinsic design or by their surrounding liquidity infrastructure, have uncovered market failures or exposed systemic vulnerabilities. Rather, we note that the ETF product *per se* performed exactly as intended, within a broader liquidity-providing ecosystem that proved robust. In light of these results, we can confidently say that the European ETF market has finally come of age, despite some of the remaining challenges as described above.

In this regard, as mentioned, we certainly believe there are possible improvements in relation to specific market infrastructural issues, as the lack of a consolidated tape in Europe for equity and equity-like products (as well as for fixed income instruments in a later phase). We are confident that more valuable evidence from the responses to Part B of the Questionnaire will tend to corroborate our views around the March/April 2020 market events, accompanying them with further suggestions for possible reforms.

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[5] Among several examples, please refer to the Bank of England's *Interim May* (2020) *Financial Stability Report*, which noted that, during this period, ETF prices provided information about future changes in underlying asset markets, offering evidence that ETF prices incorporated new information more rapidly than the NAV of the underlying assets. Similarly, the ESRB's October 2020 Non-Bank Financial Intermediation Risk Monitor also identified this as a key factor, stating that "the relative liquidity of the shares in corporate bond ETFs trading on secondary markets may be an indication that the price discovery pertaining to the underlying assets might have shifted to the ETF."

[6] For instance, when left with a basket of securities following a redemption with the ETF issuer and in an enduring volatile market, one could wonder how and when an AP would choose to deal the securities. In such circumstances, the AP may opt to hold the securities temporarily on its books as part of its inventory, use the securities to hedge other positions, create another ETF's shares if the latter are trading at a premium, deliver the securities to a client looking to establish a position, or even sell these into the market at an advantageous price. However, the AP will not automatically attempt to liquidate assets at a loss to only undermine its own capital position and forego better opportunities.

We also welcome the emphasis that the FSB's November 2020 Holistic Review of the March Market Turmoil has placed on conducting further analytical work – jointly with IOSCO's own Financial Stability Engagement Group (FSEG) - to examine the structure and liquidity provision in core funding markets under stressed market conditions, including factors that limit dealer capacity to intermediate, while also accounting for important innovations (e.g. the rise of electronic trading platforms).

About EFAMA

EFAMA, the voice of the European investment management industry, represents 28 Member Associations, 57 Corporate Members and 23 Associate Members. At end Q3 2020, total net assets of European investment funds reached EUR 17.6 trillion. These assets were managed by more than 34,200 UCITS (Undertakings for Collective Investments in Transferable Securities) and almost 29,400 AIFs (Alternative Investment Funds). At the end of Q2 2020, assets managed by European asset managers as investment funds and discretionary mandates amounted to an estimated EUR 24.9 trillion.

More information is available at www.efama.org.

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