Structured Thoughts

News for the financial services community.

Regulators Turn to the Stability Risks Presented by the Explosive Growth of Exchange-Traded Funds

Global regulators have raised concerns over the increased prevalence of exchange-traded funds ("ETFs") as investment vehicles, as well as the new uses to which these vehicles are being put. The Financial Stability Board ("FSB"), which is a global coordination organization of the world's financial regulators, published a report detailing its concerns in April 2011.[1] The Bank for International Settlements and the International Monetary Fund have each weighed in as well.[2,3]

Exchange-Traded Funds

ETFs were created in the 1990s as a product that offered investors the flexibility and cost-efficiency of exchange-traded securities while maintaining the diversification offered by mutual funds. Typically, ETFs track an index (e.g., the S&P 500 or the Nasdaq-100) and trade continuously. Unlike shares in a mutual fund, which may be traded only once at the end of each trading day, investors may buy or sell shares in ETFs continuously. They often provide additional liquidity support to the securities that make up the underlying assets of the ETF as well.

[1] Financial Stability Board Paper entitled "Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)," April 12, 2011, available at: http://www.financialstabilityboard.org/publications/r_110412b.pdf ("FSB Paper").

[2] Bank for International Settlements paper entitled BIS Working Papers No. 343, "Market structures and systemic risks of exchange-traded funds," by Srichander Ramaswamy, Monetary and Economic Department, April 2011, available at: http://www.bis.org/publ/work343.pdf.

[3] International Monetary Fund paper entitled "Durable Financial Stability: Getting There from Here," April 2011, available at: http://www.imf.org/external/pubs/ft/gfsr/2011/01/pdf/text.pdf.

At the end of the third quarter of 2010, the global ETF industry had $1.2 trillion in assets under management. The industry has grown at an average of 40% per year over the past 10 years, which dwarfs the growth rate of both global mutual funds and equity markets (around 5% per year).[4]

New Innovations in the Market for ETFs

Recently, several developments have occurred (or accelerated) that have caused regulators to question whether the ETF market requires additional oversight and regulation.

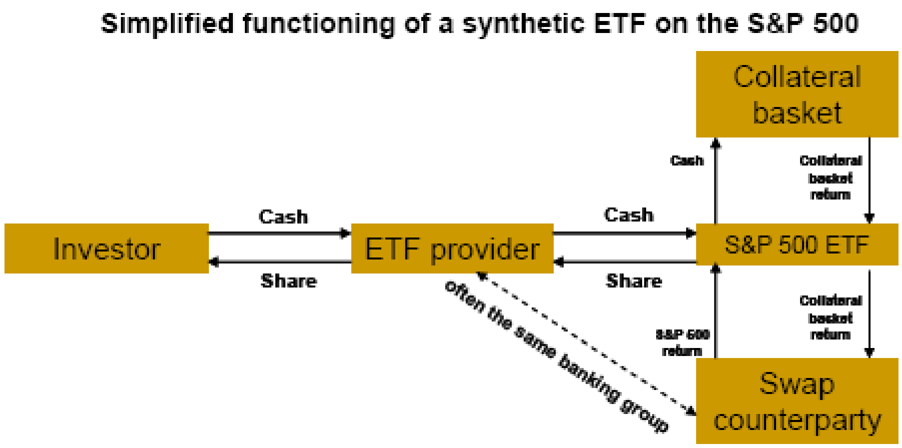
First, ETFs are no longer only focused on equity securities, but instead frequently represent underlying asset classes such as fixed income, credit, emerging markets or commodities.[5] Within these asset classes, liquidity is typically thinner and transparency lower, and investors can increasingly access leveraged or "inverse" ETFs, which introduce additional complexities that investors may not fully appreciate.

Second, "synthetic" ETFs (which use derivatives to simulate the behavior of underlying assets) as well as the greater use of securities lending by ETF providers of plain-vanilla ETFs have raised the related questions of counterparty and collateral risks. These synthetic ETFs now make up 45% of the total ETF market in Europe and are growing quickly in Asia as well.[6] Growth of these products has been slower in the U.S. because, unlike in Europe and Asia, U.S. regulation restricts the use of derivatives in investment funds.[7]

The third area of concern for regulators is the expectation for on-demand liquidity from ETF providers, the possibility of acute redemption pressures on certain types of ETFs in a period of market stress and the effect on the liquidity of large asset managers and banks active in this market.

Decreased Transparency, Increased Risk

In a typical synthetic ETF, a fund provider (usually the asset management department of a bank) sells investors shares of an ETF that tracks the performance of an asset class (e.g., the S&P 500), and uses the cash to purchase a basket of assets to "collateralize" a swap that mimics the return of the index. The structure of a typical synthetic ETF is shown in the following diagram[8]:



[4] FSB Paper, supra note 2, at 2.
[5] Some of these may be referred to as exchange-traded notes, or "ETNs," or exchange-traded vehicles, or "ETVs," but they behave very similarly to ETFs.
[6] FSB Paper, supra note 2, at 2.
[7] FSB Paper, supra note 2, at 2.
[8] FSB Paper, supra note 2, at 4.

Because of this structure, investors are exposed not only to risk in the underlying asset, but counterparty risk as well, through the swap. The interconnectedness of the ETF market and the derivatives market may also present a powerful source of systemic risk.

Because there are no requirements that the collateral basket contain easily tradable securities, there is also the risk that, during periods of market disruption when high volumes of redemption requests would be expected, the ETF provider could have difficulty liquidating the collateral portfolio fast enough, or at high enough prices, to satisfy investor demands.

Because the ETF provider and the swap provider are typically two arms of the same financial institution, this market dislocation scenario also presents the possibility that the fund provider would be forced to decide between suspending redemptions and facing a liquidity shortfall at the bank level.

The FSB notes that, in order to protect themselves, investors must scrutinize the collateral selection and arrangements underlying the synthetic ETF, but observes this will require a greater level of transparency than ETFs have heretofore provided. Important considerations for investors include the rules ETF providers follow for selecting the collateral, the screening of its credit quality and its liquidity, valuation practices and haircut determination, and segregation of assets. Regulators have suggested that regulatory or other limits regarding this exposure would also help contain these risks.

Liquidity Risks

It is not only synthetic ETFs that present liquidity risks. In physical ETFs as well, a massive wave of redemptions would force ETF providers to sell assets to cover redemptions, which would depress the price of the underlying assets and presumably trigger further redemptions, presenting a threat to the ETF itself. Regulators have argued for “in-kind” redemptions as a way to limit this risk.

The liquidity risks presented by ETFs are exacerbated by the prevalence of securities lending among ETF providers. In order to boost their very slim margins, many ETF providers engage in securities lending in order to boost their returns. Because a securities lending program is collateralized as well, it presents many of the same counterparty and collateral risks as are found in synthetic ETFs. During a period of unanticipated market stress, an ETF provider that has lent a great deal of securities will be in an even more dire liquidity position when in order to meet redemption requests.

Leveraged and Inverse ETFs

In the United States, the Financial Industry Regulatory Authority, Inc. (“FINRA”) has focused its attention on two complex strategies used by certain ETFs.[9] These strategies either use leverage that ETF providers say enable them to achieve a multiple of the performance of the underlying asset or index (e.g., the “2x S&P 500 Fund”), or provide investors with exposure to the inverse of an asset or index for the purposes of “shorting” the asset. Some ETFs combine these strategies, so the investor is able to make a leveraged short bet.

However, because these funds are managed to “reset” on a daily basis, they are likely to behave very differently than the underlying asset class over longer periods of time. FINRA has warned investors of this risk, and also cautioned investors that these funds generally charge higher management fees and have less advantageous tax attributes as a result of the frequent associated trading required to reset the funds’ strategy each day. FINRA has also urged its broker-dealer members to be sure to advise their clients of these risks when discussing investment options.[10]

[9] FINRA Investor Alert, available at: http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/MutualFunds/P119778.
[10] FINRA Regulatory Notice 09-31, available at: http://www.finra.org/Industry/Regulation/Notices/2009/P118953.

Regulatory Responses

Regulators are increasing their efforts to monitor the growing ETF market. The hope is that imposing disclosure and reporting requirements, as well as regulatory and other limits, could help alleviate some of the risks discussed above, and limit conflicts of interest.

The FSB has urged ETF providers and investors to review the risk management strategies of ETFs, especially in the areas highlighted above, and to assess their exposure to these risks. They call on ETF providers to enhance the level of transparency about these products offered to investors, and frequently make publicly available detailed information about product composition and risk characteristics to enable investors to exercise their due diligence.

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