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The Confusion About "Synthetic" ETFs

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There have been a number of press reports, both globally and locally, in recent times reporting on concerns expressed by international regulatory authorities and multi-national bodies, about the development of sophisticated or "second generation" Exchange Traded Funds.

These concerns are not currently strictly applicable to South Africa, where the Financial Services Board regulations prevent the use of derivatives or leveraged (geared) positions in the construction of ETFs. In the case of Exchange Traded Notes (ETNs), the JSE does allow the use of futures contracts in holding the underlying assets – such futures contracts, of course, are exchange traded products, subject to daily, mark to market and margin requirements as well as full transparency – but also requires that the issuer of the ETN provides a fully underwritten obligation to deliver the performance of the asset being tracked.

Deborah Fuhr, Managing Director and Global Head of ETF Research at Blackrock, which issues Exchange Traded Products globally, has responded to the debate on the regulation of Exchange Traded Products. She believes that: proper transparency and full disclosure on the assets held in exchange listed product structures; together with consistency in the construction of such products; the disclosure of counterparty risks if any; the extent of collaterisation; and fully stated regulatory controls and oversight, applicable to the different types of Exchange Traded Products, should enable the concerns of the financial authorities to be allayed.

With the Exchange Traded Products industry in South Africa, still in relative infancy, this debate on proposals to eliminate confusion and to alleviate investors concerns, by experts such as Deborah Fuhr, are of interest to participants in the market in South Africa and might help to guide the local regulators. Ms Fuhr's comments are attached.

Response to the Financial Stability Board's Report on ETFs*

"I strongly support the recent efforts by the Financial Stability Board (FSB), the Bank of International Settlements (BIS) and the International Monetary Fund (IMF) to increase the understanding of the Exchange Traded Funds and Exchange Traded Products (notes, partnerships, grantor trusts, commodity pools and other non-fund structures).

ETFs are one of the most useful financial innovations for retail and institutional investors introduced in the past 20 years.

The original ETF structure in the US and what followed originally in London was very simple for investors to understand. The first generation ETFs were funds that held an underlying basket of securities designed to track the benchmark of the fund. They offered daily transparency of the list of securities and their weights, cost efficient liquidity was supported by multiple market makers and brokers who are authorised to do creation/ redemptions allowing all investors access to a diverse tool box of useful exposures.

After UCITS III introduced greater flexibility in the ability to use derivatives in the way funds and ETFs are managed, many ETF providers along with mutual funds in Europe embraced the use of listed and OTC derivatives as the way they run the funds.

The move to synthetic ETFs (generation two ETFs) has created many different models of ETFs being offered by various providers. This has changed the level of transparency of the underlying holdings, understanding of the costs and transparency on costs of synthetic ETFs.

A greater area of concern for me is the practice of many to call products that are not funds, ETFs. This is true even in the US where the SEC provides a definition of ETFs as open-end companies or Unit Investment Trusts. There is a growing array of notes, partnerships, grantor trusts, commodity pools: ETNs, ETCs, ETVs, ETPs, that are often confused with ETFs. These products often carry very different, counterparty, regulatory and tax implications for investors. Consistency in definitions, clarity and transparency on these products is also vitally important for regulators and investors.

Greater transparency of ETF trades is also needed. Today under the Markets in Financial Instruments Directive, ETF trade reporting is not required for most trades. Mifid II should require all ETF trades to be reported and provided for in a consolidated tape. This will provide a greater level of price discovery, tighter spreads and will give all investors better transparency into the real secondary liquidity in ETFs.

Given the significant success of ETFs and ETPs over the past few years and the expectation that this growth will continue it is important that the regulators and investors understand and consider the risks.

The Financial Stability Report focused on:

- *Risks posed by financial innovation*
- *The inherent conflicts in swap based ETFs entering derivative contracts with their promoter's investment banking arm.*
- *Securities lending*
- *The distinction between fund and note structures.*

This Report is the successor to a number of papers that have raised concerns around the types of exposures available through exchange traded products and fears around systemic risk. While echoing the calls for transparency and disclosure it goes further and calls for promoters to make publically available detailed information around product composition, risk characteristics and the collateral and supporting frameworks for synthetic ETFs and securities lending programmes. Holding out the prospect that this may come through regulation, it is interesting to note that one provider has already seen the writing on the wall and announced its intention to publish its collateral holdings going forward.

The Report perhaps missed a trick in not focusing in more depth on the risks posed by exchange traded notes and certificates. Certainly it was the realisation that investors had 100% counterparty exposure to AIG that focused many minds in 2008 that, while an ETN might trade and settle like an ETF, it did not have the inherent protections one can assume in the latter structure. While many available ETNs are now collateralised, the arguments about disclosure of collateral apply equally to them, it remains the case that neither the investment exposures they offer nor the robustness – or not – of the delivery structure are anything other than very lightly regulated.

There is then rightly, as the reports identify, a debate to be had about the type of exposures that a retail investor can access through an ETF. However, it is important that any reform captures also ETNs both in terms of investment exposure but also regulation of the delivery vehicle.

The Report also omits to draw out the distinction between funds using a basket swap construction and those that utilise fully funded swaps.

This is important in as much as the latter requires an over collateralisation of securities which, if property structured, will be held in the name of the fund under a tripartite arrangement allowing for immediate sell-down if required. The basket model means that the fund holds securities at the direction of the investment bank but without any over collateralisation or requirement that the securities meet minimum collateral requirements as to quality.

This does not, as the Report suggests, present liquidity issues as in the correctly structured framework the investment bank has to buy back these securities to meet redemptions, however the fund holding less liquid securities should the counterparty default might lead to liquidity concerns.

Overall the thrust of this Report and those issued by the BIS and IMF last week points to a significant concern around systemic risk posed especially by synthetic ETFs of the "in house" model and to a lesser extent, securities lending.

As ever the solution to these fears is full disclosure and transparency to eliminate any conflicts of interest. Clarity, consistency, transparency of product structures, domiciles, underlying holdings, costs, swap counterparties and authorised participants are essential for the future success."

* Published with the permission of Deborah Fuhr, Managing Director and Global Head of Research, Blackrock Inc.

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