FIA EPTA response to IOSCO Consultation Report CR04/22:
Exchange Traded Funds – Good Practices for Consideration

6 July 2022

Introduction

FIA EPTA represents 24 independent European Principal Trading Firms (PTFs) which deal on own account, using their own money for their own risk, to provide liquidity and immediate risk-transfer in exchange-traded and centrally-cleared markets for a wide range of financial instruments, including shares, options, futures, bonds and ETFs.

Our members are independent market makers and providers of liquidity and risk transfer on trading venues and end-investors across Europe. Market making by Principal Trading Firms (also referred to as Electronic Liquidity Provision) is a distinct activity that is undertaken by non-systemic investment firms rather than banks, in a highly dispersed and varied ecosystem of independent firms. These firms operate in an innovative and competitive fashion leading to a vibrant, dynamic and diverse ecosystem which massively reduces interconnectedness and increases substitutability. This fundamentally reduces systemic risk whilst improving market quality and lowering costs for retail and institutional investors alike.

FIA EPTA appreciates the opportunity to comment on IOSCO's proposed good practices, which we generally welcome.

FIA EPTA supports open, fair, transparent and competitive markets. These principles have informed our responses. For example, we believe it is critical to ensure funds' AP selection processes remain fair and open to new entrants, as this ultimately benefits end-investors and market resilience.

We also believe that uses of measures such as iNAV can reduce transparency and increase uncertainty versus the real-time public information that secondary ETF trading allows. We consider that reliance on iNAV is not recommended therefore and we would suggest that IOSCO may wish to disincentive use of the iNAV measure itself rather than focus on ancillary measures seeking to mitigate issues identified with it.

This said, in the main we believe IOSCOs measures are sensible and also duly recognise that the ETF markets broadly continue to function effectively and have navigated recent periods of market stress well.

FIA EPTA members appreciate IOSCO's consideration of our comments and suggested solutions and stand ready to provide any further input as required.

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Measure 2

Regulators are encouraged to consider requirements regarding the transparency of an ETF's portfolio and/or other appropriate information provided to market participants so as to facilitate effective arbitrage.

Question 3 – Do the merits and other considerations as set out above accurately reflect the issues for different portfolio and basket information disclosure approaches?

Yes, FIA EPTA members believe the merits and other considerations set out above accurately reflect the issues for different portfolio and basket information disclosure approaches. We would add to this by emphasising that daily portfolio transparency provides APs and market makers with the ability to precisely value an ETF's portfolio on an intraday basis, have confidence in the accuracy of their quoting and is crucial to the efficient provision of real time liquidity in the secondary markets.

FIA EPTA members believe transparency is essential for the ETF market to operate efficiently and the default regulatory requirement for all ETFs, including active ETFs, should be an open AP model where all APs and market makers have access to the daily PCF (portfolio composition file) pre-market open. The ability for multiple market makers to accurately price ETFs results in more competition, tighter pricing, increased certainty, and a more diverse marketplace.

In addition, provision of alternative information such as composition of a proxy portfolio and composition of the creation/redemption basket should be sufficient once carefully vetted as an appropriate alternative, as long as this is provided on a level playing field basis to a minimum number of market participants. However, currently in the EU at least, iNAV prices are not reliable and lag AP/MMs pricing systems, therefore, reliance on the iNAV is not recommended (please refer to our response to question 5).

With regard to the different portfolio information disclosure approaches set out in the discussion paper i.e., i) daily disclosure of full portfolio information to the public, ii) permitting disclosure of full portfolio information to the public on a lagged basis (typically monthly) with supplemental information provided on a timelier basis to APs where needed, iii) daily disclosure of creation/redemption baskets information to the public, iv) permitting daily disclosure of portfolio or creation/redemption basket information to APs/MMs ahead of the public (typically on the basis of a confidentiality agreement), we would caution against partial disclosure to particular market participants or lagged disclosure to the public as regulators would need to give careful consideration to what issues this may present from the standpoint of non-public information and the potential risk of market participants being seen to be acting on inside information when in receipt of PCFs.

Measure 3

For jurisdictions that mandate the provision of iNAV, regulators and/or trading venues are encouraged to consider means to enhance the accuracy and usefulness of iNAV.

Question 5 - What additional means or disclosure have been put in place to address issues relating to iNAV?

Due to the underlying issues with iNAV, FIA EPTA members consider that IOSCO may wish to disincentive use of the measure itself rather than focus on ancillary measures seeking to mitigate these issues.

Published iNAV levels can suffer from being "stale" with order book pricing information, benefitting from effective real-time competitive / arbitrage pressures, typically being a more reliable indicator of an ETF's fair value.

We observe examples of some exchanges using iNAV as inputs into circuit breakers / safeguard controls. As iNAV is not a reliable indicator of the fair value for a particular ETF, using iNAV to build collars and circuit breakers can introduce uncertainty to secondary market trading on exchange and halt trading unnecessarily. Exchange controls based on ETF order book prices themselves are preferred as they use well formed, real-time, transparent and easily discernible prices.

This may be a greater issue for ETFs holding less liquid assets, where recent periods of market volatility and stress have shown ETFs to sometimes have more real-time and transparent price formation versus their underlying instruments. In these instances controls based on iNAV may use more "stale" information on illiquid ETF constituents, versus the price of the ETF itself.

Measure 4

Responsible entities are encouraged to:

- ***(i) Conduct due diligence on APs and MMs when onboarding them to the ETF, with a view towards having those that are capable of facilitating an effective arbitrage mechanism and providing liquidity;***
- ***(ii) Conduct ongoing monitoring on APs and MMs for the ETF regarding, amongst others, the functioning of the arbitrage mechanism and liquidity provision; and***
- ***(iii) Avoid exclusive arrangements with APs and MMs if they my unduly affect the effectiveness of the arbitrage mechanism.***

Question 6 – Have the examples of considerations above captured the key considerations relating to selection and due diligence of APs, and where relevant, MMs, by responsible entities?

Yes, FIA EPTA members believe the examples of considerations captured above are the key considerations relating to the selection and due diligence of APs by responsible entities and we believe the process currently in place and undertaken by responsible entities is fit for purpose. Our members do not believe that additional rules or regulations are required to be implemented in this area and, as pointed out in the Consultation Report, agree that ETF managers have sufficient market incentives (i.e., the success of their ETFs) to ensure that the AP and MM function for their ETFs is working efficiently.

Question 7 – Do you agree with the proposed good practice to promote competition in ETF arbitrage and market making? Are there any justifiable circumstances where exclusive arrangements with APs or MMs would bring net benefits to ETF investors as a whole?

FIA EPTA members concur with IOSCO that efficiency in ETF secondary markets trading, and liquidity provision, is largely dependent on the active and robust participation of APs and MMs and there is a strong incentive for responsible entities to engage with multiple APs/MMs to support their ETFs. That said, our members agree with the proposed good practice for responsible entities to promote competition by operating an open AP model.

Responsible entities that only allow for a limited number of APs or have exclusive arrangements risk undermining the stability and efficiency of their ETFs. If, for example, an ETF provider had one exclusive AP/MM that received the non-public daily PCF under an NDA agreement, all market participants would be dependent on that one source for appropriate pricing. Should that AP/MM, for whatever reason, have any form of technical outage or operational issue that caused it to either quote at bad prices or be unable to quote in the secondary market that would have a significant impact on the market.

Our members consider that exclusive arrangements with APs or MMs with regard to onboarding APs and PCF disclosure do not bring any net benefits to ETF investors in the European ETF landscape where our members operate. As pointed out in the Consultation Report, exclusive arrangements can have anticompetitive effects. They can also cause conflicts of interest where the engaged party(s) is/are also part of the responsible entity's financial group. In our members' opinion, multiple diverse counterparties need to be involved in order to prevent conflicts of interest. By way of example: competition at the swap writer level has historically been lacking. More recently, however, a number of ETF providers have introduced changes to improve this by moving away from a single swap counterparty structure; this continues to be of concern to our members as it creates a single point of failure and over-reliance on the one counterparty.

Measure 5

Responsible entities are encouraged to put in place appropriate arrangements to facilitate an effective arbitrage mechanism, including contingency plans to address the circumstances where the arbitrage mechanism of the ETF is impaired.

Question 8 – Do you agree with the proposed good practices and jurisdictional examples as set out above? What additional good practices related to primary market arrangements have been put in place to promote effective arbitrage?

Yes, FIA EPTA members agree with the proposed good practices set out in the Consultation Report. In particular, our members find that the ability for responsible entities to enable custom baskets and process smaller minimum creation / redemption baskets is extremely useful for maintaining price efficiency in the secondary markets. With having a clear and cost-quantifiable creation/redemption mechanism, running an open AP model and having multiple APs per ETF being essential for the successful operation of an ETF.

Question 9 – To what extent should responsible entities be encouraged to provide more frequent disclosure of portfolio information to the public to facilitate the arbitrage mechanism? Does it depend on the information APs/MMs receive on a daily basis and the ETF's arrangements with APs/MMs?

FIA EPTA members believe that best practice is for ETF managers to disclose their full portfolio holdings to the public on a daily basis. As per the examples detailed in the Consultation Report, quite rightly many ETF managers already elect to do this. Referring back to our response to question 3, our members believe that partial or delayed disclosure to the public is detrimental and may cause issues in the context of inside information and acting in the market when in receipt of non-public information.

Question 10 – Have the examples above captured the key operational risks that may lead to disruption in achieving the ETF's investment objective? What additional good practices have been put in place to mitigate such risks?

FIA EPTA members agree that with the example of a swap-based ETF that relies on only one or two swap counterparties and would also consider that a single swap writer model is detrimental to the running of an ETF. In a similar manner to APs/MMs, responsible entities should be encouraged to have multiple swap writers (please refer to our response to question 7).

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Measure 10: Regulators and/or trading venues, where applicable, are encouraged to monitor secondary market trading and market making activities of ETFs and have rules governing the orderly trading of ETF shares.

Question 18: What rules are there to govern the cessation of liquidity provision by a MM? Do they minimize the impact to the secondary market liquidity of an ETF? What additional good practices have you considered in this regard?

FIA EPTA members consider that, generally, a MM should be able to cease providing liquidity if it is necessary for it to do so (for example, for risk management purposes). That said, and as we refer to in our response to Question 17 above, in Europe there are rules governing market maker obligations which mean that market makers are obliged to enter into liquidity providing agreements with the relevant trading venue when certain liquidity providing thresholds are met. It is not possible for a market maker in Europe to cease providing liquidity in a particular ETF if it meets these thresholds. In addition, in Europe we see other market makers stepping in to provide liquidity if another market maker withdraws from the market for a particular reason.

Measure 11: Regulators and/or trading venues, where applicable, are encouraged to appropriately calibrate volatility control mechanisms applicable to ETFs, considering factors including their liquidity profile and volatility profile. Where an ETF is listed or traded on a number of trading venues, those trading venues are encouraged to consider communicating with one another as appropriate when VCMs are triggered.

Question 19: What are the key parameters that regulators and/or trading venues should take into account in calibrating the format of VCMs and the relevant thresholds applicable to different types of ETFs?

As we have set out in our response to Question 5, FIA EPTA members do not see iNAV as a useful tool in the calibration of VCMs. We do not believe that market participants today rely on iNAV but, rather, calculate their own intraday values of an ETF portfolio. We believe that VCMs should be set by exchanges on the same basis as other financial instruments (for example, generally VCMs are based on some kind of exceptional price move from the last traded price and we do not think ETFs should be treated differently).

Question 20: What additional good practices related to design or implementation of VCMs have you been in place?

As we set out above, FIA EPTA members believe real-time order book price information for ETFs should be used in preference to VCMs that use iNAV as a trigger for circuit breakers. VCMs used for other financial instruments such as equities would be a better mechanism.