



## Principles for the regulation of the Exchange Traded Funds. March 2012.

IOSCO Technical Committee has published a consultation report on Principles for the Regulation of Exchange Traded Funds (ETFs). This document describes the experience and key regulatory aspects regarding ETFs worldwide, aims to provide guidance for markets and market authorities, to be of such a nature that they are adaptable to different regulatory frameworks and could be applied regardless of the predominant distribution model. Some of the principles may be better suited to industry best practice as opposed to regulatory requirements. These proposed principles address only ETFs that are organized as Collective Investment Schemes (CIS) and are not meant to encompass Exchange Traded Commodities (ETCs), Exchange Traded Notes (ETNs), Exchange Traded Instruments (ETIs) and Exchange Traded Vehicles (ETVs). The 15 principles proposed are grouped as follows:

### **Principles related to ETF classification, strategy, portfolio and costs disclosure.**

**Principle 1:** Disclosure encouragement that helps retail investors to clearly differentiate ETFs from other Exchange Traded Products (ETPs). ETFs have to comply with applicable CIS regulation (except redemption rules) but other kinds of ETPs generally are not subject to such requirements.

**Principle 2:** Clear differentiation between ETFs and traditional CIS, as well as between index-based and non index-based ETFs through appropriate disclosure requirements. ETFs, unlike traditional CIS, are traded continuously at market prices but are not redeemable except through Authorised Participants (APs) and in large blocks called creation units. Any ETF information -including marketing- should contain if it is the case the feasibility of the individual redemption.

**Principle 3:** Accuracy and completeness of all ETFs information disclosure and, in particular, of those that use or intend to use more complex strategies, or other complex techniques, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risk associated with such strategies or techniques. The leveraged ETFs (those that seek to deliver multiples of the performance of the index or benchmark they track), the reverse ETFs (those that seek to deliver the opposite of the performance of the index or benchmark they track) and the synthetic ETFs in general use investment strategies such as swaps, futures and other derivatives that should be included in the prospectus and other offering documents.

**Principle 4:** Disclosure requirements with respect to the way 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). Synthetic replication seeks to replicate the returns of a target index entering into a derivative contract (typically through a total return swap) with a selected counterparty or rely on a range of investment strategies; the information should be included in the prospectus and other offering documents.

**Principle 5:** ETF's portfolio transparency 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. The tracking error (TE) is defined as the volatility of the differences in returns between a fund and its benchmark index and helps measure the quality of the replication, and the tracking difference (TD) is the total return difference between a fund and its benchmark index over a certain period of time. The information might detail the methodology used to measure TE, the policy to measure TE and the level of TE that may be reasonably expected and a description of issues which will affect the ETF's ability to fully replicate its target index (e.g. transaction costs of illiquid components). One way in which regulators might address these issues is to require that an ETF publish daily the identities of the securities in the purchase and redemption baskets which are representative of the ETF's portfolio.

**Principle 6:** Transparency on an ETF's portfolio or other appropriate measures in order to facilitate arbitrage

activity in ETF shares. Arbitrage enables market participants to realize profits from any premiums or discounts between the intraday price of the ETF and the NAV of the fund. An efficient arbitrage mechanism could minimize wide premiums and discounts).

**Principle 7:** 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. One type of ETF trading cost incurred directly by investors is reflected in bid/ask spreads. Information would describe the ETF's cost structure (management fee, operational costs, swap costs etc) and other types of costs such as brokerage commissions, tax structure and information on revenues derived from assets held by the ETF (dividends or coupons) and the way they are distributed between an ETF operator and the ETF's shareholders.

**Principle 8:** Disclosure that would enhance the transparency of information available with respect to the material lending and borrowing of securities. Concretely, some jurisdictions required specific disclosure to manage conflicts of interest that could arise when revenues accrue (at least in part) to the ETF's operator.

#### **Principles related to marketing and sale of ETF shares.**

**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 Communications to be misleading.

**Principle 10:** In evaluating and intermediary's disclosure obligations, regulators should consider who has control over the information that is to be disclosed. This means that responsibility for providing ETF product information will tend to rest primarily with the products producers, whereas disclosure of information relating to intermediary services will rest primarily with the intermediary with the next refinements: i) if the intermediary provider or alters product information, it will take additional responsibility for that information or when it is prescribed in overarching legislation (MiFID in the UE); and ii) while a product producer may be generally responsible for the content of the disclosure, the intermediary is responsible in many jurisdictions for explaining the features of the product to a client.

**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. Intermediaries should have a robust process to assess the profile of each retail customer on the basis of his/her: investment objectives (length of time for which they wish to hold the investment; risk tolerance and relevant risk preferences (portfolio diversification); financial situation and general capacity to withstand losses; and investment experience and knowledge (nature, volume and frequency of previous transactions), level of familiarity with certain products and services, customers' profession, former professional experience, and level of financial education.

**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; these processes should be written and include employees training to make sure that they understand the products they sell and are able to answer the retail investor's questions.

Principles related to the structuring of ETFs.

**Principle 13:** Appropriate identification and addressing of potential conflicts of interests raised by ETFs. The documents give some examples of potential conflicts of interest: ETFs based on indexes designed specifically for it, when there is a small number of APs, in the context of securities lending if the lending agent is an affiliate of the CIS or when the swap counterparty is an affiliate of the ETF. In the case a custom index is created by an affiliate, regulators may consider having: a) all of the rules that govern the inclusion and weighing of securities in each index should be made publicly available; b) the ability to change the rules for index compilation should be limited and public notice should be given before any changes are made; fire wall should exist between the staff responsible for the index and the portfolio management staff; d) entity responsible for index maintenance, calculation, dissemination should not be affiliated with the index provider or the ETF or, otherwise, there should be effective firewalls to avoid conflicts of interest; and e) the component securities of the index should not be changed more frequently than on a specified periodic basis.

**Principle 14:** ETFs appropriately address risk raised by counterparty exposure and collateral management. Synthetic ETFs strategy reduces TE but introduces counterparty risk. There are two synthetic ETF models: a) unfunded structure, the ETF provider/manager invest the cash proceeds from investors in a so-called substitute basket of securities where the basket's return is swapped via a derivative contract with an eligible counterparty

in exchange for the return of the index tracked, and the legal ownership of the basket of securities remains with the ETF; and b) funded or prepaid swap structure, the investors cash is exchanged in a swap without creating a substitute basket and where a collateral agent is involved. Regulators could require this ETFs to adopt risk management products (specially for risk of counterparty default), establish limits with respect to a specific issuer, checks and filters to those assets accepted as collateral and subject them to diversification rules. Physical replication ETFs could also invest in derivatives as part of their investment strategy and, also, may lend securities; in both cases, regulators should consider requirements to address counterparty risk and the collaterals accordingly.

**Other issues: markets structures and financial stability.**

Principle 15: ETF exchanges should consider adopting rules to mitigate the occurrence of liquidity shock and transmission across correlated markets (e.g. automatic trading interruption mechanisms). ETF markets could, as a consequence of the last technological changes, suffer high volatility and settlement delays. Recommendation 2 of the IOSCO Report on Market Integrity and Efficiency, that recommends to have in place suitable trading control mechanism (trading halts, limit-up/limit-down controls etc), is difficult to apply when an ETF is listed in several trading venues.

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