



28 November 2024

An Examination of the Primary and Secondary Market Trading Arrangements of Exchange Traded Funds ('ETFs') in Ireland

Dear Chair,

In 2023, the Central Bank of Ireland ('the Central Bank') undertook a review of the primary and secondary market trading arrangements of Irish authorised ETFs ('Review'). The purpose of this letter is to highlight the key findings from the Review, and to set out the Central Bank's expectations and actions to be taken by the board of the Fund Management Company ('Firm'). As Chair, you should address and prioritise the findings and actions referred to in this letter.

Background to the Review

Ireland is one of the principal domiciles for ETFs in the European Union. ETFs form a significant portion of the Irish funds sector comprising approximately 32% of total Irish authorised fund assets under management ('AUM'), and represent 70% of total AUM in the EU ETF sector.

Authorised Participants¹ ('APs') and Market Makers² ('MMs') perform crucial roles in the ETF ecosystem and represent a significant additional underpinning to market liquidity. Their importance has been recognised in both the International Monetary Fund's ('IMF') recent Financial Sector Assessment Programme ('FSAP') of Ireland, and by the International Organization of Securities Commissions ('IOSCO') 2023 report on 'Good

¹ An Authorised Participant ('AP') is an institutional investor that purchases and redeems ETF shares directly from the ETF. APs also perform a crucial role in keeping an ETF's market price close to its Net Asset Value ('NAV') per share.

² A Market Maker ('MM') is a financial institution which undertakes to the stock exchange on which the ETF is listed to provide a certain amount of defined liquidity in an ETF. Stock exchanges generally require a minimum of one MM per ETF admitted to trading on that stock exchange. The formal obligation of the MM (subject to certain exceptions) is to enter continuous two-way prices with a maximum spread and quote size for a specified period during the day. The duties and obligations of the MM to the exchange is to support the functioning of the exchange (with the MM often being compensated by the exchange through, for example, lower trading costs).



Practices Relating to the Implementation of the IOSCO Principles for Exchange Traded Funds'³ ('IOSCO Good Practices').

The Review was undertaken to ensure that, with regard to the roles played by APs/MMs and the oversight performed on those entities by Firms, the arrangements in place are sufficient to protect ETF investors and promote the integrity of the ETF ecosystem; this included consideration around the provision of liquidity during normal and stressed market conditions, and the effective functioning of arbitrage mechanisms. To fulfil this objective, the Central Bank assessed the roles played by APs and MMs⁴ within the Irish ETF ecosystem, gained an understanding of the governance structures in place between Firms and APs/Contracted Market Makers (CMMs⁵), and sought to mitigate identified risks. It included an examination of the due diligence, ongoing monitoring and board oversight arrangements in place across Firms, while also seeking to address any identified gaps and risks.

Review methodology

The methodology for the Review consisted of two phases.

Quantitative assessment

A quantitative questionnaire was issued to all Firms managing Irish authorised ETFs. Data captured included identifying the number of APs and MMs utilised, the level of AP activity over a 12 month period and the various ETF listing locations.

Qualitative assessment

A qualitative questionnaire was also issued to a sample of Firms in order to assess the oversight they perform on APs and CMMs. Areas evaluated in the Review included due diligence, ongoing monitoring, stress testing and board reporting within the Firm regarding the activity of APs/CMMs.

³ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD733.pdf>

⁴ Information was sought on exchange-required MMs and bespoke contracted MMs.

⁵ Some MMs are subject to contractual obligations with ETF managers or ETFs to trade at spreads that are tighter than that set by an exchange and provide exchange-based two-way pricing in ETF shares (referred to as Contracted Market Makers or 'CMMs').



Key findings

Overview

The Review found that at a sectoral level, the Irish ETF ecosystem is functioning effectively. Analysis showed that, during the periods in question the AP cohort functioned consistently, including during both ‘normal’ and ‘stressed’ market conditions. However, as outlined below, shortcomings were identified concerning the oversight of APs and CMMs by Firms and their boards. It should be noted that the existing supervisory views of the Central Bank regarding the governance structure that should be in place between a Firm and APs/CMMs in relation to the arbitrage mechanism and liquidity provision of ETFs are consistent with Measure 4 of the IOSCO Good Practices⁶. Additionally, some risks were identified with regards to concentration in the sector.

Details of the findings are outlined below.

1. Inadequate due diligence of APs/CMMs

The Review assessed the level of due diligence performed by Firms on APs and CMMs both at the initial and ongoing stages. The assessment evidenced examples of good practice by a small number of the sample; for example some Firms consider APs and CMMs to fall under the Central Bank Cross-Industry Guidance on Outsourcing (‘Outsourcing Guidance’)⁷, and apply their own delegate/outsourcing service provider frameworks to APs and CMMs.

However, most Firms did not evidence appropriate levels of due diligence being performed on APs/CMMs. The Central Bank found a significant portion of those sampled did not have formal policies and procedures in place to assess the nature and capability of APs/CMMs, and very little reporting is provided to their boards. Inadequate due diligence increases the risk of Firms being insufficiently prepared to

⁶ Measure 4 provides that “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 may unduly affect the effectiveness of the arbitrage mechanism.” With respect to Irish authorised ETFs, ‘responsible entities’ are the Firms authorised to manage relevant ETFs.

⁷ <https://www.centralbank.ie/docs/default-source/publications/consultation-papers/cp138/cross-industry-guidance-on-outsourcing.pdf>



deal with disruption to APs/CMMs, or relevant markets, upon which ETFs rely. This may result in Firms not fully understanding the capabilities and limitations of the relevant entities.

2. **Limited ongoing monitoring of APs/CMMs**

The majority of Firms did not demonstrate a sufficient level of ongoing monitoring of APs/CMMs, although examples of good practice were evidenced by a small number of the sample. Examples of good practices include regular reporting on defined metrics such as primary market activity, pricing information, trading data, and average spread, depth, and presence volumes. However, with the majority of Firms not performing appropriate monitoring of APs/CMMs, the findings call into question the level of ongoing oversight undertaken on APs/CMMs with regards to the performance of those entities. The Review also identified very little evidence of risk monitoring and stress testing performed on APs/CMMs. A lack of ongoing monitoring of APs/CMMs means that Firms may not have a sufficient understanding of who their APs and CMMs are, and how they are performing key roles in the context of a product which holds itself out to the market as having a level of healthy liquidity.

3. **Lack of board oversight**

Findings evidence that, at a sectoral level, boards receive minimal specific AP/CMM reporting. This raises questions as to how much oversight and awareness boards have of the performance of APs and CMMs. Insufficient oversight may increase the risk of the board being unaware of potential risks in relation to APs/CMMs relied upon by ETFs. In the event that primary market activity is not functioning in a manner in which they expect, boards should have appropriate contingency arrangements in place to ensure ETFs continue to function effectively.

4. **AP and MM concentration**

The findings identified that, while a wide number of different APs accessed Irish ETFs, creation and redemption activity is concentrated among a limited number of APs. In



that regard, approximately 81% of total notional activity is concentrated amongst the top five APs, with two APs contributing to a significant percentage of this total.

Similarly, analysis of CMMs used by Irish authorised ETFs identified market concentration with a few key entities. Here, the Central Bank notes that at a total level, CMMs referenced by ETFs are mostly concentrated amongst five CMMs. Those five CMMs were referenced as being used by approximately 88% of ETFs in total.

While the Review found that the Irish ETF ecosystem is functioning effectively, where reliance is placed on a single or few AP/CMM relationships, it may pose risks to the ETF with regards to liquidity, effective arbitrage mechanisms and access to the market if there is disruption in the market place or with individual APs/CMMs. The number of APs also acting in the dual role of CMM for specific ETFs may exacerbate this concentration risk.

Action required

To address the findings of the Review, the Central Bank requires that Firms review the actions outlined below and, where appropriate, incorporate the necessary changes to their frameworks and practices by the end of Q2 2025. The Central Bank is of the view that the governance practices of Firms in relation to APs and CMMs falls short of its expectations for oversight of such an essential feature of ETFs. The Central Bank considers that IOSCO's Good Practices in this regard represent a solid framework.

1. All Firms are required to, at a minimum, assess their current practices against Measure 4 of the IOSCO Good Practices and close identified gaps. In particular, regard should be given to the 'key findings' outlined above in relation to weaknesses identified in arrangements around due diligence and ongoing monitoring. Appropriate oversight of APs/CMMs on an ongoing basis must also be ensured.

Firms should also consider applying certain aspects of the Outsourcing Guidance when assessing the activities of APs and CMMs. Notwithstanding the nature and functioning



of APs and CMMs, the Central Bank considers that an oversight framework should be put in place, consistent with the view that the activities of APs and CMMs are material essential services. Firms should consider applying certain aspects of their delegate/outsourcing service provider frameworks when overseeing APs/CMMs as outlined in Appendix 1.

2. An assessment of reporting received by Firms regarding the activity of APs and CMMs should be conducted in order to ensure they remain fully aware of the extent to which APs interact with an ETF, and the extent to which CMMs trading is within the defined parameters of their contracts. Boards should ensure that relevant, risk-focused reporting is provided to them on a regular basis.
3. Firms should review current arrangements to ensure they have a sufficient number of APs and, where relevant, CMM relationships in place in consideration of the nature of the ETF in question. In this context, it is important to demonstrate that substitutability risk has been considered and appropriate mitigants have been put in place to address it. In addition, Firms should ensure that arrangements with CMMs are formalised and that CMM contracts have been noted by their boards.

Firms should ensure there is effective contingency planning in place in order to address circumstances of impairment of the arbitrage mechanism. Measure 5⁸ of the IOSCO Good Practices should be considered in that regard.

In circumstances where a Firm does not take into account the actions in this letter the Central Bank may, in the course of future supervisory engagement, have regard to the consideration given by the Firm to the matters raised herein. The findings from this Review will inform future policy development and enhancements to the current regulatory framework for the supervision of Firms of ETFs.

⁸ Measure 5 of the IOSCO Good Practices states that *"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."*



Should you have any queries regarding the content of this letter, please contact themedinspections@centralbank.ie.

Yours sincerely,

A handwritten signature in black ink that reads "D. Rossi". The signature is written in a cursive style with a small flourish above the 'i'.

Darragh Rossi

Head of Funds Supervision Division



Appendix 1

A list of areas that Firms may wish to consider in the context of AP/CMM due diligence and ongoing monitoring are outlined below. Although not an exhaustive list, the below review areas have been identified having regard to the IOSCO Good Practices and Central Bank Outsourcing Guidance, as well as reviews already being undertaken by some Firm peers.

1. Financial health and financial performance;
2. Ownership structure;
3. Reputation and regulatory history;
4. Operational structure and capabilities (including trading, pricing, clearing and settlement capabilities, and inventory management);
5. Ability to support arbitrage mechanism and liquidity provision, in both normal and stressed circumstances, and
6. Ensuring receipt of appropriate reports to assess activity.