DILLON EUSTACE

IOSCO publishes Final Report on ETF Good Practices

Dublin New York Tokyo Grand Cayman

BACKGROUND

Following our previous update from April 2022 in relation to the International Organisation of Securities Commissions (**IOSCO**) consultation report in respect of Exchange Traded Funds (**ETFs**) (the **Consultation Report**), IOSCO has now published its Final Report on ETF Good Practices (the **Final Report**).

In the Final Report, IOSCO confirms its view that the ETF structure has generally remained resilient during historical stress events. Accordingly, the measures in the Final Report are intended to build on its 2013 report on Principles for the Regulation of Exchange Traded Funds, which remain relevant and appropriate according to the Final Report. As anticipated, the Final Report mirrors the measures that were proposed as part of the Consultation Report. In this regard, we set out below the measures outlined in the Final Report along with some further comments and considerations that should be borne in mind.

PROPOSED GOOD PRACTICES

Effective Product Structuring

Measure	Good Practice	Comment
Measure 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.	Given the unique features of ETFs (notably the arbitrage mechanism), IOSCO recommends that regulators and responsible entities take into consideration certain factors when establishing an ETF, including (i) the nature, novelty and complexity of the asset class/strategy, (ii) the effectiveness of the arbitrage mechanism, (iii) orderly secondary market trading, (iv) capacity or liquidity of the asset in its underlying market and local circumstances, and (v) availability and capability of service providers (including Authorised Participants (**APs**), Liquidity Providers and swap counterparties. However, IOSCO acknowledges that in most jurisdictions the range of assets and strategies for ETFs are typically no different to those available under the general funds regime – in Europe this would be the UCITS regime, which provides for strict limits in respect of matters such diversification and collateral management. In addition, IOSCO recognises that in Europe the MIFID regime imposes requirements in relation to product suitability.
Measure 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.	IOSCO has again acknowledged the importance of the provision of sufficient information to facilitate an effective arbitrage procedure. It confirms that it continues to take the view that there are merits to different disclosure approaches (other than full daily portfolio transparency). These include proxy portfolio/baskets (in the case of equity ETFs) or information/metrics such as interest rates, yield spreads, duration and credit quality (in the case of fixed income ETFs), which can provide sufficient information to facilitate an effective arbitrage procedure.

Measure 3	For jurisdictions that mandate the provision of an iNAV, regulators and/or trading venues are encouraged to consider means to enhance the accuracy and usefulness of the iNAV.	IOSCO notes that the usefulness of the indicative net asset value (**iNAV**) of an ETF may vary across jurisdictions, asset classes and investment strategies. It encourages regulators and trading venues to review the merits and limitations of iNAV and (when it is required) how it may be enhanced, such as (i) using real-time fair value for the inputs of the iNAV, (ii) increasing its frequency, and (iii) verifying the iNAV calculation against live quotations on the secondary market.
Measure 4	Responsible entities are encouraged to: (i) conduct due diligence on Authorised Participants and Market Makers when on boarding 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.	IOSCO notes that respondents were generally happy with the examples of the initial and ongoing due diligence on APs and Market Makers (**MMs**) as outlined in the Consultation Report. It notes that ETF managers typically have detailed practices for onboarding APs/MMs and policies for monitoring them, including dedicated oversight teams that work with APs/MMs on a daily basis to make sure that these parties make markets efficiently (e.g. tight bid-ask spreads and sufficient market depth). It also notes that engaging multiple APs/MMs can contribute to effective competition between APs, which contributes to efficient arbitrage (although the Final Report recognises that in certain circumstances the number of available APs may be limited). We would anticipate that this will continue to be an area of regulatory focus.
Measure 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.	IOSCO notes the importance of sufficient information being available to APs but also encourages other arrangements such as encouraging APs to be available to conduct agency trades for third parties. IOSCO also queries the "direct" redemption which UCITS are required to arrange in the event of significant price dislocation between the iNAV and the secondary market price.

Measure 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.	IOSCO notes that existing regulatory frameworks (such as UCITS) already contain significant requirements in respect of the identification, monitoring and management of conflicts of interest. These requirements apply to UCITS generally (including ETFs). However, IOSCO provides examples of potential ETF-specific conflicts of interest such as (i) where an AP is affiliated with the ETF (which could result in business being channelled through in-house trading desks or influence upon the construction of creation baskets that favour the AP over the ETF's investors) or (ii) affiliation with derivative counterparties. IOSCO recommends that potential conflicts should be identified and disclosed to investors.

Disclosure

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Measure 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.	IOSCO suggests that there should be greater disclosure on (i) risks arising from the distinctive features of the ETF structure (such as trading on a secondary market at a discount/premium to net asset value), and (ii) for more complex strategies, the Final Report references some strategies which may warrant additional disclosure.
Measure 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.	While IOSCO acknowledges that most jurisdictions already have requirements regarding the disclosure of fees and expenses, it is suggesting that there could be more detailed disclosure regarding ETF-specific fees, including in respect of trading costs in secondary markets and perhaps also in respect of brokerage commissions and tax considerations.

Measure 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.	IOSCO notes that potentially imprecise and inconsistent use of acronyms by the media or investors has been observed in certain markets and encourages regulators to consider any imprecise and inconsistent use of terms and labels between ETFs and other exchange traded products (such as exchange traded notes (**ETNs**) and exchange traded commodities (**ETCs**)) whose characteristics and risks may be different from ETFs. However, under the UCITS regime there is already a clear naming convention/ identifier for UCITS ETFs.

Liquidity Provisions

Measure	Good Practice	Comment
Measure 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 notes that, depending on the local circumstances of an ETF market, the secondary market liquidity of certain ETFs may heavily depend on MMs fulfilling their functions. Accordingly, regulators and trading venues, where applicable, are encouraged to (i) regularly monitor MMs' compliance of market making obligations and the secondary market trading of ETFs, and (ii) impose specific rules governing the orderly trading of ETF shares.

Volatility Control Mechanisms

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Measure 11	Regulators and/or trading venues, where applicable, are encouraged to appropriately calibrate volatility control mechanisms (**VCMs**) applicable to ETFs, considering factors 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.	Regulators and/or trading venues are encouraged to evaluate whether the existing VCMs applicable to ETFs (i.e. trading halts based on historical secondary market price and those based on divergence between the ETF share price and the iNAV) are appropriately calibrated and to review the merits of different approaches to enhance their existing approaches.

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