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Central Bank Feedback Statement on Discussion Paper 6 on ETFs

On 14 September 2018, the Central Bank of Ireland (the "**Central Bank**") issued its eagerly anticipated 'Feedback Statement' on Discussion Paper 6 - Exchange Traded Funds. The outcome of the discussion paper is the culmination of over a year's analysis into the exchange traded fund's industry. The Central Bank's views on certain matters which were subject to the Discussion Paper consultation have been outlined and, in an Irish context, the Feedback Statement sets out some policy changes which have resulted from industry's dialogue on the specific themes raised.

Discussion Paper 6 sought to address certain key themes which relate to European exchange traded funds including, amongst others, disclosures relating to Authorised Participants and Official Liquidity Providers; portfolio disclosures; share class dealing arrangements; ETF and non-ETF share classes, ETF market liquidity and European ETF Specific Considerations.

The publication of the Feedback Statement is welcomed as it clarifies that the Central Bank will permit listed and unlisted share class in the same ETF and by extension in a traditional mutual fund and that different dealing arrangements may be implemented for hedged and unhedged share classes within the same ETF.

We have set out below the key outcomes from the Discussion Paper 6 Feedback Statement:

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Disclosures relating to Authorised Participants and Official Liquidity Providers

A key element of the discussion paper was a consideration of the role played by Authorised Participants and Official Liquidity Providers in the ETF ecosystem. The Central Bank holds a strong belief that information as to the identity and activity of Authorised Participants and Official Liquidity Providers is important for all participants and that transparency relating to such entities is of value. The Central Bank made particular reference to the disclosure of costs which are borne on behalf of the relevant ETF where an Official Liquidity Provider obtains remuneration for its services noting that such costs should be sufficiently clear and should indicate the basis on which all costs including OLP remuneration (either monetary or otherwise) is calculated.

The Central Bank has stopped short of requiring disclosure of the identities of Authorised Participants and Official Liquidity Providers to be disclosed or the remuneration paid to such entities while it seeks to encourage regulatory convergence on the matters.

Portfolio disclosure

A key element of ETFs is transparency and portfolio disclosure which seeks to ensure effective arbitrage and is seen as being integral to pricing. Transparency and portfolio disclosure however is seen by many industry participants as a stumbling block to the development of 'active ETFs' and the Central Bank noted that respondents to the Discussion Paper have advocated full portfolio disclosure to a restricted group of recipients including regulators, stock exchanges and, where bound by confidentiality, Authorised Participants.

The Central Bank noted that it requires daily portfolio disclosure to the public in the context of the authorisation of ETFs as investment funds. The Central Bank further noted that different requirements applied to ETF portfolio transparency across the EU with disclosure related obligations stemming in some cases from investment fund regulation and in others imposed by the regulated market.

While acknowledging the differing views of respondents and that full portfolio information may not be of practical use to retail investors and that other forms of disclosure may be more beneficial, the Central Bank has stated that it will not, at this time, amend its requirement for daily portfolio disclosure to the public in the context of the authorisation of ETFs but would continue to engage in European and international regulatory forums on the issue in the future.

Share Class Dealing Arrangements

A fundamental principle of the Central Bank for investment funds is that dealing deadlines must be the same for all share classes. To date an accepted exception to this requirement was in the case of dealing arrangements for ETFs that accept both cash and in-kind subscriptions. Through the consultation paper, the Central Bank sought to engage with industry in relation to the potential to permit a further exception in the case of hedged and unhedged share classes. Following the Central Bank's consideration of responses received, the Central Bank has proposed to depart from its fundamental principle and permit different dealing deadlines to be implemented for hedged and unhedged share classes.

ETF and non-ETF Share Classes

The Central Bank has not to-date permitted ETF providers to establish unlisted share classes in ETFs due to concerns that the structure may prejudice investors in one class over the other, depending on the circumstances. However, many industry participants have advocated for ETFs pursuing a single investment strategy to be permitted to have both listed and unlisted share classes to facilitate, amongst other issues, primary market and secondary market dealing.

The Feedback Statement provides welcome news to industry participants as the Central Bank has indicated that it will permit listed and unlisted share classes within an investment fund (which may be either an ETF or a traditional mutual fund) and will develop guidance on appropriate disclosure requirements that will apply to both types of classes.

ETF Liquidity

The Central Bank through its engagement noted that liquidity in ETFs is complex and may be impacted by two influences: primary dealing arrangements and liquidity of the underlying assets. The Central Bank noted that ETF liquidity is likely to be the focus of ongoing discussions at European and international work streams and it will continue to engage in relation to this matter, particularly in light of the extensive feedback received.

European ETF Specific Considerations

The Central Bank has noted that the European ETF market suffers from fragmentation in terms of operations which is highlighted through the differing listing rules which apply across European stock exchanges. The Central Bank noted the differing approaches taken throughout Europe in relation to a number of themes, including transparency, the understanding of 'direct redemptions' with the relevant ETF, the use of listed and unlisted share classes and approach to conflicts of interest. The Central Bank has noted that a more homogeneous approach from a structural, listing and regulatory perspective would benefit the continued growth of ETFs in Europe.

Conclusion

The Central Bank of Ireland intends to utilise the feedback received from market participants to assist it with engagement on an international level on the regulation of exchange traded funds. Advocates of more active ETFs who were looking for flexibility in relation to the transparency obligations have been left waiting for an international regulatory position to be adopted and which is likely to result in the more actively managed ETFs remaining in the Fixed Income space.

If you have any queries about the information contained in this article, please contact Brian Kelliher, Brian Higgins, Shane Coveney, David Walsh or another member of Dillon Eustace's exchange traded funds team.

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