Submission is response to Central Bank of Ireland Exchange Traded Funds Discussion paper

29 June 2017

General points

ETFs have live pricing and trading, conventional funds have daily valuation and settlement with stale pricing. Would conventional funds (stale, once a day pricing, trading desk and investment management in one organization) exist if not for the fact they arose in a legacy trading/settlement technology environment? As the cost of providing live pricing on funds becomes trivial there is good argument that all funds could be run on the same basis with a manager or algorithm producing a model portfolio, which is then used as a basis for assembling a portfolio by a unit creating entity. Conventional asset managers currently provide model portfolios for SMA (separately managed account) and some segregated account customers.

Moving to live pricing and out-sourcing would get rid of a whole series of practical and, administrative, and regulatory problems which have long created problems for legacy/conventional investment managers.

Throughout discussions of ETFs there is discussion of the definition of Large and Small liquidity events. The definition of large and small depend on; the size of the fund relative to the liquidity of underlying assets, market conditions, and can change from trading period to trading period.

The ideal solution for balancing; “fair” trading for investors, efficient & profitable trading for liquidity providers, and risk minimisation for regulators, has not been found for any/most traded securities and will not be found here. Liquidity risk event solutions will always have an element of qualitative risk analysis and ad hoc solutions

There are some features of the ETF business which are new, and can become problems as the segment grows larger.

- The research vs efficiency paradox.
    - How does information get included in prices
        - We might take an analogy from the US political-media industry.
            - Is there less “quality” coverage of politics in the US?
            - Are there fewer analysts and fewer outlets looking for news items?
            - Is coverage more partisan? If there are 1,000 analysts and 1 “single issue” activist, that is different to 10 analysts and 1 single issue researcher.
            - Have elections and the process of elections become more problematic.

- There are analogues of all these questions in the passive investing business.

- Roles of index "chooser" and index provider
  - Someone must choose which index to follow; FTSE or MSCI, developed Europe or "Europe", market cap or trade weighted.
  - Index providers make many decisions about what goes in the index.
  - Index providers are businesses and wish to maximize some definition of revenue or profit.
  - Access to index data is not cheap and is a barrier to entry. If index data costs US$100,000, then a fund company and fund must be a certain size before that cost can be borne. Index providers price by region, location, or chair (single point of access), investment managers with multiple locations face an "artificial" cost versus those who operate in a more compact location.
- ETFs appear to be a natural monopoly business, and thus raise different issues to the more traditional fragmented investment managers.
  - Liquidity: "activity follows market liquidity". Hypothetically, one ETF provider might come to dominate a particular ETF index product, and thus the underlying index. I.e. if a Vanguard S&P500 ETF was priced at 3bps, while the competitors were priced at 4pbs, some portion of category AuM would flow to the lowest cost provider, enhancing the Vanguard competitive advantage which in turn could enable Vanguard to offer even better pricing.
  - There is the argument that monopolies are a good thing when a product is young. A single strong provider is better able to fund investment and cost reduction. In the early stages the company's interests will likely align with clients. Later on company goals move from growing the business, to optimising outcomes (revenue/profit/benefits for staff/owners). The balance of benefit shifts from customers to internal goals; the company's interest no longer align with customers.
  - Relative size and power: Example, a custodian can say "no" to a relatively smaller customer, larger ETF providers may provide a different challenge.
  - In a conversation some time ago a bank regulator remarked that once banks got beyond a certain size, they were regulated by the government of the day. Large ETF providers might become too large to be regulated by a market authority.
  - Ratio of size of ETF provider to "index" may be important. A hypothetical ETF promoter might have a US index product in Ireland & the US, and a company held in both may also appear in their global fund offered in Asia, and World ex domestic funds offered in Europe.
- Cheaper = less revenue = less informal oversight,
  - Analogy might be media.
    - Traditional media meant many eyes editing "inappropriate content". Self-censorship and social shoaling have bad reputations, but they did mean that there was some filter on questionable content. Digital media means no-one/fewer monitoring content, and some oversight now has to be built back in (i.e. Facebook hiring content checkers).
  - There needs to be some level of investment responsibility. As investment becomes automated more responsibility for decision falls earlier in the decision chain.
  - Cost of capital; if investing and trading in ETFs is cheaper than conventional equities, there may also be an implication that companies in large ETF focused indices benefit from cheaper cost of capital. Example: 2 equivalently sized companies facing a

    (single) new opportunity might find that the index participant can raise capital more easily and cheaply. This may be less of an issue at present due to the low cost of debt funding.
  - This could happen in 3 ways;
    - absolute cost to the investor is lower so cost to the borrower is lower,
    - inflows into ETFs mean that companies included in some indices are seeing flow of capital,
    - (inconvenient) oversight is lower. Fewer analysts means less communication cost,
- Distribution
  - There is not a single European fund market.
    - "On Tuesday Vanguard confirmed plans to launch a UK business that will enable investors to buy funds directly from the fund house and bypass online investment platforms such as Hargreaves Lansdown and Barclays Stockbrokers, which charge higher fees." FT 20 May 2017
    - Vanguard has a UK platform, not an EU/Irish/Dutch/… platform
- Trading and information service.
  - In the conventional fund business larger clients get better information flow. In the index ETF business promoters do not value information, but they do like lower cost more competitively priced trading. Larger ETF promoters get better deals because they can deliver volume. Example, an ETF promoter with 500 funds representing €1t of AuM will get a better deal on a new offering than a smaller promoter will, even if the smaller promoter has larger *product* AuM or a better feature list. This cross subsidy may be(come) a barrier to entry.
- A market maker or unit creator/destroyer who commits to offering volume at price may find themselves exposed to price moves they cannot trade out of. Europe is not a single market. European market holidays fall on a whole range of dates. Stockholm might be closed on Monday for a holiday, Dublin might be closed on Tuesday, XYZ market might be closed for technical reasons on Wednesday, Paris might be closed on Friday. This may be a variant of market timing.
- Small versus Large ETFs, or ETF promoters.
  - Size is an important factor in the ETF business.
  - Large ETF funds, or those which are produced by a large provider, will be able to offer a traded ETF.
  - Small and Micro-cap ETFs may not be able to pay for, or attract, sufficient liquidity for the "T" to be meaningful.
  - An ETF where the fund is small enough that the promoter must also be the AP and OLP, is a conventional fund.
  - APs and OLPs don't have any obligation to create liquidity where there is none, there role is to provide some sort of liquidity management and short-term warehousing.
  - This liquidity problem is a reality with micro cap stocks, and is usually handled by creating tiers of stocks; big board, OTC, pink sheet, AIM; but also restricting access of retail investors.

Section I Questions

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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?

Identity: Yes. The ability of the ETF to function across a range of market conditions is, whatever ETF promoters might argue, a part of the product. Health of the AP/OLP ecosystem is important. Potential investors carrying out due diligence should be in a position to draw conclusions from the identity of critical infrastructure providers. These would include; auditors, custodians, transfer agents, even regulators. In most cases the AP/OLP will be an insider to the fund, and is in a privileged position, and is trading against the investors, and in the interests of the investors. The role may be complex, and disclosure is appropriate.

Remuneration: Overall the remuneration of APs and OLPs is modest, relative to the fees charged on more traditional funds. However the tendency to bundle some services across funds (custodial and audit tend to be charged to a fund, AP/OLP trading can be on an omnibus deal) raises some potential that some clients (i.e. those in a mature flagship fund) are subsiding other clients (those in a start-up).

Are trading costs commercially sensitive? There is relatively small variation around the cost of trading company X on exchange Y at time Z. There is room for manipulation when there is bundling.

Opaque dealing costs and practices (research, other service bundling, soft commissioning) have bedeviled the traditional industry for decades. There is no reason to believe that this is not the case in the ETF business.

The liquidity provision/creation/destruction is both a part of the product, and a means of making trading revenue/profit. The AP & OLP can be serving & competing with unit holders.

There are some practices that are not sustainable in the long-term. Some AP/OLP contracts are priced off increases in AuM, with AP/OLP providers assuming that rising AuM equals a growing trading volume. That will not always be the case, these deals will need to be re-priced. That re-pricing will lead to a change in costs for investors.

"A large number of ETFs have APs which are connected persons to the ETF provider." This is a problem with some conventional funds, why allow it to persist? Example; a promoter runs a fund at an advertised 50bps MER/TER. All trading is carried out through a connected entity (a company owned by the proprietor). Trading as at 55bps (perhaps 50bps higher than normal execution only). Trading is a "hidden" cost paid directly by the fund investors. Why accommodate the same practice for ETFs?

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?

There are two different reasons for ETFs to exist. One is as an efficient mechanism to gain exposure to an underlying set of assets (“exposure to the Japanese market”). The other is a mechanism to gain efficient exposure to an underlying strategy, where the strategy has some value over and above the underlying assets (“a long/short algorithm on the Japanese market”). The goals are different and will trigger different responses to the question.

Transparency must be a given on a passive index ETF. An index provider might argue that an ETF promoter cannot provide transparency to the extent that the promoter is effectively providing index constituent data for free to ETF clients. However, there does need to be some mechanism to allow clients to test whether the promoter is actually providing an index fund. Some agreed % efficiency measure (on day X the ETF replicated the index to 99.7%) might fit this requirement. This is different to whether the ETF delivered the full return as shown by the index.

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?

Custodial services are regarded as a different service to investment management, AP service could be regarded as a similar problem. The AP service will always the necessary, though the service might remain inactive for long periods (in the same way that a Transfer Agency service might be inactive for long periods). It may be appropriate that regulators would demand that an AP service exists separately from ETF provision, and in a robustly capitalized and risk managed structure.

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?

The problem of liquidity provision in “certain market conditions” has not been solved in any asset class, and regulators have generally accepted this reality. Regulators can insist that a fund is priced and “available for sale” on a live or daily-settle basis. This requirement will either push funds to an idealized, and occasionally artificial model (i.e. funds become overly selective on what assets can be included to guarantee daily settle under ALL conditions). Or remaining open-ended/daily settle should be accepted as something that is put aside from time to time.

Example: small cap equities, or smaller bond issues, Irish & other EU government bonds, are generally liquid to a certain size. They could be included in a daily settle fund. From time to time there will be no liquidity. The choice is to exclude; these assets from daily settle eligibility, allow less than daily settle (or fortnightly settle) funds [AKA interval funds], or tolerate that there can be times of crisis.

Comment on C and D

Market crisis is fundamentally different to AP/OLP breakdown, the first can and will happen, the risk of the second should be managed out of the system. The growth and natural monopoly tendency may make this challenging. Hypothetically, regulators might have to impose some “too big to be allowed” rule on ETF promoters or liquidity providers.

E. Is it correct to permit share classes to be structured having regard to the operational concerns of APs and the impact this may have on secondary market pricing? Are there factors (other than those noted above) that could be relevant to ETF structuring?

If the product is dependent on a single AP, then the existence/remuneration of the AP is part of the product and should be accounted/listed/regulated as such.

This is a broad question. There can be many situations where an AP might raise concerns. It is not obvious that adding extra share classes solves these problems.

- A strategy ETF might be difficult to replicated on a live basis (perhaps one involving level 3 securities), maybe there are some funds where live, daily, even weekly or monthly pricing is not appropriate.
- An ETF may be opaque, and the AP/OLP feels that they are not able to be sufficient of an insider to the fund.
- Availability of the constituents of an index may mean that the AP is not able to create units on a timely basis.

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?

There may be advantages. However, the research quoted in the discussion paper shows premia/discount range of +6%/-12% on ETF price/NAV. The whole market timing issue on conventional mutual funds operated off far smaller ranges and was ultimately seen to be an abuse of some categories of investor. The notion that there might be differently priced classes on the same set of assets is puzzling.

Unlisted ETF is a contradiction in terms, does one of the classes operate outside of regulatory/AP coverage? Who pays for the services consumed by the different classes?

Section II 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?

The AIFM conflict of interest rules are likely too "light". I believe there is a lot more work that could be done on connected and related party Conflict of Interest.

A conflict of interest might be defined as; where there are asymmetric inputs and and/or outputs within a shared ongoing structure. The way to address the conflict is to either remove things from being within the single structure, or ensure that the inputs and outputs are clearly defined. Complex business inputs and outputs are typically very difficult to fully unentangle; the easiest way is to separate the structures.

Some of the roles listed above rely on competition to operate effectively on behalf of the end user. Those that rely on competition are more problematic when within a single financial group. Multi-jurisdictional and more complex relationships make ensuring competition more challenging.

H. Could multiple counterparties expose ETFs to unintended risks and consequences?

This is reality of any relationship, and is increased where counterparties have different goals and relationships.

Companies normally have multiple providers where they judge that competition or competencies require them to accept the complexity of adding extra relationships.

If competition is necessary to ensure that the end client gets a satisfactory product (as in pricing of AP and/or OLP services) then that is part of the reality of ETF products.

There is some good work on the application of agency theory to out-sourced relationships (see Mary S. Logan, (2000) "Using Agency Theory to Design Successful Outsourcing Relationships", The International Journal of Logistics Management, Vol. 11 Issue: 2, pp.21-32). Overall, third party relationship management (TPRM) is a skill that can be learned, improved, and monitored.