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The regulatory regime of Exchange traded funds in the European Union

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Abstract

Exchange traded funds have become an essential part of our financial landscape: they stand globally for $ 1,3 billion assets, 2% of listed securities and 5% of all investment funds, and constitute also for the retail investor an attractive alternative to the traditionally managed funds. Their legal regime needs further analysis especially also due to the multiple forms they can adopt, and the innovations in the regulation of investment funds. The different hypotheses are analysis, including the application of the new regime under the Alternative Investment Funds directive. Systemic issues may receive a new answer on the basis of this directive.

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The regulation applicable to exchange traded funds is a relatively complex matter as several regimes may be developed, and there is a question whether and to what extent these are mutually exclusive. Much depends on the activity of the ETF, and the way it has been construed.

As a starting point, an ETF is a portfolio of securities, corresponding to a certain index, owned by an issuer of securities that are listed on an exchange and made available for investment to all investors that can be active on that exchange. In that sense there is no difference with any other company the shares of which are listed. The listed ETF is subject to all obligations imposed on listed companies, such as annual disclosures, published accounts, interim statement about price sensitive events. The shares are created in bloc ("creation units") and later placed on the market. Upon listing, the ETF has to publish a prospectus, but later distribution of shares take place by a secondary sale on the market by the original owner or subscriber of these. There is no need to publish additional prospectuses, or updated versions of these, as there is no offer to the public. The formula has certain drawback: ETFs are supposed to follow the price of the index and hence of the underlying values. Technically this objective can be achieved by having the sponsor sell securities when demand exceeds offer, and vice versa, as was done in the past for other exchange traded funds of the open type. Also the tax treatment would be less favourable than the UCITS formula. Therefore this formula is not frequently found for ETFs by applies for Exchange traded notes (ETNs) e.g. instruments standing for a certain quantity of physical commodities, or precious metals, excluded from the UCITS ambit, or for real estate that Ucits can only held in an "ancillary capacity", i.e. for their own housing. The diversification rules would not apply to these instruments. As their assets would not yield a dividend, the tax argument would not apply.

Most ETFs have organised themselves under a fund formula, whereby the assets that correspond to a certain index or pre-announced portfolio are owned by the fund, a separate legal person. This fund can be whether a "national" fund, subject to the local requirements of the place where it is organised, or a UCITS fund, regulated according to the UCITS directive 2009/65 of 13 July 2009. That directive limits the activity of the fund in certain respects, but offer advantages in terms of reputation and taxes, the latter being in most countries quite lenient for investors. The replication of the index is pursued by trading the underlying securities, often leading to a certain "tracking error" or difference with the value of that index. Reducing this tracking error is one of the important criteria for selecting an ETF, as it is technically at least the only factor where the ETF can differ from the index. Cost to investors are much lower than investing in managed funds. Moreover as UCITS, they enjoy the European passport and can be offered and listed in several EU member states without significant additional obligations. It will not astonish that many ETFs have chosen this form.

Some ETFs are however organised differently: they do not physically replicate the underlying securities but try to achieve that objective by buying or selling derivatives on the index[1]. This enables them to act more flexibly as the derivatives can instantly be created, often in-house, and the tracking error would disappear, as the derivatives would not create any friction with the underlying. However that approach creates a different risk position for the investors: he will be confronted with the risks of the underlying derivatives, i.e. a liquidity risk and

[1] This practise is followed in Europe by about hlf of the ETFs, but less frequently in the US, see Shichander Ramaswamy, Market structures and systemic risks of exchange-traded funds, BIS Working papers, nr.343, April 2011.

especially a counterparty risk. Information is usually very scant on these items, if mentioned at all. In many cases the derivative is the result of a swap with the funds assets: the swap is limited in time, and has to be reset, what creates certain costs. The assets used by the promoter to create the swap my be first quality liquid assets, but the temptation exists for the promoter bank to transfer some of its less well regarded assets to the fund. All this may create risks for the investors.

Some ETFs allow shorting, whether on the ETF itself, or by creating a short portfolio underlying the ETF. The same applies to leverage: investors can themselves leverage their purchase, but may also acquire ETFs where the portfolio of the ETF is leveraged.

If the ETF is created under the UCITS regime, the latter imposes some restrictions on the investment policy of the fund. Risk diversification is the hallmark of the UCITS, with a ceiling of 5% of the overall assets for any individual investment. Due to the diversification of the index portfolio, that figure will for most trackers, rarely if ever be reached. Moreover the UCITS directive contains a special allowance for trackers, whereby the ceiling can be fixed as up to 20% provided the index is sufficiently diversified, is an adequate benchmark for the market it replicates, and is published in an "appropriate" manner. (Art 53). These conditions should not be very restrictive of almost all the existing UCITS ETFs. In some cases, underlying portfolios lead to securities lending operations, procuring some additional return.

There is prohibition for UCITS to borrow, except on a temporary basis and than for not more than 10%. Except for the leverage ETFs, that restrictions would not be very significant as the leverage can be construed in the derivatives.

The use of financial derivatives has been liberalised in the UCITS III directive: UCITS may acquire derivatives on listed securities and instruments – including indexes relating to those instruments - whereby the total exposure in derivatives should not exceed the total net value of its portfolio, leading to a maximum 100% leverage (art 51.3). Henceforth derivatives, both listed and OTC are allowable for up to 100% of the fund's assets, provided that

- the underlying belongs to the permissible assets (interest rates, financial indices)
- the counterparties are financial institutions subject to prudential supervision

The risk exposure to one counterparty is limited to 5%, except if it is a credit institution, in which case it will be increased to 10% (art 52.2) this limit would also apply to the derivatives in terms of the exposure to underlying assets; but Member states can waive this restriction for investment in derivatives. Counterparty risk flowing from derivative transactions to be limited to 20% of total assets, and this percentage should be read for each individual entity in the group (e.g. a parent bank and its subsidiaries)(art.52.5).

There can be little doubt that the use of derivatives allows UCITS funds – and not only ETFs[2] – to very freely move around the investment restrictions.

With the adoption of the AIFMD, the issue of the regulatory treatment of ETFs should be analysed again. There is no doubt that the ETFs that are organised as UCITS would not be governed by the AIFMD. However the other ETFs would probably be, allowing ETFs to opt for the latter more liberal regime in terms of investment management. Indeed the definitions used in the AIFMD are based on a reasoning whereby the AIFM is regulated, not the AIF, but

[2] The "Newcits", coming closer to some of the hedge funds, also are viewed here.

the AIFM only falls under the directive to the extent that it acts for an AIF. The definition of the latter is therefore crucial. According to article 4(1)(b) of the AIFM directive, an AIF or 'alternative investment fund' is defined as meaning

> "any collective investment undertaking, including investment compartments thereof,(i)which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and (2) (which is not a UCITS).

This definition, nor any other provision of this directive, does refer to any particular type of assets, what would normally mean that all types of assets would trigger the qualification. It also does not refer to any diversification criterion, what is logical as many hedge funds invest in one single type of assets (e.g. gas derivatives). The only restrictions flowing from this definition concern the characterisation as an "undertaking" and the "collective nature of the enterprise, in terms of its funding and therefore as far as its organisation is concerned. This very wide definition raises many issues and some consequences will be clearly unexpected. Some practicing lawyers state that real estate funds will not be subject, what is clearly incompatible with the directive's definition.

The notion of undertaking would probably refer to a certain activity undertaken in the legal entity. Totally passive bodies would therefore not be viewed, but the question arises what activity is referred to: is this managing the portfolio, or also following up o the other types of assets. So e.g. for a company with a single real estate asset in its portfolio the managing of this building, receiving the rent, effectuating the repairs would all lead to considering that there is a certain form of management, even if the building itself will not be sold, and even less bought. For ETFs the activity of buying or selling the underlying securities, or action to avoid the tracking error would probably suffice to consider the fund as being managed. A further factual analysis would be needed to determine whether the remaining activity, such as bookkeeping, evaluation and fixing the NAV, etc would suffice to consider the fund as an "undertaking".

This analysis would lead to the conclusion that the exchange traded funds organised otherwise than in the form of a UCITS would fall under this directive. The asset manager responsible for the fund would have to apply for the authorisation as an AIFM. As a consequence, the minimum capital and liquidity rules would become applicable, as well as the rules on leverage and on remuneration, the latter not very different from the ones applicable in banking. The fund should have a depositary, whether a bank, or another institution (e.g. a notary for a real estate fund) and a valuer. It could be a closed-end or an open-end fund, in the first case eliminating the disturbing difference between market price and exit price. Moreover the ETFs from third countries would fall under the restrictions for third country funds as far as their marketing in the EU is concerned. The fund would however enjoy wide flexibility and all types of management, physical or synthetic, index linked or not would be permissible. But as "marketing" has been defined in the directive[3] these funds are not being marketed, they are not sold but bought and hence the rules on marketing would not apply. However being managed in the Union, the manager of the ETF would have to be authorised as an AIFM. The listing of the fund would have no influence on the foregoing: the AIFMD does not take any

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[3] Art .4(1)(ty) 'Marketing' means any direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares in an AIF it manages to or with investors domiciled in the Union".

account of whether the fund is listed or not, what is logical as this directive does not aim at protecting investors but at avoiding financial instability and systemic risk.

The fund's manager would be subject to supervision, but whether the fund – different from the asset manager - would have to be supervised would depend on the law under which it has been created. Under the existing legislation, for some fund types, national law may hold no authority responsible in the national legal order. The supervisor of the AIFM will be able to collect information on the fund, its activities and its financial position.

The fund will per hypothesis be listed and traded on a regulated market, or any equivalent market, enabling investors, including retail investors, to invest directly in the fund, and without having to pass by structures like the Fund of hedge fund. The disclosure duties of the AIFMD will have to be supplemented by the obligations flowing from the directives applicable to listed companies.[4] The Treaty rules on freedom of capital movements will apply.

There are some points where there will be tension with the existing model of regulation.

There will be a question of investor protection: indeed, investor buying listed securities are mainly protected by disclosure, by the organisation of the trading markets and the support of their investment advisers. The question will arise whether that protection regime is sufficient, also due to the sophistication of some of these products. In the AIFMD, it was the hypothesis that the AIFs would only be marketed to professional investors, the offer to retail investors being left to a decision of the individual states. Once listed these securities would be generally accessible. The ongoing discussion on complex and non-complex products under Mifid will take this factor into account. Maybe that for some products access will have to be restricted on the basis of the national laws, or more exceptionally by ESMA using its powers to restrict or suspend certain financial activity[5].

Another point of tension concerns distribution: today non-UCITS compliant funds would not enjoy the European passport. Being listed, member states could not prevent the distribution of these funds to their investors. Whether third country funds can be listed will be a decision of the listing authority, but non-EU securities have never been discriminated against as far as listing is concerned.

But there is more. There are grave concerns about the so-called "shadow banking"[6] market, in which the hedge funds, and other similar structures constitute a considerable part. Voices are heard that the systemic risk that may develop in this subsection of the financial system urgently needs to be put under some form of supervision[7]. This analysis did not take into account the AIFMD in Europe: there is probably no need to develop an additional regulation dealing with financial stability and systemic risk for these fund structures and other structures submitted to the directive, as there are sufficient instruments available, whereby the directive introduced an express link with the information to the ESRB.

This does not mean that the question does not deserve attention as far as other financial markets other than the European would be concerned.

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4 Prospectus directive and Transparency directive for the continuous information.

5 See art 9.5 under the ESMA regulation.

6 FSB, Shadow banking: scoping the issues, www.financialstabilityboard.org/publications/r_110412a.pdf

7 See FSB, Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs), 12 April 2011

Conclusion

The introduction of exchange-traded funds constitutes one of the more important innovations in the fund business for the last 10 years, and not only for cost reasons. The regulatory apparatus has not yet assimilated these new structures. The AIFMD opens new interesting avenues that may meet some of the wider concerns in the post-crisis period.

Financial Law Institute

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