FSA factsheet for

Investment advisers

FSA
Financial Services Authority

Exchange Traded Products (ETPs)

This factsheet is for any firm or adviser who:
- **currently includes ETPs as part of their advice offering; or**
- **is considering including ETPs in their advice offering.**

The retail market for ETPs is small, but is expected to grow. We have reviewed the risks posed by ETPs, and completed a number of visits to providers who account for over 70% of the EU market. Our work leads us to believe that there are a number of competing views on the risks consumers face if they choose to invest in an ETP.

We want to raise awareness of the key features and risks we consider important. This factsheet is not intended to provide formal guidance on Handbook rules.

This factsheet explains:
- **the key features of ETPs and the differences between them;**
- **the investment strategies ETPs use to generate a return, and the risks these strategies pose to investors;**
- **the transactions which the fund enters into with third parties to improve the investment return, including where this involves collateral;**
- **the mechanisms by which ETPs are traded and the risks that investors face when trading; and**
- **the potential for conflicts of interest in ETP structures.**

Investment advisers should be aware that the European Securities and Markets Authority (ESMA) published a **consultation** on these products and their regulatory framework in January 2012. Some aspects of this factsheet may change as a result of the consultation.

In this factsheet:

What are the key features of ETPs?

- ETPs are quoted and traded on stock exchanges throughout the day like ordinary shares. The price of the share determines the value of the investment.
- The ETP's price movement should track a pre-defined financial index or benchmark (e.g. the FTSE 100). The mechanism that ETPs use to ensure the share price stays in line with the fund value is explained more in Section 5.
- ETPs may engage in transactions with third parties (such as using derivatives and securities lending), which results in the ETP being exposed to different assets or risks other than the risks of investing in the index.
- ETPs vary by investment market, investment strategy, legal structure and risk. This means that not all ETPs are suitable for all types of investor.

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What are the differences between ETPs?

Legal structure

ETPs are structured as either funds or debt securities but the structure is not always clear. Most ETPs structured as funds comply with European legislation for protecting fund investors, known as the UCITS Directive. Most UCITS ETPs are called Exchange Traded Funds (ETFs). UCITS imposes certain regulatory requirements on funds, such as having a required level of portfolio diversification, rules regarding the segregation and protection of fund assets and restrictions on the types of assets the fund can buy (e.g. commodities).

ETPs structured as debt securities do not comply with the UCITS rules and may use complex financial techniques (such as borrowing). As a debt security, the value of the ETP is directly related to the creditworthiness of the issuer, which may increase risks for investors. Examples of ETPs structured as debt securities are those that directly invest in commodities.

Underlying index

Most ETPs seek to track a diverse range of indices. The index may be an equity index (e.g. FTSE 100), but could represent changes in the price of bonds, commodities or other financial products (e.g. oil or gold). Different indices pose different risks to investors.

There may also be differences in the construction of indices. While the majority of ETPs are tracker funds, some pursue active strategies. Some indices are custom-made for an ETP and therefore may contain an element of stock selection.

Key areas for consideration

- **Is the ETP structured as a fund or as a debt security?**
- **Does the ETP comply with the UCITS regulations designed to protect investors?**
- **Is the index a passive or an active index? Is the index custom-made?**

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What investment strategies are used by ETPs?

Physical investment strategy

A physical investment strategy is where an ETP buys and holds the shares or securities that make up the index it intends to track.

In order to offset the trading costs of the underlying securities, and boost the return, the ETP may lend some of those securities to other financial institutions such as banks or hedge funds through a securities lending arrangement. To guarantee the return of the borrowed securities, the borrower provides collateral in the form of assets of an equivalent value. Collateral and the role it plays in ETPs is explained in the next section.

Synthetic investment strategy

A synthetic investment strategy uses swaps to ensure the value of the ETP reflects the value, or change in value of the intended index. A swap is an arrangement between the ETP and an investment bank. The investment bank promises to pay the value of the daily change in the index value to the ETP, in return for the cash the ETP has received from investors. This ensures that the value of the ETP reflects the value of the index.

Some synthetic investment strategies use the cash received from investors to buy a basket of assets, which usually have little in common with the index being tracked. The ETP 'swaps' the return on the portfolio of assets it holds with the investment bank, and receives the return of the index.

While the price (or net asset value) of the ETP might change in line with the index or benchmark that it intends to replicate, investors should not assume that the ETP directly holds the securities in that index or benchmark. Both physical and synthetic investment strategies can expose the ETP to a portfolio of unrelated assets.

Complex investment strategies

Some ETPs use derivatives, such as futures and options, and borrowing techniques to achieve different investment returns compared to the index. 'Short' or 'inverse' ETPs attempt to provide a return that is the reverse of an index (i.e. as the index falls, the ETP increases in value). 'Leveraged' ETPs attempt to multiply the size of changes to an index (e.g. as the index rises 1%, the ETP increases in value by 2%). The indexes of inverse and leveraged ETPs 'reset' (i.e. the index value returns to 100) on a daily basis, which may distort the price performance of an ETP if it is held for a period of more than one day.[1]

Key areas for consideration

- **Does the ETP lend out the securities it invests in?**
- **Is there a maximum proportion of securities that can be lent?**
- **Does the ETP enter into a swap contract to achieve the return on the index? (i.e. does it use a synthetic strategy?)**
- **Is the ETP exposed to collateral assets?**
- **Does the ETP intend to achieve the inverse or a multiple of the index return?**

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How does collateral and third party involvement create risks to an ETP investment?

Collateral and the risks

Collateral is the transfer of assets between an ETP and third parties to guarantee contracts between those parties (e.g. the return of borrowed stock, or the provision of a swap). Both physical and synthetic strategies can expose investors to high levels of collateral.[2] In order to maintain the value of an ETP, it is important that the collateral provided is of sufficient quality and quantity to cover any losses:

- For physical investment strategies, the borrower must provide collateral assets in case they cannot return the borrowed securities. The securities lending agent will oversee the transfer of collateral to the ETP to maintain the value of the ETP's portfolio.
- For synthetic strategies, the obligation is on the bank to pay the ETP the return on the index. If the bank is unable to make those payments to the ETP (e.g. if it becomes insolvent) the value of the ETP becomes dependent on the value of the collateral assets.

The collateral is valued – or marked-to-market – at regular intervals (e.g. daily, weekly, etc.), depending on the terms of the contract with the third party. The ETP must be able to value and sell the collateral assets quickly and at a fair price in order to replace missing securities or to set up new swap contracts.

Firms providing ETPs normally have individual guidelines on the type, quality and quantity of collateral that they accept. The UCITS rules also provide a minimum standard for collateral. Most ETP providers publish details of the quantity and types of assets held as collateral on their websites for investors to review. The frequency this information is updated varies.

If a third party fails to meet its obligations, the collateral should be sold by the ETP and the proceeds used to replace lost securities. It is likely that there will be delays and expenses while this happens. During this time, the value of the ETP is unlikely to reflect the movements in the index.

Third parties an ETP depends on

ETPs may rely on single or multiple third parties and there is a trade-off between the simplicity of having a single party and the complexity of maintaining multiple relationships.

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1 For example, consider a 2x-leveraged ETP, with the index value and ETP value at 100 on day 1. Throughout day 1 the index increases 10%, to 110. The value of the ETP rises 20% to 120. At the beginning of day 2, the index 'resets' to 100. On day 2, if the index increases a further 20%, to a new index value of 120, the price of the ETP rises by 40%, from 120 to 168. Overall, the index has increased by 32 from 100 to 132. As the ETP achieves double the index return, it should increase in value by 2 x 32; 64. In fact, it has risen by 68, to 168. If this continues over time, the divergence between the index value and the ETP price changes could be significant.

2 Physical strategy ETPs lend out, on average, 15% of their securities, but the total holdings lent out may be as high as 80%. The entire portfolio of synthetic strategy ETPs can comprise collateral.

A physical strategy ETP may lend its securities to a number of different parties, which is arranged by a specialist lending agent. Agents may not provide investors with information about who is borrowing securities from the fund. Instead, they ask ETP investors to trust their judgement and use collateral to offset any mistakes.

Synthetic strategies normally use one or a few parties to provide the swap. Some synthetic ETPs make it clear that their parent bank always provides the swap to the fund and promote themselves under the parents' brand name. Some ETP providers publish the identity of the third parties, as it is important to know whether those parties can be depended upon.

Key areas for consideration

- **Are third parties involved in the investment strategy?**
- **What are the guidelines for acceptable collateral for the ETP?**
- **Does the ETP disclose the composition and quantity of the collateral assets? How frequently is this information updated and where is it made available?**
- **How often can the collateral assets be changed and under whose authority?**
- **Does the ETP have full legal title over those collateral assets?**
- **How quickly can the ETP access the collateral assets if a third party fails in its obligations?**
- **Who monitors and enforces the guidelines for acceptable collateral?**
- **Are the collateral assets valued? How often and by whom?**

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What are the mechanisms for trading ETPs?

Individual ETP shares are normally traded on a stock exchange, just like ordinary shares. As investor demand rises, this pushes up the price of the ETP relative to the value of the securities in its portfolio. To ensure the price of the ETP reflects that of the value of its portfolio, new ETP shares are 'created'. In order to create these new shares, stock trading firms called Authorised Participants must purchase the individual securities contained in the index, using new investors' cash, and give them to the ETP in exchange for ETP shares.

Conversely, as demand for the ETP falls, Authorised Participants 'redeem' ETP shares by purchasing them from investors, and gives them to ETP in exchange for the index shares or cash. This process is known as 'creation-redemption'.

Another function of Authorised Participants is 'market making'. Authorised Participants maintain buy and sell quotes on the exchange throughout the day. These quotes allow investors to buy and sell ETPs whenever they need to, allowing continuous trading and maintaining a fair price for the ETP. Generally, competition among Authorised Participants improves investors' ability to trade at a reasonable price.

Authorised Participants agree to facilitate on-exchange trading and to administer the creation-redemption process, in normal circumstances. In a scenario where it is difficult to value the ETP's portfolio – such as the insolvency of a swap provider or stock borrower, releasing the collateral assets; or during periods of heightened market volatility – the Authorised Participant may be unwilling to either facilitate a trade on exchange or to redeem investor's shares. This means that when an investor wants to sell their investment, they may be unable to.

The normal settlement period is three working days after the trade date (T+3), but there may be delays in settlement. During the creation process of an ETP, Authorised Participants must use investors' cash to purchase the individual securities contained in the index on behalf of the ETP, which may take more than three days, causing delays in the settlement process. These delays may be longer when the ETP invests in overseas or exotic securities, or during periods of market volatility.

Key areas for consideration

- **How many Authorised Participants have agreed to provide continuous quotes for the ETP on exchange?**
- **How many Authorised Participants administer the creation-redemption process of the ETP?**
- **Who is the primary Authorised Participant?**
- **Is the Authorised Participant willing to provide buy/sell quotes and run the creation-redemption process continuously, even in periods of high market volatility?**
- **Does it matter if investors may have to wait for delivery of ETP shares, as a result of settlement delays?**

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What is the potential for conflicts of interest in ETPs?

ETPs depend on a number of third parties:

- agents who arrange stock lending for physical investment strategies;
- the firms selling swaps to funds using synthetic investment strategies;
- custodians safeguarding investors' assets; and
- Authorised Participants who facilitate trading.

These parties' interests may not be the same as those of the investor. In some cases, ETP providers may be affiliated (i.e. part of the same company) to the parties providing these services to the ETP, which can increase the potential for conflicts of interest. Many ETPs are managed electronically, not by a dedicated fund manager. Therefore, the ETP provider may not be able to effectively challenge potentially conflicted parties.

Conflicts of interest associated with collateral

Both physical and synthetic investment strategies involve the provision of collateral assets to the ETP. The party borrowing securities or the swap provider may have an incentive to provide low quality collateral assets to the ETP in order to minimise their costs. Conflicts may arise between the ETP and third parties when the fees obtained for the arrangement of securities lending are shared between the stock lending specialist and the ETP. The specialist can increase its income through fees by lending more stock, but the risk is taken by the ETP. Where third parties are affiliated to the ETP provider, the freedom to choose unaffiliated parties may be affected.

Conflicts of interest associated with ETP trading

If the Authorised Participant is part of the same parent company as the ETP provider, the company may also have the incentive to restrict the number of competing Authorised Participants to maximise revenue through their own, in-house Authorised Participant. The lack of competition could have a knock-on effect on the way the ETP is priced, as the Authorised Participant may have the ability to affect the price in its favour.

Conflicts of interest associated with indices

In some cases, the index intended to be tracked is created especially for an ETP. If the institution that creates the index is affiliated to the ETP provider, it may have an incentive to select the individual constituents of the index to optimise its own revenues, rather than that of the investor.

Key areas for consideration

- **Is the ETP provider affiliated to borrowers of securities, swap-providing banks or the custodian?**
- **Are you satisfied you understand what potential for conflicts of interest exist and how each ETP provider manages them?**
- **Does the ETP provider have the freedom to choose the number and identity of the parties that borrow securities in physical ETPs, or provide swaps in synthetic ETPs?**
- **Can the ETP provider challenge the quality and/or valuation of the collateral assets?**
- **Are the fees obtained from lending securities disclosed to the investor?**
- **How is the revenue from those fees split between the ETP and those arranging the lending of securities or the provision of the swap?**
- **Is the ETP provider affiliated with any Authorised Participants?**
- **Is the ETP provider affiliated with the institution that chooses the constituents of the index?**

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