16 May 2011

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

By email to fsb@bis.org

Dear Sirs,

Potential financial stability risks arising from recent trends in exchange-traded funds (ETFs)

The IMA represents the asset management industry operating in the UK. Our members include independent fund managers, the investment arms of retail banks, life insurers and investment banks and the managers of occupational pension schemes. They are responsible for the management of around £3.8 trillion of assets, which are invested on behalf of clients globally. These include authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds (i.e. unit trusts and open-ended investment companies, the majority of which are UCITS).

IMA is a member of the European Fund and Asset Management Association (EFAMA). We were party to discussions within EFAMA on the Financial Stability Board's paper and support EFAMA's response to this consultation.

We welcome the FSB's note and analysis of the market. We note the comments and concerns set out in the paper, which are broadly consistent with the papers recently published by the BIS and IMF.

A number of the points raised in the note are not relevant only to ETFs although we recognise that certain issues (such as heightened conflicts of interest) may be more significant for exchange-traded products than others. In relation to ETFs that are UCITS, however, we would emphasise that most of the points raised in the paper (and summarised in the last paragraph) are already the subject of detailed requirements and constraints. Indeed, some of the structures mentioned in the Note would not be possible under the UCITS Directive, and in other examples raised the UCITS rules deal with the

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concerns expressed. For example, the same legal entity cannot be the ETF provider and the derivative counterparty

In the attachment we summarise the key requirements that are pertinent to the points raised in the paper. For example, all UCITS are subject to prescriptive requirements on maximum exposure to any one counterparty, on disclosures to investors, on risk management, on collateral quality and so on. We therefore suggest that further work undertaken by the FSB (or other international bodies) should focus on those products that are not already subject to detailed regulation.

More generally, although perhaps not within the specific remit of the FSB, we have concerns about the way in which unregulated products may be marketed and sold to retail investors. Increasingly the acronym "ETF", which has over many years become established as a form of brand, is being used in relation to exchange-traded products that are not regulated funds. We suggest that such practices are not in the interests of retail investors, or of investors more widely.

We welcome the opportunity to discuss these points further with your secretariat.

Yours faithfully

Perry Braithwaite

Adviser, Product Regulation

All UCITS (including exchange-traded UCITS) are regulated and are subject to the same requirements and constraints. This robust product regulation is at the heart of the high level of investor protection the UCITS framework provides. Key elements of the framework include: that the assets of the fund are held separately from the management company's balance sheet; that there is an independent depositary that oversees the activity of the manager and that safeguards the assets; and that the manager is subject to detailed requirements relating to the management of conflicts of interest.

The universe and strategies of UCITS are evolving due to investor demand for risk reduction and return enhancement. This is true for all UCITS (including exchange-traded UCITS) and is a global trend. In relation to UCITS, however, all strategies must fit within the detailed UCITS requirements and constraints.

The key UCITS investment limits and requirements relevant to the FSB's stated concerns are:

- There are strict limits in relation to the global exposure of a UCITS; cover for investment in derivatives, and counterparty risk. There is a limit on absolute Value at Risk (VaR): a 99% confidence limit of 20%.
- Relative VaR: with the same confidence levels VaR has to be less than 2 times that of the benchmark.
- Benchmark Indices: where a UCITS aims to track a particular index, that index must be sufficiently diversified, an adequate benchmark for the market to which it refers and published in an appropriate manner.
- Liquidity: investor right to redeem and NAV publication at least twice a month. In practice, most UCITS are priced daily and exchange-traded UCITS provide investors with the ability to buy or sell shares at intra-day prices to the market.
- Collateral: there are strict requirements regarding liquidity and issuer credit quality in respect of collateral received for transactions in OTC derivatives. In addition, the collateral must be capable of being valued on at least a daily basis.
- Disclosure requirements: annual and semi-annual report, simplified prospectus (to be replaced by the key investor information document, the KIID, under UCITS IV) and a prospectus for the fund need to be published. In particular, the specificities and characteristics of the investment strategy of the UCITS and the relevant risks involved must be adequately explained. In practice, exchange-traded UCITS provide much more frequent disclosures relating to portfolio holdings and counterparty exposures.

All these limits and restrictions are <u>minimum</u> requirements. In practice, UCITS managers (including exchange-traded UCITS managers) operate against self-imposed tighter limits.

Also, the UCITS requirements impose detailed responsibilities on management companies in relation to risk management and risk measurement, in terms of both their organisation and procedures and in the way that funds are monitored. Management Companies are required to employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to meet redemptions. Senior management is responsible for approving and reviewing the risk management policy and arrangements, and the processes and techniques for implementing the risk management policy. UCITS management companies must establish a permanent risk management function, which must be functionally and hierarchically independent from other departments within the management company, and which is responsible for implementing the risk management policy and procedures. Managers are required to measure and manage at any time the risks to which the fund is or might be exposed, and must ensure compliance with the UCITS limits concerning global exposure and counterparty risk.

It should therefore be emphasised that risk management in UCITS is already state-of-the-art, and will be enhanced even further by the entry into force of the UCITS IV Directive on 1 July 2011. These new rules include many, even more detailed provisions on internal control mechanisms for the UCITS management company. The rules cover the risk management, compliance and internal audit functions, risk management policies, risk measurement, counterparty risk and issuer concentration risk calculation, as well as procedures to value OTC derivatives. Conflicts of interest rules (to be strengthened under UCITS IV) apply to the choice of counterparties, and the risk management process must be submitted to regulators for approval.

In addition, exchange-traded UCITS are subject to listing rules, to European-wide requirements relating to their prospectuses, and to national rules on securities lending. Furthermore, market makers in shares of exchange-traded UCITS are subject to European-wide rules on transaction reporting.