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Central Bank of Ireland
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IRELAND

submitted via email to fundspolicy@centralbank.ie

CONFIDENTIAL

Re: EXCHANGE TRADED FUNDS – Discussion Paper (DP6)

Introduction

The Bank of New York Mellon Corporation (BNY Mellon) is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. As one of the world's largest investment services and investment management firms, BNY Mellon welcomes the opportunity to respond to the Central Bank of Ireland's Discussion Paper on Exchange Traded Funds (ETFs).

BNY Mellon operates in Europe through: (i) branches of The Bank of New York Mellon (a New York state chartered bank) and (ii) directly established and duly authorised subsidiaries established in certain EU jurisdictions and branches of those entities operating in core EU member states including Ireland.

BNY Mellon has had a presence in Ireland for over 20 years. In Ireland, BNY Mellon operates through a number of legal entities, including:

- BNY Mellon Fund Services (Ireland) DAC
- BNY Mellon Trust Company (Ireland) Limited
- The Bank of New York Mellon SA/NV, Dublin Branch
- Pershing Securities International Limited

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BNY Mellon Fund Services (Ireland) DAC is authorised as an Investment Business Firm and as an administrator to funds – and provides administration services such as fund administration and fund accounting, valuation services and transfer agency activities. BNY Mellon Trust Company (Ireland) Limited is authorised as an Investment Business Firm and as a trustee to Irish funds – and provides custodial operations involving the safekeeping and administration of investment instruments. BNY Mellon Trust Company (Ireland) Limited is also an authorised AIF Irish Collective Asset-management vehicle (ICAV). The Bank of New York Mellon SA/NV is a Belgian credit institution providing services including custody services. It operates in Ireland through its Dublin Branch.

Pershing Securities International Limited is the Irish subsidiary of Pershing, a BNY Mellon company. Pershing is a provider of global financial business solutions, including execution, clearing, settlement and custody services.

Our clients in Ireland include traditional and alternative asset managers, banks, pension funds, insurance companies and corporates.

BNY Mellon has a physical presence in Dublin, Cork and Wexford, and employs over 1,600 people in Ireland. We are active participants in our communities, including through our Community Partnership and Diversity & Inclusion initiatives. On 16 June 2014, BNY Mellon signed the Diversity Charter Ireland.

We participate in a number of Ireland-based industry associations including Banking & Payments Federation Ireland (BPFI), Federation of International Banking in Ireland (FIBI), Irish Funds and the Irish Association of Investment Managers (IAIM).

As noted in the Discussion Paper, Ireland is one of the principal domiciles for European ETFs and many of the largest global ETF promoters domicile their European products in Ireland. As one of the world's largest investment services firms, BNY Mellon plays an important role in providing ETF services in Ireland.

Executive Summary

Please find herewith comments from BNY Mellon on the Central Bank of Ireland Discussion Paper on ETFs. BNY Mellon is a leading global service provider in the ETF space with almost $400 billion assets under administration globally. The Discussion Paper was welcomed by us and broadly by our clients. We have solicited feedback internally from multiple areas in various jurisdictions at BNY Mellon and hope that our comments will contribute to the wider discussion the Central Bank of Ireland is driving.

Our Approach to Responding to this Consultation

At BNY Mellon, we obtained views on this Discussion Paper from multiple sources across our lines of business. Although much of our response is sourced from our Irish regulated entities, we have taken a global view, and therefore our response is not exclusive from our Irish regulated entities.

We also liaised with our clients in regard to the Discussion Paper. We can report that client feedback on the issuance of the Discussion Paper was positive. A number of clients noted that the Discussion Paper contained some very useful educational information, and some clients had indicated that the Central Bank may wish to consider arranging translation of the Discussion Paper into other key languages to facilitate such education.

In our response below, we have followed the structure of the Discussion Paper. For each Section of the Discussion Paper, we first provide our commentary, and then answer the questions posed by the Central Bank. In our commentary, we have indicated the relevant paragraphs of the Discussion Paper in brackets.

Response

Section I: ETF dealing

Primary Dealing and Secondary Trading

(5-25) The role of an authorised participant (AP) is distinctly different than the role of a Market Maker. However many AP's also perform Market Making functions. At a high level, an AP acts in the primary market transacting directly with the fund off-exchange, whereas Market Makers perform liquidity trading (profiting from bid/ask spread) and/or arbitrage trading (riskless opportunities) functions in the secondary market on exchanges.

Typically an AP will also be a liquidity trader, but not necessarily an arbitrage trader. Keeping the roles separate may enhance the ecosystem by limiting conflicts of interest and/or allowing certain market participants to stick to a specialty – using up less capital and allowing them to focus on areas they can provide the most value.

Secondary market liquidity is dependent on the functioning of APs and OLPs

(28) One might argue that in stressful/volatile periods, an AP or Market Maker may be able to identify profitable situations that should in theory stabilize any disconnection of market prices to net asset value (NAV).

(34) A bespoke fund level mechanism may be required to allow the ETF to maintain the efficiencies of bulk trading. Allowing direct redemptions without stipulations could cause

high turnover and/or costs to the remaining investors of the fund. In addition each investor would need to open an account on the share register and undergo know your client (KYC) checks at the primary market level and they would need access to a depositary account through which they can return the ETF shares.

ETF's – who are the shareholders?

(36) It may be difficult for an ETF provider to disclose the potential costs of a direct redemption for a secondary market investor considering their own broker/nominee agent will likely be applying charges to any such trading activity, for example.

ETF traded price and net asset value gaps

(44) One could argue that if it is trading away from NAV that the iNAV is the correct intrinsic value. One potential solution for spread based concerns would be to creating a secondary trading order type which would put a price restriction based on % deviation from the iNAV. This would act as a sort of limit order.

Share classes – different dealing deadlines for hedged and unhedged share classes

(63) Another option is the "Basket DVP" or "Double Cash" approach where the AP sells the underlying securities to the fund, but still pays cash for their ETF shares.

ETF / non-ETF share classes

(74) It is possible the fees charged by the issuer would also.

(75) Investors should be educated as to how to sell the asset they have bought. Equally, where there is a possibility of an investor being at a disadvantage to another investor in selling the asset, due to the mechanism through which they bought and hold the asset, it seems prudent that the investor is be made aware.

It should also be noted that an investor can trade a non-ETF mutual fund on a secondary market and effect settlement by transferring the units (albeit on a less liquid forum). Also, in some cases secondary market investors can sell on the primary market, subject to meeting the set up requirements.

Section I: ETF dealing - Questions

A. Is public disclosure of the identity of APs and OLPs of an ETF of benefit and should regulators have a clearer view of the interconnectedness of the AP / OLP ecosystem? Should remuneration models of OLPs (and if relevant APs) be disclosed?

The identity of the APs is not opaque to the market and those who trade with the APs generally have this information. However, it may be argued that provision of this information might increase shareholder confidence and integrity of ETFs.

It could be argued that Investors are entitled to know the costs, including where costs are incurred where reciprocal arrangements are in place. This would align to an extent with existing UCITS requirements to include details of other service provider fees in fund documentation.

Where limits are in place on spreads, there is a risk that this could lead to an increased probability of an AP exiting the market in stressed conditions, if they feel they cannot reflect the volatility in their spread.

B. Transparency is described as the feature which enables a tight secondary market price (by comparison to net asset value) to be maintained. It also provides certainty to investors in terms of exposure achieved through the ETF. It might be the case that there are other mechanisms which achieve the same goal as transparency? If ETFs are not transparent does this have unintended consequences?

Where the underlying portfolio is not transparent there could be larger spreads as a consequence. This could be considered worthy of disclosure in the fund documentation.

C. Is the idea of secondary market investors dealing directly with an ETF when the AP arrangements breakdown unworkable in practice or unnecessary? Is there a better way of enabling secondary market investors to dispose of their ETF shares at a price close to the next calculated net asset value when secondary market liquidity is impaired?

It could be suggested that issuers contemplate this in their business plan, however it should be noted that in order to efficiently allow secondary market investors return ETF shares to the Transfer Agent, the Issuer may need to queue and bulk orders, which may be detrimental to remaining shareholders. There are also KYC and tax considerations. Redeemers would need access to a depositary account through which they can return the ETF shares.

D. Should ETFs warn investors that the ETF may temporarily become a closed-ended fund in certain market conditions? Would requiring an ETF to remain open-ended in a stressed market be disadvantageous to existing investors or have other unintended consequences?

In practice, it would seem appropriate that secondary market investors be subject to similar disclosures as investors in any other listed stock. Investors buying on an exchange should be educated, or made aware, that their investment is subject to the supply and demand on the exchange, though it could be argued that it is not necessarily the function of a regulator to inform them of this. Closed-end funds historically trade away from NAV generally. Building in this feature could widen spreads to hedge the risk of it turning into a closed end fund.

F. What are the benefits or disadvantages of permitting listed and unlisted share classes within the same investment fund? Do listed and unlisted share classes create unfairness as between investors in the same investment fund and if so, can these be mitigated or addressed?

Where there is a possibility of an investor being at a disadvantage to another investor in selling the asset, due to the mechanism through which they bought and hold the asset, they should be made aware.

Tax treatment will also be an issue. For example, many ETFs pay 15% withholding tax on US securities versus 30% for a comparable mutual fund. So the questions to be asked are "What rate would a hybrid pay? How would this be determined?"

Section II: Distinctive ETF risk factors

AP Interdependencies – Synthetic ETFs

(84) This could be considered to be the case, in that the performance of the index is provided by the counterparty. In a physical fund the performance comes from more diverse sources (the portfolio). In the event a counterparty fails, the time and effort to adjust and achieve the performance of the index through another means comes into question

(89) One might expect that the value of the collateral should be greater than the NAV by a sufficient amount to allow the manager to cover the costs of revising the strategy.

Collateral Risk

(102) On one hand, it may seem reasonable to assume that collateral risk is the same in an ETF as any other UCITS and that this is not an ETF-specific risk, though failure of a counterparty may

greatly impact tracking error and result in veering away from the funds objective, albeit there are a number of mitigating measures in place to reduce these risks.

(109) Where collateral is third party managed, the collateral manager would have a list of acceptable securities.

Section II: Distinctive ETF risk factors - Questions

G. Are conflicts of interest rules effective for dealing with concentrations of activities within an ETF provider's financial group (e.g. group entities could act as promoter, investment manager, AP and swap counterparty or SFT counterparty)? Are other approaches worthy of consideration?

Insofar as the collateral is provided by / correlated to a related party to the fund or swap counterparty, it does not change the value of the collateral. One might argue the more appropriate focal measure for collateral risk management is in the value of the margin above the exposure and the liquidity of the collateral.

I. Some academic research suggests that if a synthetic ETF experiences counterparty default, the synthetic ETF is more likely to be able to deliver the performance of its underlying index if the collateral received is correlated to that index. Should collateral received (where a funded model is used) or securities purchased (where an unfunded model is used) be correlated to the index being tracked? Is this practical, particularly for example where the index tracked by an ETF is comprised of securities which may be relatively expensive to access? Is collateral quality sufficiently regulated and disclosed?

This does not appear to be an ETF-specific consideration. The key consideration with collateral is that it is liquid and that the value is sufficient to allow a timely rebalance at minimal/no expense to the fund. In this regard, it could be argued that collateral risk is the same in an ETF as any other UCITS and that this is not an ETF-specific risk.

Section III: Particular types and features of ETFs

Active ETFs – Transparency and pricing

(140) An agreed delineation of regulatory roles, common across regulatory bodies and exchanges, may be useful.

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Front running and active ETFs

(143) Some issuers may choose to reconstitute prior to or after the given date in order to counteract front running.

Section III: Particular types and features of ETFs - Questions

J. Are active strategies appropriate for "housing" in an ETF structure and if so, is there a limit to the type of strategy that would be appropriate? If the ETF structure provides opportunities for managers to achieve scale is there a downside to this where the strategy is active (or, if scale is achieved, its potential impact is not otherwise capable of being ascertained)?

It could be considered that an active ETF is no less appropriate a structure than an active non-ETF mutual fund, albeit consideration could be given to disclosures to shareholders. One viewpoint is that the exchange traded nature of an ETF is simply the mechanism to buy the fund.

K. Similar to the question posed in Section I, is portfolio transparency fundamental to the nature of an ETF or are there are other mechanisms which achieve the same goal as transparency? In the context of an active ETF, is transparency essential in order to achieve a liquid market and to facilitate efficiency in pricing?

Transparency is not a requirement for the working of an ETF from an operational perspective. It could be argued that without it, some of the price discovery and front running opportunities are lost, reducing liquidity on the secondary market, though these points may be weighed up by the Issuer versus protecting their proprietary strategy.

Section IV: EFTs and market liquidity

Assessing the Liquidity Impact of ETFs as rules-based investment vehicles

(154) Taking a macro-economic perspective, in a liquid market, liquidity is quickly reached by adjusting the price of a security as the level of demand changes in relation to the supply.

ETFs may impact the informational efficiency of underlying securities

(171) This research seems to indicate that ETF ownership may reduce the opportunity the informed trader has to trade with the uniformed trader. A contrary line of thought may be that this is a positive for an uninformed trader. On might consider is it a negative from a

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regulatory perspective if the uninformed trader is not losing out to the informed trader as much. It could be argued is levels the playing field somewhat.

ETFs may encourage non-fundamental volatility of the underlying securities

(179) It seems this example could be replicated without using an ETF. The ETF may make the process simpler however.

(181) Further studies cited appears to conclude that rather than contributing to the volatility, the ETF may simply allow for a quick realisation of (the implicit volatility in) the market price, thus giving the appearance of volatility. The passive ETF is traded more frequently than a passive mutual fund, leading to perhaps greater price discovery when compared to its mutual fund counterpart.

ETFs and the creation of fragile liquidity

(185) It could be argued that it is not necessarily the case that liquidity in the secondary market perfectly correlates to liquidity in the primary market. One way to think about the secondary market would be to compare the buy/sell of the ETF share in the secondary market to a Transfer on the primary market. The underlying security is not bought or sold - the ownership is simply transferred, without impacting liquidity. The underlying share is still owned by the same ETF, but the beneficial owner beneath that has changed.

(190) It is difficult to see how such assumptions can be beneficial or how such ratios can be accurately calculated, or how they might change in time/ different conditions.

(192) In this instance the UCITS would have to sell the positions and the Market Makers/APs, as the arbitrators, would need to build potential volatility into their spread. In theory at least, the Market Maker would still intervene, albeit the spread offered would be reflective of the additional risk in a volatile period.

(195) In this regard, they are akin to a derivative, albeit a physical derivative (of the UCITS).

ETF provider support

(204) One viewpoint on ETF secondary market liquidity that could be held would be to consider it as you would a non-ETF equity in terms of the issuers' obligations to ensure liquidity.

(207) A potential consideration would be to include this as a specific ETF risk disclosure in the fund documentation.

Section IV: ETFs and market liquidity - Questions

L. Some commentators are concerned that ETFs are tracking indices of underlying stocks which are not sufficiently liquid to match the intra-day liquidity on the secondary market which the ETF offers.

This statement is quite simplistic and does not, for example, reflect that there may be much secondary market activity but very little primary market activity. UCITS, including UCITS ETFs, are subject to general liquidity management rules which should ensure that ETFs track indices of underlying stocks that are sufficiently liquid to allow the ETF to meet creation and redemption requests.

Is this sufficient? What liquidity practices do ETFs follow? Are there other practices that might be appropriate for ETFs?

The UCITS liquidity management rules address the requirement to sell the fund at the primary market level. It could be considered that the supply and demand on the secondary market level is not an obligation of the UCITS in that the UCITS manager only needs to manage liquidity for transactions in the primary market. Secondary Market trades are subject to the economics of supply and demand on an exchange and could be viewed more like a transfer in that the underlying securities don't need to be bought and sold when the ETF shares are.

M. One of the potential impacts from greater investment in index-tracking ETFs is decreased informational efficiency of underlying securities as well as increased non-fundamental volatility of underlying securities. However, these may not be risks *per se* or, at any rate, may not be risks that ETF providers or regulators can mitigate, manage or eliminate.

Is this assessment correct or could measures be taken to address this impact?

As ETFs are a tool for price discovery, they can help a portfolio manager to react quicker to market movements.

N. One of the key issues in the context of support by ETF providers is investor expectation. Investors' views about purchasing ETFs and their ability to sell may be informed by whether or not the ETF provider will support the ETF in the face of stress events. There are, however, divergent views amongst ETF providers as to whether they would support their ETFs.

Is provider support a desirable objective?

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Taking a macro-economic perspective, in a liquid market, liquidity is quickly reached by adjusting the price of a security as the level of demand changes in relation to the supply. From a portfolio management perspective liquidity should be managed to meet primary market demand. Investors on the secondary market are subject to the economic laws of supply and demand of the open market.

Section V: Other considerations

European-level analysis is not available – is the commentary in the Discussion Paper equally valid in a European context?

(209) This must depend on the subject under review. With the exceptions of operational settlement and local exchange rules and regulation, the products are notably similar.

Section V: Other considerations - Questions

P. Does the nature of an ETF have peculiarities (and therefore risks) that neither the UCITS nor MiFID regulatory frameworks, either in isolation or in conjunction, address and which we have not examined here?

Specific items referenced in the document may merit further focussed attention. For example, how a large scale investor could use a short and leveraged ETF in stressed market.

BNY Mellon looks forward to further engagement with the Central Bank of Ireland in regard to this Discussion Paper and any future discussion or consultation papers on this topic.

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