ASSET MANAGEMENT BY LYXOR

Financial Stability Board (FSB)
Secretariat
c/o Bank of International Settlements
CH-4002 Basel
Switzerland

Sent by email: fsb@bis.org

Paris, Friday 13 May 2011

Re: Feedback by Lyxor Asset Management on the note issued by FSB on "Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs)" (hereafter named the "FSB Note").

Dear Sirs,

Lyxor Asset Management ("Lyxor") is an asset management company based in Paris, France, and regulated in France according to the UCITS Directive. At end of March 2011, Lyxor manages approximately 93 bn USD, including 38 bn USD of ETF, which makes it number 2 in Europe, with a market share of 18%.

We welcome the opportunity to provide answers to the FSB Note.

The FSB Note is a reflection of both the high growth that the investment products have had over the past ten years in Europe and even longer in the US market. More importantly it reflects the expectation that they will continue to form a core part of the investment products that investors are likely to use over the next decade.

The growth in ETFs has outpaced the growth in other product categories driven by a combination of benefits that clients have found attractive and that have delivered value. Clearly the exchange traded nature of ETFs has provided significant competition to other exchange listed products and as UCITS funds ETFs have proven to be compelling trading vehicles compared to either futures or OTC swaps.

ETFs in Europe have grown substantially and although they fall outside the scope of the current MiFID reporting requirements, statistics show that they regularly account for up to 20% of European equity traded volumes, even with a lack of full trade reporting.

Clients have been increasingly attracted by the high liquidity in the primary market available across many asset classes, the secondary market on exchange liquidity and tight spreads. In addition to this the availability of multiple listings and choice of trading venues, commitment by market makers, liquidity providers and exchanges have helped build a robust environment.

The ETF market and underlying end investors continue to benefit from the undoubted strengths of the UCITS regulatory framework.

Lyxor believes that there are specific points raised by the FSB Note are worth addressing with respect to the Lyxor ETF range.

FSB: While the growth in ETF markets is at an early stage in a number of countries, the speed and breadth of financial innovation in the ETF market has been remarkable in some large financial systems over the past five years, and has brought new elements of complexity and opacity into this standardized market.

Firstly Lyxor welcomes dialogue with the regulators, and believes that the FSB's attention to the market is actually a sign of the success and growth that has been experienced and is to be expected in coming years. As with all successful products it is however important that the regulators consider risks and importantly with respect to Lyxor ETFs we can show how we control and manage these risks for the end investor.

Lyxor ETFs has been a pioneer of the swap-based ETF in Europe since 2001, with an ETF product that complies with the UCITS requirements and approved by regulators. Our ETFs have consistently been transparent and open for all clients to understand and we would argue that in general swap-based providers as a whole have been open. We would argue that the main areas of complexity and opacity relate to instruments often confused with ETFs (ETNs, ETCs and ETVs – these are mentioned on page 3 of the FSB Note)

FSB: Product innovation has recently flourished in the ETF market, as well as in the market for close substitutes of ETFs such as ETNs or ETVs, which are essentially debt products (while ETFs are funds4), extending the asset class beyond its initial plain-vanilla standardized nature. Some new products are archetypes of this trend (leveraged ETFs, inverse ETFs, and leveraged-inverse ETFs5), although as yet they represent only a tiny fraction of the market, around 3% of total. The first ETF of speculative grade corporate loans was also recently launched. The complexity and opacity characterizing these innovations warrants closer surveillance as it may leave investors exposed to risks they have not anticipated.

The new products that the FSB Note highlights, specifically leverage ETFs, inverse ETFs and leveraged-inverse ETFs, have evolved successfully in Europe since they were first launched in 2005. One of the key differentiating factors in Europe is that such ETFs need to track dedicated indices and this allows investors to understand how they have performed historically under different market conditions and levels of volatility. The ETF industry in Europe has been extremely proactive in educating investors as to how to use these ETFs from an investment and portfolio perspective. As the FSB has highlighted these ETFs represent a low % of total assets that the industry has gathered over the past few years (only 2% in Europe). On the other hand they often represent over 10% of daily ETF reported trading volume reflecting the fact that investors understand the short-term trading nature of these funds.

FSB: There are a number of disquieting developments in some market segments which call for closer scrutiny. ETFs have branched out to other asset classes (fixed-income, credit, emerging markets, commodities) where liquidity is typically thinner and transparency lower.

Our position on ETF liquidity in all asset classes, not just equities, is that the liquidity of the ETF cannot transcend the liquidity of the underlying asset class until for example the ETF is of such a size that it has its own active on exchange liquidity. In less transparent asset classes it is also true to say that the ETF, due to its on-exchange traded nature benefits from an efficient price discovery mechanism and this is a benefit that the ETF market can provide to these other markets as investors may use the ETF as a source of transparent market access and liquidity. ETFs have been successful in these new areas of the market and non-equity asset class exposures as they serve investors by increasing capital market efficiency which is a benefit for all clients.

FSB: The increased popularity of "synthetic" ETFs (which use derivatives) as well as the more intensive recourse to securities lending by ETF providers of plain-vanilla ETFs raises new challenges in terms of counterparty and collateral risks.

Lyxor ETF's position on counterparty and collateral risk has been very clear and available for clients. We have recently enhanced our disclosure and for the French website we are live in terms of daily swap exposure and for the end of month disclosure of the Swap and Assets owned by the fund. We would agree that there has been a lack of attention to equivalent counterparty risk in physical ETFs with securities lending exposure being less well disclosed than equivalent synthetic risk measures. Whether synthetic or physical, ETFs are simple products with simple operations and where, in the case of synthetic exposures, the derivative content is restricted to a simple index swap. Derivatives regulations are very well detailed and well established in the context of the UCITS Directive. They are regulated in details at different levels: the last CESR guidelines concerning the use of derivatives by UCITS, including the management of their counterparty risks, published in July 2010, contain no less than 43 pages! There is no such level of EU regulations concerning securities lending by UCITS, and the proceeds from securities lending are often paid to the manager or the custodian rather than to the fund.

FSB: In addition, the expectation of on-demand liquidity may create the conditions for acute redemption pressures on certain types of ETFs in situations of market stress, which could in turn affect the liquidity of the large asset managers and banks active in this market.

In an extreme situation of market stress, we would emphasize a number of important factors with respect to our ETFs. Firstly we believe that the key is the liquidity of the underlying markets which includes not just the cash securities markets but also associated futures markets. In a worst case scenario investors in Lyxor ETFs have access to liquid and high quality of assets held by the fund. This is an important point of differentiation that we should emphasize – we typically have a significant proportion of liquid European equities (a minimum of 75% for PEA funds). In aggregate the Lyxor ETFs with equity and commodity exposure have 87% of their assets in European equities whilst Fixed income ETFs have 93.6% in European bond holdings. In a situation of market stress this level of liquid collateral would mean liquidity in the fund assets would be retained even if the exposures related to different strategies were impacted. We also know from previous market experience during periods of extreme turmoil that the repo market remains very deep and liquid therefore this should not represent a risk for banks active in this market. It should also be noted that the physically owned assets of the ETF are segregated from the bank's assets.

FSB: One factor supporting their (Synthetic ETFs) growth resides in the synergies created within banking groups if the derivative trading desk acts as swap counterparty to the asset management arm providing the ETF. Another factor is the more liberal stance of European regulation on the use of derivatives in investment funds, while the US regulator has adopted a more conservative approach, limiting de facto the development of synthetic ETFs.

From a regulatory standpoint, European ETFs fall under the requirements of the UCITS Directive. They benefit from all the UCITS regulations concerning among others the use of derivatives, the use of leverage, counterparty risks, conflicts of interests and fiduciary duties of the asset manager. With respect to synergies created within banking groups it is clear to us that these synergies operate to the benefit of the ETF holder and allow for efficiencies and enhancements to be passed through to the end client in a transparent way through the total return of the ETF versus the index.

FSB: Among recent innovations, a specific trend warranting closer scrutiny is the recent acceleration in the growth of synthetic ETFs on some European and Asian markets…... Since the swap counterparty is typically the bank also acting as ETF provider, investors may be

exposed if the bank defaults. Therefore, problems at those banks that are most active in swap-based ETFs may constitute a powerful source of contagion and systemic risk.

We always explain to clients that our ETF structure has two components, the assets held by the fund and the swap exposure, where the counterparty is Societe Generale. The swap-exposure is limited by UCITS regulations and so clients are aware that as a UCITS vehicle our ETFs adhere to the risk regulations outlined by UCITS. However, the focus on the OTC swaps used within ETFs is perhaps an unfair reflection of the size of the market and indeed overly dramatic. At the end of June 2010, according to the Bank for International Settlements, total forwards and swaps in equity linked derivatives was $1,754bn. The total size of assets under management in swap-based ETFs in Europe was only $124bn. Naturally there is a mix of swap-based models in Europe (and with Lyxor ETFs the swap exposure is limited to a maximum of 10% of the funds AUM). But even if one were to assume the full $124bn figure, this would represent 7% of OTC swap-exposure. All equity-linked derivatives exposures at the end of June 2010 totaled $6.3trn so again as a proportion of this European ETF swap exposure would be less than 2% of the total. Therefore we would argue that European ETF swap exposure cannot easily be presented as a source of contagion and systemic risk when compared to the broader swap and OTC market.

FSB: In addition, the incentives behind the creation of synthetic ETFs may not be aligned along the ETF chain, especially as conflicts of interest can arise from the dual role of some banks as ETF provider and derivative counterparty.

ETFs in Europe fall under the requirements of the UCITS Directive and UCITS regulations do not prohibit them from entering into derivatives or shares lending to counterparties that belong to the same group. These transactions must however respect all UCITS regulations concerning conduct of business, including conflicts of interests, in order to ensure that investors' interests always come first. These regulations will be very much enhanced by the UCITS 4 level 2 Directive that comes into force on 1st July 2011.

FSB: As there is no requirement for the collateral composition to match the assets of the tracked index, the synthetic ETF creation process may be driven by the possibility for the bank to raise funding against an illiquid portfolio that cannot otherwise be financed in the repo market….. More broadly, investors in synthetic ETFs need to exercise an adequate level of scrutiny and due diligence on collateral selection and arrangements, which in turn depends on the level of transparency made available by ETF providers

Lyxor ETFs have always been open and transparent about the collateral composition, and the fact that these are assets held by the ETF. The quality of the assets in the ETF is also covered by the fact that the majority of our funds are PEA eligible, and these are required to hold at least 75% of assets in European equities. Lyxor has always made available on client request the full basket of the fund's assets. Since the middle of March, 2011, we have been displaying the month-end fund holdings on our French website and we are in the process of rolling this out to other countries. In addition we also show the daily level of the swap exposure and the swap counterparty. We also provide a full explanation of our swap mechanism and collateral fund structure on the websites. In terms of index tracking we publish monthly statistics, as required by the AMF, showing the tracking error of Lyxor ETFs compared to the designated benchmark index. It should also be mentioned that these issues are not ETF specific. As UCITS funds ETFs follow the same rule as all UCITS funds and so should be treated in the same way. European ETFs, after all, represent only €230bn of AUM, whereas UCITS in general represent (at end of February) €5,921bn of AUM.

FSB: While benefiting formally from market making arrangements, ETFs may nevertheless experience liquidity disruptions. In principle, ETFs offer on-demand liquidity to investors while they are in some cases based on much less liquid underlying assets. Therefore, in the event of

a market sell-off or an unwind in any particular ETF, there is a risk that investors massively demand redemption. Depending on the specific ETF arrangements, redemptions could be made "in-kind" which would alleviate liquidity pressures. However, were redemptions to be made in cash, this could raise issues as to the exit strategies and liquidity risk of ETF providers and swap counterparties.

Lyxor ETFs benefit from the liquidity of the collateral within the funds, the depth of the repo market and the open multi-dealer market maker model that we have for our ETFs. We believe that this structure, especially with counterparty risk on the swap limited to a maximum of 10%, means that exit strategies can be implemented efficiently and reflecting market prices in a transparent way. Naturally if the underlying market is closed or suffers a severe disruption then the ETF will have to reflect this type of event, but in general we believe that ETF pricing accurately reflects the underlying market both due to efficient liquidity provision by market makers and trading participants and the strength of the listing environment across European exchanges and trading platforms. Again, if we compare ETFs with other UCITS, the main difference is that ETFs can be traded intra-day, with the help of market-makers, whereas other UCITS are in general redeemable only at end-of-day. If, because of a major market disruption, there was an absence of liquidity intra-day, the ETF would still be redeemable under the same conditions as other UCITS.

FSB: The very strong growth of collateralised structured operations in the context of synthetic ETFs and ETF-based securities lending suggests that there are significant benefits for authorities and ETF market participants alike in improving their understanding of the risks attached, and the ways in which they can be mitigated.

Lyxor welcomes and has a continuous dialogue and interaction with regulators, exchanges and clients across Europe with respect to UCITS compliant ETFs and how risks are both balanced and explained.

FSB: The interaction of ETF regulatory frameworks with recent innovations as well as the scope for regulatory arbitrage across regions and markets is also being examined.

We believe that UCITS IV, which is effective as of 1st July 2011, has been designed to create a level playing field with respect to product approval and passporting. We are content that the guiding principles behind UCITS IV are beneficial for end investors and reflect a positive enhancement to the UCITS framework used in Europe.

FSB: In view of the new challenges raised by recent trends on ETF markets, ETF providers and investors should review the risk management strategies of ETFs, especially in areas such as counterparty risk and collateral management, as well as assessing their exposure to market and funding liquidity risks.

Lyxor believes that counterparty risk is currently very well defined under UCITS, whilst collateral management has become increasingly well defined as ETF providers have made visible their fund holdings and assets. Typically this disclosure allows investors to assess the quality, diversification and exposure of these assets.

Conclusion

Overall Lyxor believes that the ETF industry has been able to thrive under the current regulatory environment and that UCITS provides the correct framework for the future growth of the European ETF industry. We also expect that the ETF industry and end clients will be best served through a steady and ongoing dialogue with all the relevant regulators in order to clarify and address ETF specific issues.

We would welcome further discussion with FSB. We are at the disposal of FSB for further information or discussion. Please contact me at the following email address and telephones.

Best Regards

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