EFAMA

European Fund and Asset Management Association

Demystifying ETPs: A simple guide for the European investor

EXECUTIVE SUMMARY

Over the course of the last decade, exchange-traded products (ETPs) have witnessed a spectacular growth, breaching US$ 7 trillion in assets under management (AuM) at the end of September 2020. Of these, approximately 97% were invested in exchange-traded funds (ETFs), a product wrapper whose prominent success within the global – including European – investment community has been identified in its low ownership cost, its ample daily liquidity and its high degree of transparency.

Considering the implications of such asset growth in the future and studying how recent market episodes have affected some specific ETP product structures, certain commentators from regulatory, academic and media circles have too often bundled these together, overlooking some of their key characteristics. Recognising that the broad "ETP" category represents a convenient short-hand label to identify instruments that are listed and trade daily on an exchange, there are nevertheless fundamental differences between them that must be recognised by investors and more broadly in the public domain.

As the European industry association representing a substantial part of the ETP offer in Europe, EFAMA believes that greater understanding around different types of ETPs is needed, especially in view of retail investors' growing interest towards these products. To this end, the following guide wishes to draw out the defining features of the three main types of ETPs for the European market:

1. An **exchange-traded fund (ETF)**, as built around a collective investment scheme, more commonly known as a "fund", predominantly of the UCITS-type;
2. An **exchange-traded note (ETN)**, as built around a zero-interest debt instrument intended to typically offer investors a narrow exposure to an underlying instrument or to a niche index; and
3. An **exchange-traded commodity (ETC)**, as built around another debt instrument known as a certificate, albeit offering investors a narrow exposure to single commodities or commodity indices.

Such categorisation rests primarily on the nature of the underlying instrument (i.e. a fund, a debt instrument or other) and is only further refined by considering three core criteria that we believe will allow investors, as well as the broader public, to easily differentiate one ETP from another. First, we consider the product's **structural set-up**, involving the specific contractual and operational arrangement chosen by the issuer at launch. Second, we consider **risk management** as a decisive criterion for investors to become familiar with different types of risks emanating from the product's structure. Finally, we consider the existence of applicable **EU regulatory requirements**. For each criterion, we furthermore suggest a non-exhaustive series of questions for investors to consider before committing their capital.

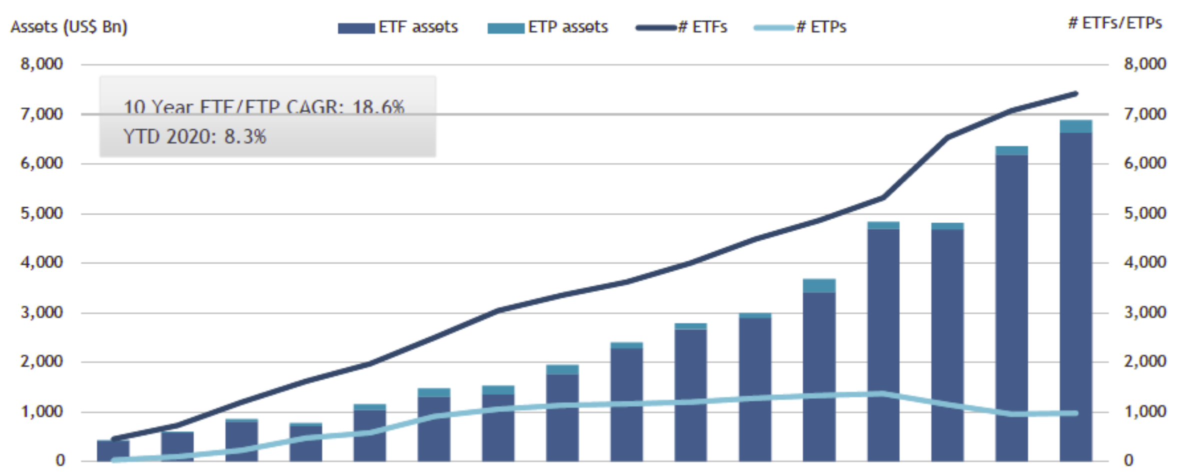
Underlying our effort is the belief that a better understanding by investors is worthwhile, not only to sustain further ETP demand growth in the future, but - more importantly - to assist investors in making better investment decisions once they are able to appreciate the differences between ETPs more intimately, especially from a risk and product complexity viewpoint. Our basic descriptions remain broad and are not intended to provide advice on which product types are suitable for which investors. As ever with investing, individual circumstances and features of any proposed investment must be considered, alongside professional advice where necessary, before making any investment decision.

Lastly, we trust this guide may also remove some common misconceptions within the wider regulatory, academic and media community regarding certain product features. We refer, in particular, to the frequent confusion between ETFs and other (non-fund) ETPs.

INTRODUCTION

The steady rise of ETPs over the course of the last decade has increasingly attracted the interest of a broad audience. Financial service providers and growing numbers of institutional and retail investors have learnt to appreciate the general features of the ETP wrapper, among which, its tradability, its overall transparency, as well as its low ownership cost. Depending on the jurisdiction, investments in ETPs may also be accompanied by tax advantages. ETFs have unquestionably marked the accelerating fortunes of the broader ETP universe by contributing to most investor demand, as measured by flows, underlying asset growth and spurring innovation in ways previously unimagined. The following charts capture these trends, globally and for Europe respectively, demonstrating the combined ETF/ETP asset growth, as well as ETFs' overwhelming share of it, since 2005. Considered together, ETPs are offering an ever-increasing choice of exposures to accommodate virtually all types of desired allocations.

Global ETF and ETP asset growth as at end of September 2020

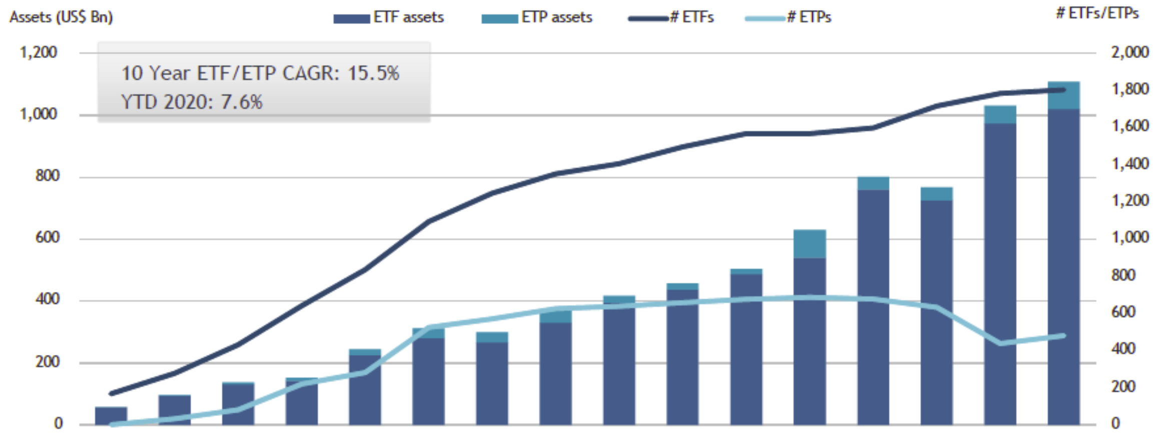


Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Sep-20
# ETFs	453	729	1,195	1,621	1,972	2,501	3,043	3,358	3,625	4,010	4,486	4,867	5,322	6,539	7,080	7,424
# ETFs/ETPs	483	829	1,425	2,096	2,553	3,415	4,101	4,493	4,789	5,210	5,766	6,201	6,691	7,692	8,039	8,402
ETF assets	417	579	806	716	1,041	1,313	1,355	1,771	2,283	2,674	2,898	3,423	4,690	4,683	6,193	6,636
ETF/ETP assets	426	603	856	774	1,157	1,478	1,526	1,951	2,402	2,787	2,997	3,552	4,839	4,815	6,363	6,892

Source: ETFGI Global ETF and ETP industry insights - October 2020[1]

[1] ETFGI the leading independent research and consultancy firm on trends in the global ETF/ETP ecosystem, based in London, England. Deborah Fuhr, Managing Partner, co-founder, ETFGI website www.etfgi.com.

European ETF and ETP asset growth as at end of September 2020



Year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Sep-20
# ETFs	168	278	432	642	837	1,096	1,249	1,353	1,408	1,498	1,570	1,570	1,600	1,719	1,786	1,806
# ETFs/ETPs	170	312	515	863	1,120	1,622	1,821	1,980	2,048	2,157	2,248	2,258	2,279	2,353	2,225	2,288
ETF assets	57	94	131	143	226	281	268	331	395	438	487	542	762	726	974	1,021
ETF/ETP assets	58	96	138	152	245	313	300	369	418	458	505	573	802	768	1,031	1,110

Source: ETFGI European ETF and ETP industry insights - October 2020[2]

Yet, there are layers of complexity in an ETP wrapper's structure that investors need to understand when conducting their due diligence before committing their capital. As a greater share of the global investment public turns to invest in ETPs - as means for capital growth or preservation, for hedging or for collateral provision - concerns within the regulatory community, academia and in the financial media have also been raised in relation to some ETPs' intrinsic features.

Although legitimate, these concerns stem in large part from the short-hand convenience of lumping together products that share only very few commonalities: (i) their prices are derived from their underlying assets and (ii) trade intraday on one or more national securities exchanges. The broad and commonly-used "ETP" notion otherwise blurs the distinctive features of the single underlying instruments around which the ETP is built. Within the ETP universe, ETFs are certainly the most distinctive in relation to other types of ETPs. They are structured around a collective investment scheme, or more commonly, a "fund" (i.e. the letter "F" in the "ETF" acronym) and consequently embed important investor safeguards as broad diversification and mandatory asset segregation, among others.

In view of such concerns, the investment management industry globally believes that a guide to better identify different types of ETPs is long overdue, including in Europe. Recognising the challenges behind attempts at categorising a very diverse range of investment products, EFAMA believes that a simple guide for such products in Europe – even if at a high-level - remains critical. Such need is warranted not solely with regard to ETPs' significant demand growth prospects in the decade ahead, but more importantly, in view of enabling investors to better appreciate the main features of what they wish to invest in, especially from a risk and product complexity standpoint. In addition, we believe that a simple guide will contribute to also redress some common misconceptions within the wider regulatory, academic and financial media community regarding certain product features[3].

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[2] *Ibid.*

[3] Recent publications have often conflated the behaviour of certain exchange-traded notes (ETNs) with that of the wider ETF product class. For instance, the equity market sell-off and heightened volatility during the first week of February 2018 highlighted the unique behaviour associated with inverse leveraged ETNs tracking the VIX index. Yet, the event generated much confusion around the ETF product. After the closing bell on 5 February 2018, a few inverse VIX ETNs suffered declines in excess of 90%, reflecting the embedded economics of these specific ETPs and forcing one provider to close one product. That same week, because of the sudden volatility spike, ETFs were also affected by experiencing more than US$ 1 trillion in U.S.-listed secondary market trading volume (i.e. roughly double that in normal times). Nevertheless, no single ETF product was forced to close as a result, with the deep secondary market absorbing the

Our guide is European by vocation and seeks to serve investor education in a way that accurately reflects these wrappers' inherent structural features, risks and applicable EU regulation.

OUR THREE CORE CRITERIA

We proceed by defining the three complementary core criteria that we deem valuable to guide investors in their due diligence process and inform the broader public about the European ETP landscape. For each, we identify a set of key questions investors and the broader public should ask to decisively differentiate one ETP from another.

I. **Structural set-up**: We refer specifically to the contractual and operational arrangement chosen by the ETP issuer at product launch, including the choice of the underlying instrument and the involvement of other essential financial market participants to the product's lifecycle.

   Investors/broader public should ask:

   – What is the ETP's underlying instrument, around which the wrapper is structured (e.g. a fund, a debt instrument, a derivative, a financial index, or another instrument)? Is the exposure broad or narrow (i.e. a well-diversified portfolio vs. a single asset)?
   – What is the nature of the issuing entity/ETP provider (e.g. a fund, an SPV, a bank, or other)?
   – What type of replication is used to derive the ETP's cash flows (physical vs. swap-based)?
   – Does the ETP expressly employ leverage to meet its investment objective, or any technique whereby returns would be non-linear compared to the underlying reference asset(s)/benchmark(s) (e.g. inverse performance, option-like features, or other)?
   – Are there further return enhancements foreseen for investors (e.g. securities lending)?
   – Is there a sufficient degree of transparency on the ETP's holdings, its reference asset(s)/benchmark(s) and daily pricing?
   – On how many trading venues is the product listed? How many APs and alternative liquidity providers are supporting the ETP's secondary market liquidity?

II. **Risk management**: We refer to the ETP's overall degree of risk, emanating from the underlying instruments (i.e. market risk), as well as from the chosen structural set-up (e.g. liquidity risk, counterparty risk, credit/default risk, or other). Depending on the type of ETP, risks can vary considerably.

   Investors/broader public should ask:

   – How well diversified is market risk deriving from the ETP's underlying exposure (single instrument vs. index/basket)?
   – Besides market risk, what additional risks derive from the ETP's structure and choice of replication techniques (e.g. counterparty risk, liquidity risk, credit/default risk, or other)?
   – What operational safeguards or regulatory requirements are in place to mitigate such risks, including those around counterparty risk, access to underlying assets or collateral, or use of leverage?
   – Is an investor's exposure backed by the underlying physical assets, by some form of eligible collateral, or a mix of both?
   – Are exposures adequately collateralised, or even over-collateralised, compared to the market value of the ETP?

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shock and normalising quickly thereafter. Similar confusion has emerged in the context of the recent Covid-19 outbreak and its effects in the international oil market. Stresses in exchange-traded commodity products linked to oil futures in the course of March/April 2020, have again been erroneously attributed to the ETF wrapper, whereas in reality the corresponding regulatory disclosure documents have categorised them exchange-traded (non-fund) securities.

- Are an ETP's underlying holdings and/or collateral segregated and subject to independent oversight from a third-party depositary/custodian or trustee?

III. **EU regulatory requirements**: We refer to the existence of a comprehensive set of EU regulatory requirements, applying to the ETP issuer, but potentially also to the product as such. The more comprehensive and robust these requirements, the better informed an investor is when choosing to purchase a wrapper.

Investors/broader public should ask:

- Is there specific EU regulation foreseen for the issuing entity/ETP provider, as well as for other financial market actors involved in the ETP's structural set-up (e.g. authorised participants, liquidity providers, depositaries/custodians or trustees, third-party advisors and distributors, exchanges, etc.)?
- Is there an EU financial "product" regulation in place (e.g. UCITS) with consequent features, especially in terms of portfolio composition, index quality, collateral and counterparty diversification requirements and exposure limits?
- Are there EU disclosure requirements to investors (both *ex ante* and on an ongoing basis), especially around the trading and valuation of ETP shares, around costs/charges (including total expense ratios, securities lending revenues, swap spreads, rebalancing costs, creation/redemption costs, etc.), as well as around potential risks?

Depending on the answers to one or more of the above questions, a basic three-tiered ETP categorisation emerges, identifying

I. **Exchange-traded funds (ETFs)**, predominantly structured as UCITS[4],

II. **Exchange-traded notes (ETNs)**, and

III. **Exchange-traded commodities (ETCs)**.

The following chart depicts this basic configuration for the European ETP market, while also recognising each ETPs' prominent features.

[4] We do acknowledge the existence of non-UCITS collective investment schemes (e.g. ETFs that are domiciled and authorised both inside or outside the EU) that are listed and traded daily on a number of European exchanges.

The European ETP market

Based on 3 complementary core criteria, an **ETP** can either be...

... a collective investment scheme

ETF - Exchange-traded Fund

Structural set-up

- Built around a collective investment scheme (fund), characterised by diversified portfolio, in turn mainly tracking a diversified index, regardless of replication method
- Issued by a regulated asset management company, in Europe essentially a UCITS-licensed manager
- Counts typically on several APs/liquidity providers to facilitate secondary market liquidity

Risk management

- Robust portfolio concentration limits, extended to any underlying index
- Non-market risks addressed by diversified collateral and counterparty exposure limits
- Strict limits to use of leverage
- Portfolio's assets are segregated in issuer bankruptcy-remote accounts, entrusted to independent depositary/custodian/trustee, with oversight duties

Regulatory requirements

- Product structuring ensures EU UCITS Directive requirements are respected, for issuer, product and key service providers
- Further requirements apply in terms of managing exposures (EMIR) and for disclosures (SFTR)

... a debt instrument

ETN - Exchange-traded Note

Structural set-up

- Built around a (zero interest) note, entitling holder to income stream from performance of an underlying instrument. Exposure is typically narrow (non-diversified)
- Issued by an SPV, generally registered in non-EU/EEA jurisdiction and dependent on bank guarantor/sponsor
- Typically have one (or very few) AP/liquidity provider, usually coinciding with guarantor/sponsor/affiliated entity

Risk management

- The notes are non-rated, but usually depend on guarantor/sponsor's credit rating (with direct credit/default risk)
- Investor claims may not necessarily be backed by collateral (unsecured). Where secured, collateral pools may not be diversified, or correlated to guarantor/sponsor's credit rating.
- ETNs may contain leverage/inverse leverage features (up to 3-4 times NAV)

Regulatory requirements

- Disclosure requirements under EU Prospectus Regulation and MiFID II point of sale disclosures. Where offered to non-professional (retail) investors, PRIIPs disclosure rules also apply in the form of KID

ETC - Exchange-traded Commodity

Structural set-up

- Built around a (zero-interest) certificate, offering a narrow (non-diversified) exposure to single commodities
- Issued by an SPV, which may or not be registered in an EU/EEA jurisdiction
- Counts typically on average several APs/liquidity providers to facilitate secondary market liquidity

Risk management

- The underlying certificate is non-rated
- Investor claims may be either physically backed (i.e. secured by physical quantities of a given commodity held in custody with a third-party institution) or secured via a collateral pool. Latter may not be diversified, or correlated to guarantor/sponsor's credit rating.
- ETCs may contain leverage/inverse leverage features (up to 3-4 times NAV)

Regulatory requirements

- Disclosure requirements under EU Prospectus Regulation and MiFID II point of sale disclosures. Where offered to non-professional (retail) investors, PRIIPs disclosure rules also apply in the form of KID

About EFAMA

EFAMA, the voice of the European investment management industry, represents 28 Member Associations, 60 Corporate Members and 24 Associate Members. At end Q2 2020, total net assets of European investment funds reached EUR 17.1 trillion. These assets were managed by more than 34,200 UCITS (Undertakings for Collective Investments in Transferable Securities) and 29,100 AIFs (Alternative Investment Funds). Including discretionary mandates, third-party regulated asset managers managed EUR 24.9 trillion in Europe at end Q2 2020

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