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// ASSET MANAGEMENT & INVESTMENT FUNDS

IOSCO reaffirms its 2013 ETF Principles and consults on good practices

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IOSCO has published the much-anticipated follow-up to its 2013 ETF Principles in the form of a consultation on supplementary good practices. The consultation report, published on 6 April 2022, represents the output of a five-year long collaboration between regulators of major global ETF domiciles focussed on two broad themes, namely the effective functioning of the primary market and appropriate disclosure to investors, and is set against the backdrop of significant ETF growth, in-depth market studies and stress events.

Notably, IOSCO considers the 2013 ETF Principles to have stood the test of time and so neither proposes replacing them nor introducing additional standards or recommendations. Instead, it seeks feedback on a set of good practices to supplement the 2013 ETF Principles.

We have set out below the measures proposed by IOSCO as good practices for consideration by regulators, ETF managers/sponsors (**responsible entities**) and/or trading venues along with commentary on each.

Measure (emphasis added)	**Comment**
Effective product structuring	
1. Regulators and responsible entities are encouraged to consider the range of **asset classes and investment strategies** that may be **appropriate for the ETF structure**, taking into account their nature, novelty, and complexity, the effectiveness of the arbitrage mechanism for such assets and strategies and local circumstances.	The UCITS regulatory framework already provides a well-established set of rules on eligible investments, level of exposure and investment concentration to which UCITS ETFs are subject.
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.	The acceptable level of portfolio transparency to accommodate both the effective arbitrage mechanism and the protection of proprietary active strategies has long been a focus of industry discussions. Significantly, in contrast to the Central Bank's requirements, IOSCO does not suggest that full portfolio transparency is the only correct approach. IOSCO's recognition of other approaches as workable, including those adopted by

<table>
<tr><th>Measure (emphasis added)</th><th>Comment</th></tr>
<tr><td></td><td>a number of jurisdictions to date (including in the EU), is helpful to the case for "semi-transparent" active ETFs.</td></tr>
<tr><td>3. For jurisdictions that mandate the provision of iNAV, the real-time estimate of an ETF's value, regulators and/or trading venues are encouraged to consider means to enhance the accuracy and usefulness of iNAV.</td><td>iNAV, which is an important metric especially for retail investors, has been observed as susceptible to accuracy and reliability issues, for example due to stale pricing of underlying securities. As an example of how these issues could potentially be addressed, IOSCO cites Hong Kong where ETF issuers are required to monitor iNAV providers and the accuracy of the iNAV itself.</td></tr>
<tr><td>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 may unduly affect the effectiveness of the arbitrage mechanism.</td><td rowspan="2">The arbitrage mechanism, designed to keep the market price of an ETF sufficiently close to its value through the activity of authorised participants and market makers, was not specifically considered in ESMA's 2014 guidelines on ETFs and other UCITS issues which form the basis of much of the rulebook applicable to UCITS ETFs.

Although in practice UCITS ETFs undoubtedly conduct due diligence on their authorised participants and likely have in place contingency plans should the arbitrage mechanism become impaired, it is entirely plausible that these good practices identified by IOSCO will eventually be formalised into additional regulatory requirements applicable to UCITS ETFs, potentially by way of an update to ESMA's 2014 guidelines.

<u>Secondary market redemptions</u>

ESMA's 2014 guidelines require UCITS ETFs to facilitate direct redemptions by secondary market investors where the stock exchange price of the ETF significantly varies from its net asset value. IOSCO has reported that the direct redemption mechanism has been rarely used and commented on its limitations, particularly due to ETF shares being settled through securities depositaries which the secondary market investors, particularly retail investors, may not be members of.</td></tr>
<tr><td>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.</td></tr>
<tr><td>6. Regulators are encouraged to consider whether the securities laws, and applicable rules of securities exchanges within their remit and jurisdictions, appropriately address potential conflicts of interests raised by ETFs.</td><td>IOSCO notes that broader regulations applicable to funds, such as the Irish rules on connected party transactions, typically address the management of conflicts issues which may arise where authorised participants or counterparties are affiliated with the ETF. Potential conflicts arising from affiliation with index providers are addressed through detailed index eligibility requirements applicable to UCITS ETFs and the EU Benchmarks Regulation.</td></tr>
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Measure (emphasis added)	**Comment**
Disclosure	
7. For ETFs, in particular those that invest in more **complex** or novel **asset classes**, or use more complex investment **strategies**, regulators are encouraged to consider appropriate requirements for the adequacy and appropriateness of the disclosures regarding ETF-specific aspects, including whether certain disclosures are presented in an understandable manner and whether they address the nature of risks associated with the ETFs' strategies.	The current disclosure requirements applying to UCITS ETFs using leveraged, synthetic and active strategies and engaging in securities lending were identified as good practices in the IOSCO report. However, there may be an opportunity to improve the information available to investors on the total cost of investing in ETFs by requiring the publication of bid-ask spreads and the premium / discount to the net asset value at which the ETF has been trading. In this regard, IOSCO highlights the US disclosure requirements which mandate the provision of this type of information on the ETF's website. We see an increasing trend in European regulation (for example, the SFDR) requiring website disclosure rather than focusing solely on the offering documents. This additional information, required to complete the picture on the total cost of investing, would sit well with the comprehensive information already provided by many UCITS ETFs on their websites.
8. Regulators are encouraged to consider appropriate requirements for the disclosures of **fees and expenses for investing in ETFs (including secondary market trading costs)** 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.	
9. Regulators and responsible entities are encouraged to consider appropriate disclosure requirements or disclosures to help investors to clearly **differentiate ETFs from other ETPs / CIS**, as well as appropriate disclosure for index-based and non-index-based ETFs.	UCITS ETFs must have the "UCITS ETF" identifier in the name. IOSCO does not refer to the potential for listed and non-listed share classes in an ETF and the impact on the naming convention in those circumstances. IOSCO raises the possibility of having different labels for conventional and more complex ETFs, e.g., active, leveraged or synthetic ETFs. As the UCITS framework already defines the permissible types of investment, additional sub-categorisation of UCITS ETFs by reference to complexity would arguably not be beneficial for the UCITS brand.
Liquidity provision	
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**.	IOSCO identifies good practices such as trading venues monitoring market makers' performance of their functions and ETF management companies having procedures in place in the event of market makers ceasing to provide liquidity to the ETF.
Volatility control mechanisms	
11. Regulators and/or trading venues, where applicable, are encouraged to appropriately calibrate **volatility control mechanisms (VCMs)** applicable to ETFs, considering factors	IOSCO notes adoption of various VCMs including those in the form of trading halts such as Euronext

Measure (emphasis added)	**Comment**
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	preventing ETFs from trading outside a pre-defined corridor around the iNAV. Where an ETF trades on multiple trading venues IOSCO continues to encourage those trading venues to communicate among themselves in relation to the VCMs that may be employed. This is particularly relevant in the context of UCITS ETFs which commonly trade on multiple European markets.

Next Steps

Feedback to the Consultation Report is sought by 6 July 2022. Following the conclusion of the public consultation period, IOSCO will publish its final good practices report. The consultation and the final report are likely to be influential in further development of the European rulebook on ETFs, for example through a revision to the ESMA Guidelines on ETFs and other UCITS issues which have remained in their current form since 2014.

Contact us

If you have any queries on the matters raised in this briefing, please contact Sergey Dolomanov, any of the Asset Management & Investment Funds team or your usual William Fry contact.