REPORT 282

Regulation of exchange traded funds

March 2012

About this report

This report is for stakeholders in the exchange traded funds (ETFs) industry. It explains how ETFs are regulated in Australia and how proposed international principles for regulating ETFs may apply in the Australian context.

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Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

Contents

Executive summary

1 This report is for stakeholders in the exchange traded funds (ETFs) industry. It explains how ETFs are regulated in Australia and how proposed principles addressing concerns by international regulatory agencies about ETFs may apply in Australia.

2 Identifying the regulatory risks arising from ETFs is part of ASIC's role to promote confident and informed investors and fair and efficient financial markets. ASIC has a range of regulatory powers relating to ETFs that help to promote these objectives. In developing this report and considering how to use our powers, we have been involved in ongoing consultation with the ETF industry and will continue to liaise with the industry in the future.

ETFs in the Australian market

3 In Section A, we discuss in general terms the Australian ETF market, explaining the different types of ETFs that may be available, the various strategies used and giving a general overview of the regulatory environment.

Regulation of ETFs and international principles

4 In Section B, we discuss how regulation in Australia may address the proposed principles for the regulation of ETFs from the Standing Committee 5 on Investment Management (SC5) of the International Organization of Securities Commissions (IOSCO).[1] We will review the principles when they are finalised by IOSCO, following IOSCO's consultation, to assess whether any additional issues are raised for Australian regulation.

5 In setting out the regulatory position, the report explains aspects of ASIC's current expectations about the operation of ETFs. This reflects current industry practice and is not intended to imply any new regulatory requirement or standard.

[1] IOSCO SC5, *Principles for the regulation of exchange traded funds*, March 2012, http://www.iosco.org.

A ETFs in the Australian market

Key points

In this section, we describe ETFs and how ETF trading is conducted in Australia.

We look at the current ETF market, the pre-issue regulation of ETFs, and how market pricing and arbitrage for ETFs occurs.

We discuss some of the strategies used by ETF issuers, such as physical and swap replication strategies, representative sampling and the use of derivatives generally.

We explain the different types of ETFs, such as inverse, leveraged, commodity and fixed income ETFs, and how these differ from interests admitted to trading status as managed fund products.

What are exchange traded funds?

6 ETFs are a type of open-ended managed fund which is traded on a financial exchange. Like all managed funds, investors' contributions are pooled so they can be managed as a fund, in line with an investment strategy, and investors hold an interest in the pool. In Australia, this interest is usually in the form of a unit in a unit trust and the ETFs are managed investment schemes. This paper focuses on ETFs rather than other financial products traded on a financial exchange. For a discussion of the distinction between ETFs and some of these other financial products, see paragraphs 76–84.

7 In Australia, ETFs are quoted under the ASX Listing Rules or the rules in Sch 10A of the ASX Operating Rules (known as the 'AQUA rules'). The AQUA rules provide for three different classes of open-ended scheme and corporation-issued products that trade at a price closely reflecting their underlying value: ETF securities, managed fund products and structured products. The underlying value may be net asset value (NAV) for ETF securities or managed fund products or, for a structured product, is intended to be a value that closely tracks the assets or indices that the product is designed to track.

8 ETFs engage in passive investment strategies, tracking an index or other asset. Actively managed funds are permitted to call themself an 'active ETF' in other jurisdictions such as the United States, although in Australia, ASIC is discussing with ASX the appropriateness of that terminology: see paragraphs 93–97. Any fund that meets certain tests designed to identify if it should more appropriately be listed cannot be admitted to trading status on the AQUA market under the AQUA Rules.

9 ETF issuers allow ongoing application for and redemption of ETF units at a price based on the NAV of the ETF by certain market participants (known as ‘authorised participants’) who have entered an arrangement with the issuer. As in other jurisdictions, this process seeks to ensure that the market price will generally reflect the current NAV of the fund through arbitrage. Retail investors are not permitted to be issued or redeem units directly (except in exceptional circumstances), but can trade the ETF units within the secondary market.

10 The NAV of an ETF will not completely replicate the performance of the underlying assets the ETF is seeking to track, in part because of fees and expenses in the ETF. In addition, an ETF may have tracking error in that the NAV will not always accurately replicate the performance of the relevant underlying assets being tracked for other reasons. For example, this may be because the ETF uses a sampling strategy rather than replicating the exact composition of the index.

How are ETFs traded?

11 In Australia, ETFs are quoted under the ASX Listing Rules or the AQUA rules. The AQUA rules were introduced in 2008 to facilitate the admission to trading on ASX of ETF securities, other open-ended managed fund products and structured products that track underlying instruments. In addition, ETF securities are traded through the exchange market operated by Chi-X Australia Limited (Chi-X market). No ETF securities are currently quoted on the National Stock Exchange of Australia or other Australian licensed public exchanges.

12 Before 2008, the admission of non-futures products on ASX was largely limited to products issued by a listed entity and quoted under the ASX Listing Rules or admitted to trading under Sch 10 of the ASX Operating Rules (warrant rules). However, ASX considered that neither set of rules provided a suitable framework for ETFs or other open-ended managed funds which trade with reference to the fund’s NAV calculated from readily priceable assets or for structured products which are a corporation’s promise to pay holders an amount that is linked to the price of an instrument, index or commodity price. These structured products may or may not include managed fund-like aspects such as holding underlying reference instruments in trust to secure the corporation’s promise.

13 ASX created the AQUA market to specifically manage the admission of ETF securities, managed fund products[2] and structured products (collectively referred to as ‘AQUA products’) on the ASX market and to provide access to clearing and settlement services provided by the ASX Group. More

[2] Managed fund products are treated separately from ETFs in some respects under the AQUA rules and are products that may not seek to track an underlying instrument, index or commodity price.

broadly, the nature of AQUA products is that they are products (e.g. units) that relate to assets where:

- the value of the assets which affects the value of the AQUA product is not under the control of the issuer (e.g. the assets are shares issued by a third party); and
- the prices at which the assets can be bought or sold can be determined by authorised participants and market makers in a timely manner.

14 Not all ETFs are subject to the AQUA rules. At the date of this report, 19 classes of CHESS depository instruments conferring a beneficial interest in BlackRock iShares ETFs and three State Street ETFs are still traded under the ASX Listing Rules. The iShares listed products are each traded as a security in a foreign corporation.[3]

15 There are also disclosure requirements for AQUA ETF issuers that differ from those that apply to listed companies and listed schemes, such as the requirement to publicly disclose the fund's NAV on a daily basis (typically in the morning before trading commences). AQUA ETF issuers are also under an obligation to disclose to the market any information that would suggest a false market exists in the AQUA products. Nearly all AQUA ETF issuers produce an intraday indicative NAV (iNAV) for their fund and the index it tracks that is updated almost continuously during trading hours.

16 Generally, under the terms of Class Order [CO 05/26] *Constitutional provisions about the consideration to acquire interests*, issues of quoted interests must be at a price based on the prevailing market price, rather than one based on NAV, subject to certain exceptions such as placements. In some cases, we have given relief to allow listed open-ended schemes to issue at the higher of prevailing market price and NAV. In light of the particular protections in the AQUA market that are relevant to schemes that price at NAV (e.g. daily NAV publication), we amended [CO 05/26] to allow interests in a registered scheme that has interests quoted on the AQUA market to be priced based on NAV. To avoid the risk of having to price issues based on market price if it is higher than NAV, there is an incentive for open-ended schemes to use the AQUA market for quotation.

17 ASX has applied several other conditions to AQUA ETF issuers for the purposes of enhancing the existing AQUA framework, including as follows:

- Product Disclosure Statements (PDSs) must contain information about the regulatory differences for products that are listed under the ASX Listing Rules and products that are admitted to trading status under the AQUA rules.

[3] As stated, these iShares products trade as CHESS depository instruments, so, technically, at law they may be regarded as issued by ASX subsidiary CHESS Depository Nominees Pty Limited.

- Any general disclosure documents (e.g. half-yearly and annual financial reports) that are made available or provided to existing product holders must be disclosed via ASX's Company Announcement Platform (CAP) or the issuer's website as specified in the PDS.
- All AQUA product issuers must immediately advise ASX if the issuer is no longer able to comply with any of the key suitability and financial standards that are required at the point of admission.

18 ASX also requires that an Australian listed entity that is a registered managed investment scheme that intends to delist from ASX in order to change the quotation status of its securities from the ASX Listing Rules to AQUA rules must obtain the approval of its security holders before ASX will consent to the securities being quoted under the AQUA rules. This ensures that investors have a say in circumstances where they may wish their issuer to remain on the listed market.

Who invests in ETFs and why?

19 ETFs can be a very useful product for many retail investors, offering a simple and low-cost way to invest in passively managed funds. They are an alternative to unlisted managed funds, and for retail investors without large sums to invest, can be a more convenient and cost-effective way to own a diversified investment portfolio, compared to, for example, buying a diversified portfolio of shares directly.

20 However, innovation in the ETF industry brings new complexity and risks to a segment that until recently has been widely perceived as 'plain vanilla'. This increased complexity has been most notable in the introduction of 'synthetic' ETFs and structured products that appear to offer similar outcomes. The potential risks of physically-backed ETFs (such as mispricing and divergence from NAV, and the potential for tracking error) also need to be understood by investors.

21 ETFs attract wholesale and retail investors for a number of reasons: see Table 1. In late 2011, ASIC sought information from the ETF issuers currently in the Australian market about their investor base. ETF issuers reported a very high level of retail investment (50–75% across most products), based on their assessment of the register. Self-managed superannuation funds (SMSFs) have been early adopters of ETFs and may account for up to 30–40% of the member register of Australian ETFs. By contrast, in Europe, institutional investors hold approximately 80% of ETF assets and in the United States, institutional investors hold approximately 50% of ETF assets.[4]

[4] Financial Stability Board (FSB), *Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs)*, 12 April 2011.

Table 1: Perceived advantages of ETFs

Low cost	ETFs tend to be a more cost-effective way to gain diversified market exposure and deliver low-cost market-related returns compared to actively managed funds, for example. While there are costs associated with brokerage fees for trading in ETF securities, ETFs are attractive for investors who do not seek advice, as typically no ongoing deductions are payable for commissions to licensees who arranged or advised on the acquisition.
Liquidity and transparency	Trading flexibility and liquidity of ETFs mean investors can generally trade continuously when markets are open and execute strategic or tactical investment decisions quickly and efficiently. They can use ETFs as a cash management tool—for example, to quickly convert a cash position into an equity position (referred to as 'cash equitisation'), or on portfolio re-balancing.
Access	Investors have access through ETFs to a broad range of market and asset classes and relatively efficient international diversification.
Tax efficiencies	Compared to traditional managed funds, ETF portfolios tend to have lower turnover in the underlying assets relative to actively managed funds, and therefore realise less capital gains on buying and selling underlying assets for which capital gains tax is payable without a discount. This lower turnover reduces the amount of distributions of taxable income relative to capital receipts (which may be taxed concessionally) that members of an ETF will receive. Additionally, for a number of ETFs, gains realised on redemption are attributed to the redeeming authorised participant, rather than being distributed across the entire member base, as with many unlisted funds.
Managing exposure	ETFs allow active traders to trade on market movements or hedge the market. ETFs also provide an alternative to futures and other investment tools for investors who seek to adjust their exposure by country, region, sector, investment style or asset type (e.g. equities, fixed income and commodities, currency). Wholesale investors can short sell ETFs to hedge a portfolio.

Pre-issue regulation of ETFs

22 As stated earlier, in Australia ETFs are generally registered managed investment schemes. As such, they are subject to all the usual requirements for registered schemes under the *Corporations Act 2001* (Corporations Act). ASIC has given limited case-by-case relief on application on behalf of the responsible entity of an ETF as follows:

- Responsible entities of ETFs may treat members unequally to the extent that redemption is restricted to authorised participants or persons who are Australian residents for tax purposes, or both.
- Responsible entities of ETFs may treat members unequally to the extent they limit current information about the assets in the portfolio to authorised participants and market makers, as long as they publish this information as at the end of the previous trading day, and intend to provide an estimate of NAV (iNAV) during the trading day at intervals not exceeding 15 minutes.

- Members of ETFs may disregard any relevant interest in underlying securities held by the ETF that the member would be regarded as holding, until they are entitled to receive any of the securities as their withdrawal proceeds on making a redemption request.
- Responsible entities of ETFs do not have to send to members notifications of significant events, but must instead comply with the Corporations Act as if the ETF were an unlisted disclosing entity, including the requirement for disclosure of certain price-sensitive information.
- We have given technical relief reflecting the fact that ETF securities are quoted automatically on their issue rather than only being quoted after an application to ASX.

Market pricing and arbitrage

23 ETF issuers in the AQUA market engage market makers as required by the AQUA rules to ensure liquidity, so that the ETF's unit prices continue to track the value of the ETF's NAV per unit, subject to a relatively narrow spread between the bid and offer. The spread may in part reflect transaction costs in the underlying assets.

24 If the ETF unit price diverges from the value that market makers and authorised participants believe to be the NAV per ETF unit, a market maker or authorised participant may generally be expected to take advantage of the arbitrage opportunity. For example, if an ETF unit price is higher than the expected NAV per unit, a market maker will sell ETF units to realise gains or enable gains after being issued with new interests applied for on that day. This selling will tend to drive the ETF price back towards NAV. Conversely, if an ETF unit price is less than the expected NAV per unit, the market maker will buy ETF units, driving the ETF price back towards NAV, and then profit by redeeming those interests at NAV at the end of the day.

25 The availability of hedging means that until the ETF unit price adjusts, there is an arbitrage opportunity. On entering a transaction in ETF units, to protect against any change in NAV until the end of the trading day, the authorised participant may hedge its position by varying its net position in the assets that underlie the ETF, relative to what they would have been if the transaction in ETF units had not taken place.

26 For example, the authorised participant may buy the underlying assets to hedge against any increase in the NAV until the end of the day if it has already sold ETF units on-market. Where securities in a particular basket must be provided for the issue of an ETF unit, the market maker or authorised participant can buy the basket of securities required, at the time it sells the ETF unit on-market. The market maker or authorised participant will apply for an ETF unit at the end of the day if needed to meet its settlement obligations, or redeem units if it holds more than needed.

Common strategies for trading ETFs

27 To the extent that the ETF does achieve replication, it will be through one or more strategies, such as physical replication, representative sampling, securities lending, derivatives, or swap replication.

Physical replication

28 An ETF may be regarded as physically replicating to the extent that the underlying assets are held in the same proportions as the assets that are being tracked. Commonly in securities-based ETFs, the ETF issuer receives these securities in exchange for issuing units. Critically, the fund always has title to the securities needed to 'back' the units it has created.

29 For index-based ETFs, a basket of assets will need to be transferred for the issue of units for an index fund. The basket will comprise predetermined proportions of assets, and is referred to as the 'creation basket'. Similarly, there may be a 'redemption basket' provided to the authorised participant when it redeems ETF units.

30 Instead of receiving or paying cash on issue (or redemption), the ETF issuer may accept (or provide) the assets it calculates are necessary to minimise the transactions the fund will have to undertake to achieve the required portfolio. Generally, this will closely resemble the assets or the assets in the index being tracked. By commencement of the trading day, the ETF issuer will communicate to authorised participants the creation basket to apply to applications at the close of business on that day.

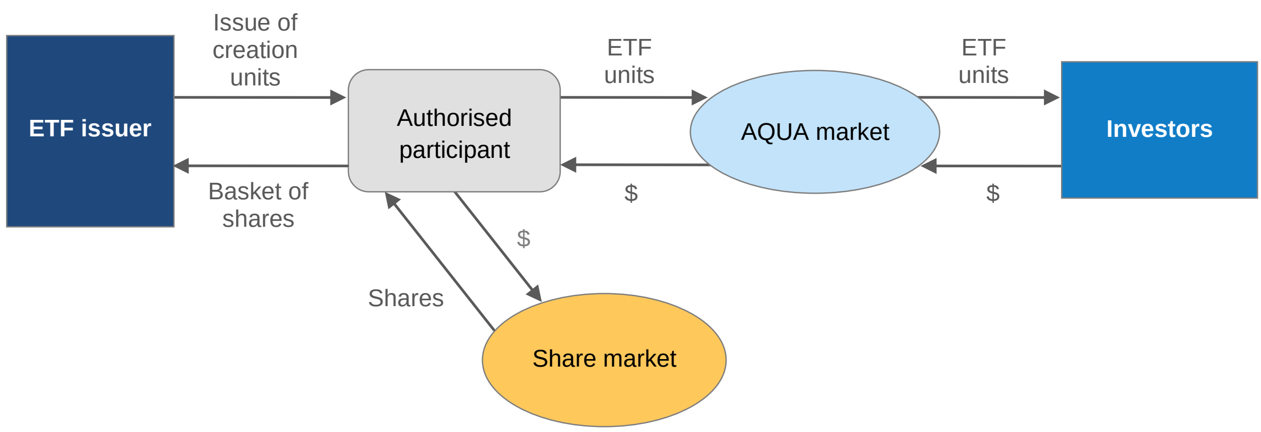
31 Only authorised participants are generally permitted to transact directly with the ETF issuer whether by acquiring (by issue) or disposing of (by redemption) ETF units. Many ETFs require the payment for ETF units to be by transfer *in specie* of assets. The assets will generally reflect the underlying assets of the ETF that are held to enable replication of the performance of those assets, or an index that includes them.

32 The size of the permitted transactions with the ETF issuer may be restricted to one or more creation or redemption units, which are predetermined bundles of the underlying assets of the ETF. Each creation or redemption unit will equal a large number of ETF units.

33 The issue or redemption price per unit is based on the NAV calculated as at the end of the day and published before the next day's trading. The amount of units to be provided for the creation or redemption unit will also depend on the value of the assets in the creation or redemption basket. Since the assets in the basket will generally closely reflect the makeup of the ETF's portfolio, there should be little movement between the value of the basket relative to the ETF's unit price. This process also facilitates authorised participants and market makers in hedging the risk of intraday moves.

34 In terms of physically replicating ETFs, the application and redemption process for these funds generally involves the exchange between the ETF issuer and authorised participants of large blocks of ETF units (one or more creation units) in exchange for an equivalently-valued basket of the securities underlying the ETF units, rather than cash consideration. However, a physical replicating fund may also allow applications and redemptions in cash in whole or part, and deal in the relevant underlying assets in order to achieve physical replication.

Figure 1: How ETF units are acquired in a physically replicating share ETF



35 Physical replication may not be the most cost-effective ETF strategy (e.g. compared to a synthetic replication). It could involve avoidable transaction costs and taxation burdens. It may be impossible or costly to acquire certain kinds of assets at prices implied by an underlying index. This could be, for example, due to the market impact of acquiring less liquid assets, or to the unavailability of assets subject to ownership restrictions, or the impracticability of physical holdings. Some assets yield cash, and re-investment immediately may not be possible because of rounding differences. Having a large portfolio can also increase operational risk.

Representative sampling

36 An ETF may be regarded as replicating by representative sampling, to the extent that the fund's assets are among the asset(s) in the index that it is the ETF's strategy to track, but are not held in the same proportions as the assets that are being tracked. The assets actually held by the fund may be selected to achieve a sufficiently similar outcome. The same process may be used for issue and redemption as for physically replicating ETFs, but the basket of assets transferred from ETF units may diverge more from the assets being tracked.

37 Representative sampling may be used to reduce the disadvantages of physical replication. Most ETFs in Australia offer representative sampling with close to physical replication.

Securities lending

38 Unlisted managed funds that invest in financial assets commonly engage in securities lending, where the responsible entity lends out securities held in the fund to third party borrowers in return for a fee.

39 In the case of ETFs, securities lending may occur to earn additional income for the fund to offset expenses. By minimising net costs, closer replication of the performance of the physical holding may be possible. However, in this case, the fund will hold the collateral assets rather than assets that physically replicate the index.

40 Where securities lending is conducted, there is usually a program involving credit due diligence on prospective borrowers (typically investment banks and other fund managers). The borrower(s) will post collateral to the responsible entity (or its custodian) on behalf of the relevant ETF as security for the loan. Ordinarily, to diversify counterparty risk, the responsible entity will lend securities to a selection of borrowers from a pre-vetted panel and limits will be imposed on the level and type of securities that can be lent, and the value and composition of assets that can be posted as collateral.

41 We understand that no Australian ETFs currently engage in securities lending. There may be several reasons for this, including that much of the Australian ETF market appears to be intermediated retail—that is, retail investors who invest under advice from a financial planner. ETFs have enjoyed a reputation for being ‘simple’ products. Securities lending can be seen as overcomplicating and creating an additional layer of risk for ETFs that is inconsistent with how they are currently marketed and difficult for financial planners to explain in a way which is positively received by prospective clients.

42 Relative to costs and risks, the reward from securities lending for fixed interests ETFs might be higher, and this may increase the prospect of fixed interest ETFs engaging in securities lending.

Derivatives

43 It is also not uncommon practice for unlisted managed funds to use derivatives for hedging (e.g. currency risk) or speculatively.

44 In the case of ETFs, derivatives may be used instead of holding particular assets in an index being tracked, for example, to enable quicker and more cost efficient adjustment to changes in the cash position of the ETF to maintain the exposure to the index assets.

Swap replication

45 An ETF may seek to replicate by using a derivative in the form of a swap agreement. Under the derivative, payments are made to the ETF based on any shortfall in the performance of the ETF's assets relative to the performance that would have been achieved by a physical holding of all assets to be tracked. These arrangements may be termed an 'unfunded' swap as they do not involve a transfer of the ETF's assets to the counterparty (i.e. it is unfunded from the counterparty's perspective). The ETF may hold assets reflecting those to be tracked to a greater or lesser extent, or other assets. There could be arrangements with the counterparty that influence what assets can be held.

46 An ETF using the above approach will typically be considered by ASIC as 'synthetic'. However, in relation to one issuer, we indicated that we would not object if the ETF was not referred to as 'synthetic' since the fund applied a physical or representative replication strategy. The responsible entity was relying on a swap agreement only as a secondary means without conferring on the swap agreement counterparty any control over the ETF's assets. The responsible entity of the ETF indicated that it would ensure that any exposure to the swap agreement counterparty was managed so that it would not exceed a small non-material percentage of the NAV. We are currently reviewing the criteria that we consider should apply to the use of the term '(synthetic)' in the product name.

47 Using a swap agreement may achieve closer replication of the performance of the index the ETF is seeking to track and may in some circumstances be cheaper for it to implement. However, it exposes the ETF to some counterparty risk.

48 An ETF may replicate by a funded swap to the extent that the fund's major assets are the swap and any security held is related to the obligations of the counterparty under the swap. These arrangements are 'funded swaps' in that they are funded from the point of view of the counterparty and involve a transfer of the assets to the counterparty, subject to a security in favour of the ETF. In terms of counterparty risk, this kind of ETF may be the most risky as identified by international commentary including by the Financial Stability Board (FSB) and the Bank of International Settlements (BIS).[5]

49 For a particular ETF, actual counterparty risk will depend on a range of factors including the counterparty's identity and the quality of the collateral as a security. There can also be significant liquidity risks and legal risk in enforcing swaps. European experience is that counterparty assets transferred as collateral to the ETF as part of a swap have sometimes been of poor quality. Swap counterparties tend to be the asset management divisions of banks, and there is a risk that the security offered will be those securities that are otherwise difficult to realise or borrow against. In some cases, the swap counterparty may be a

[5] See FSB, *Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs)*, 12 April 2011 and BIS Working Papers, *Market structures and systemic risks of exchange-traded funds*, April 2011, No. 343.

related party of the issuer and this raises an increased risk that the terms of the transaction may not be in the best interests of members.

50 In Australia, some ETFs use swaps but, to date, none involve a funded swap. ASIC would consider carefully the appropriateness of any proposed product using a funded swap.

Types of ETFs

Inverse and leveraged ETFs

51 Outside Australia, inverse or leveraged ETFs are available. They are not currently available in Australia.

52 Inverse ETFs aim to deliver the opposite performance of their underlying investment over a particular period. For example, an inverse share index ETF would seek to give a positive return when the share index goes down, and should lose value when the share index increases.

53 Leveraged ETFs aim to deliver a multiple of the performance of their underlying investments over a particular period. For example, a US share index ETF with two times leverage would aim to provide a 10% return when the market increases by 5%. And conversely, if the market falls by 5%, the investor could expect to lose double that amount, or 10%. A leveraged inverse ETF seeks to achieve a multiple of the opposite performance of the relevant index.

54 To ensure that this investment objective is achieved for an incoming investor, the relevant multiple (e.g. two times or minus one times) needs to be reset regularly. This is generally based on the previous day's close. However, this daily reset feature means that if interests in the ETF are held for more than the trading day, the ETFs is not designed to, and is unlikely to, achieve an outcome reflecting the relevant multiple of the amount invested. The actual outcome will be affected by the market price's path.

55 Inverse and leveraged ETFs are designed for short-term trading. Due to the resetting of gearing, usually on each trading day, they generally should not be held past the reset except if a discrete decision is made by the member to hold them until the next reset to seek the actual level of gearing after the previous reset. However, some overseas investors have inappropriately adopted a buy and hold strategy, causing unexpected outcomes.

56 In this case, inverse and leveraged ETF prices are likely to start to diverge from the relationship to the assets they are designed to track—as implied by the simple multiple (e.g. two times the change or the inverse of the change) —when measured over a period of more than one reset period (day). Tracking gaps can become more significant if daily reset leveraged ETFs are held for many days in volatile market conditions.

Commodity ETFs

57 Most commodities cannot be held physically as trust assets. Some can be held—for example, gold, silver and palladium are often held in custodian warehouses. Commodity ETFs may be seeking to replicate prices of futures contracts or a futures index or tracking the 'spot price' (as the two may differ) whether directly or through an index that is based in turn on spot or futures prices. Where an ETF references the spot price of an unstoreable commodity, it will obtain exposure through derivatives.

58 In addition, where the ETF uses futures contracts, the price being tracked will reflect the cost of, or return on, replacing (rolling) existing futures contracts before they expire with new contracts that expire at a later date. In some cases, the price of new longer-dated futures contracts will be higher than the shorter-dated ones that are being replaced before they expire (i.e. the market will be in 'contango'), and the cost of paying for these new contracts could cause loss to the fund (although not necessarily relative to an index based on the futures price). Some indices of futures have provisions to reduce the contango roll risk, being based on gradual transfer to longer-dated contracts.

Fixed interest ETFs

59 Effective from 9 January 2012, ASX has changed the AQUA rules, and the associated definitions, to allow it to admit to trading status products that reference fixed interest underlying instruments. The rule changes allow ETFs to have certain fixed interest assets and indices as underlying instruments.

60 The underlying instruments in the extended definition include exchange traded bonds or debentures. They may also include bonds or debentures which are included in a recognised index, or bonds or debentures that are issued by a government, semi-government or prudentially-regulated entity. The rules impose restrictions on what indices or non-exchange traded bonds or debentures can underlie an ETF to help ensure that there is adequate information available to promote market pricing being sufficiently related to NAV.

61 In Australia, bonds and debentures trade substantially through the Yieldbroker professional market. Professional debt markets are transparent only to institutions (e.g. issuers of AQUA products), wholesale participants who act as market makers, and authorised participants who arbitrage the difference in the primary market for the assets underlying the ETF and secondary markets for ETF securities.

Managed fund products

62 As mentioned earlier, the AQUA rules provide for admission to trading or quotation of three different classes of open-ended scheme and corporation-issued AQUA products: ETF securities, managed fund products and structured products. All three product types would be expected to generally

trade at a price close to NAV or the price that reflects the underlying instruments that the product seeks to track.

63 There are important distinctions between managed fund products and ETF securities. ETFs disclose portfolio holdings daily. Issuers of managed fund products admitted to trading status on the AQUA market must offer continuous issue and generally daily redemption and publish their NAV daily. Unlike an ETF, for which ASIC may give exemptions under the Corporations Act, for managed fund products, redemption is not restricted to authorised participants.

64 An issuer of managed fund products may actively manage the fund to outperform rather than track an index or to achieve some other investment objective.

ASIC's role in regulating ETFs

65 ASIC has a particular close regulatory involvement with ETFs.

66 We remain in close dialogue with ASX on proposed refinements and amendments to the AQUA rules.

67 We provide informal feedback on draft PDSs for ETFs, including determining whether the product is of the kind intended for quotation as an ETF, before the ETF units are approved by ASX for quotation.

68 We continue to remain in contact with other regulators about ETFs, including the Securities Exchange Commission (SEC) in the United States and the Securities and Futures Commission (SFC) in Hong Kong. We take into account international literature and media on ETFs to inform our approach. ETFs are also a key issue on the current agenda for IOSCO (SC5): see Section B.

69 In late 2011, we conducted surveillance at the offices of some responsible entities of ETFs using our powers under s601FF to check compliance. This formed part of our program of risk-based surveillance of responsible entities and included verifying appropriate documentation in a number of important areas of compliance risk. We took this opportunity to have broader discussions with key staff involved in management of the ETFs to inform our understanding of the industry. We also had meetings with other stakeholders, including certain ratings agencies.

70 We continue to consider how the current regulatory framework applies to ETFs and how compliance can be achieved. We are currently having discussions with the ETF industry about how the periodic statement provisions of the Corporations Act apply to ETFs.

71 We have issued a consumer alert about ETFs on our MoneySmart website to educate investors about the potential risks and benefits of investing in ETFs and will continue to be pro-active in this area for retail investors and the market generally.[6]

[6] https://www.moneysmart.gov.au/investing/complex-investments/exchange-traded-funds-(etfs).

B Regulation of ETFs and international principles

Key points

In this section, we look at the regulatory position on ETFs in other key jurisdictions.

We also explain how Australian regulation addresses the proposed IOSCO principles for regulation of ETFs.

Liaison with other jurisdictions

72 The ETF market developed to significant scale in major overseas jurisdictions while the ETF market in Australia was relatively small. In identifying regulatory issues that might arise, we have monitored international literature and discussions about ETFs. We have been in contact with other regulators about ETFs, including the SEC in the United States, the SFC in Hong Kong and the Financial Services Authority (FSA) in the United Kingdom.

73 We will continue to be in contact as needed to ensure we are aware of international developments. References to some key international sources are listed under ‘Other references’ in the ‘Related information’ section of this report.

Proposed IOSCO principles for regulation of ETFs

74 ETFs are a key issue on the current agenda for IOSCO’s Standing Committee 5 on Investment Management (SC5). This committee recently issued a consultation paper setting out proposed principles for regulation of ETFs: see Table 2. In this section, we explain how the proposed principles may be addressed in Australia. We are open to continuing dialogue with ETF issuers about the application of these principles and will take into account Australian industry perspectives in providing input to the IOSCO consultation process.

75 We consider that regulation in Australia is in line with proposed IOSCO international standards and reflects consideration of the issues identified in IOSCO’s consultation. Our view is supported by surveillance of current ETF issuers in Australia, and discussion of these issues with certain ratings agencies and other industry participants. We will undertake ongoing surveillance and other engagement as appropriate to ensure that those standards continue to be addressed.

Table 2: Summary of proposed IOSCO principles for regulation of ETFs[7]

	Principle	Discussion
1	Regulators should encourage disclosure that helps retail investors to clearly differentiate ETFs from other exchange traded products.	See paragraphs 76–101
2	Regulators should seek to ensure a clear differentiation between ETFs and traditional collective investment schemes, as well as between index-based and non index-based ETFs through appropriate disclosure requirements.	
3	Regulators should encourage all ETFs, in particular those that use or intend to use more complex strategies, or other complex techniques, to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with such strategies or techniques.	See paragraphs 102–109
4	Regulators should consider imposing disclosure requirements with respect to the way in which an ETF will replicate the index (or the asset basket or the reference portfolio) it tracks (e.g. physically holding a sample or full basket of the securities composing the index (or the asset basket or the reference portfolio) or synthetically).	
5	Regulators should consider imposing requirements regarding the transparency of an ETF’s portfolio or other appropriate measures in order to provide adequate information to investors concerning: • the index (or the asset basket or the reference portfolio) tracked and its composition; and • the operation of performance tracking in an understandable form.	
6	Regulators should consider imposing requirements regarding the transparency of an ETF’s portfolio or other appropriate measures in order to facilitate arbitrage activity in ETF shares.	See paragraphs 110–129
7	Regulators should encourage the disclosure of fees and expenses for investing in ETFs 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.	See paragraphs 102–109
8	Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities.	
9	All sales materials and oral presentations used by intermediaries regarding ETFs should present a fair and balanced picture of both the risks and benefits of such products, and should not omit any material fact or qualification that would cause such a communication to be misleading.	See paragraphs 130–140
10	In evaluating an intermediary’s disclosure obligations, regulators should consider who has control over the information that is to be disclosed.	

[7] IOSCO SC5, *Principles for the regulation of exchange traded funds*, March 2012, www.iosco.org.

Principle	Discussion
11 Before recommending the purchase, sale or exchange of an ETF, particularly a non-traditional ETF, an intermediary should be required to take reasonable steps to ensure that recommendation is based upon a reasonable assessment that the product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.	See paragraphs 130–140
12 Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations when recommending any ETF.	
13 Regulators should assess whether the securities laws and applicable rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interests raised by ETFs.	See paragraphs 141–149
14 Regulators should consider imposing requirements to ensure that ETFs appropriately address the risks raised by counterparty exposure and collateral management.	See paragraphs 150–161
15 ETF exchanges should consider adopting rules to mitigate the occurrence of liquidity shocks and transmission across correlated markets (e.g. automatic trading interruption mechanisms)	See paragraphs 162–177

Distinguishing ETFs from other products (Principles 1 and 2)

Principle 1

Regulators should encourage disclosure that helps retail investors to clearly differentiate ETFs from other exchange traded products.

Principle 2

Regulators should seek to ensure a clear differentiation between ETFs and traditional collective investment schemes, as well as between index-based and non index-based ETFs through appropriate disclosure requirements.

ETFs and other exchange traded products

76 Retail investors may not easily differentiate between the risk profiles of similarly named products. This raises the risk that investors may purchase structured products or managed fund products that are not ETF securities in the belief that they are investing in an ETF.

77 As at 19 March 2012, there were around 46 structured products quoted on the AQUA market, issued by three different issuers. Some structured products may look and feel like ETFs, as they also track share indices or other investments. These products may have names such as 'exchange traded notes', 'exchange traded commodities', 'exchange traded international securities' or 'trackers'—or abbreviations of these terms.

78 However, structured products admitted to trading status on the AQUA market are different from ETFs in a number of respects:

- The product may be an unsecured promise to pay the investor, rather than an interest in a registered managed investment scheme to which certain regulatory protections apply, including disclosure and governance requirements.
- Structured products are generally not backed by the pools of securities that underlie physical ETFs. Rather, they rely on the balance sheet of structured product issuers (or in some cases, a parent company guarantor), although, in some structured products, security may be provided by the issuer.
- Counterparty risks for structured products may be higher than for synthetic ETFs, as certain ASX requirements for synthetic ETFs (see paragraph 159) do not apply.
- There is no restriction on the investor’s exposure to counterparty credit risk, which may cover 100% or more of the amount paid by investor for the product.

79 Retail investors may mistakenly assume that the rights and protections applying to ETFs apply to all exchange traded products.

80 There is also a risk that, in an effort to avoid the regulatory requirements that apply to ETFs, issuers may launch new products as structured products rather than ETFs, where it would be more appropriate for the product to be structured as an ETF, given the protections that apply to managed investment schemes.

81 To ensure investors are not misled, we expect PDSs for structured products and where appropriate promotional material to ensure that it is clear on what basis the products are admitted to trading status. This can help to avoid the possibility of confusion that the product is an ETF security or carries the protections applying to ETFs or other registered managed investment schemes.

82 We are also concerned to ensure that where practicable, product names are not confusing for retail investors and reflect that nature of the product on offer: see paragraphs 85–88.

83 Retail investor education about the risks of structured products and the significance of naming conventions is important, through means such as ASIC’s MoneySmart website and the general and financial media.

84 For example, information about ETFs on our MoneySmart website highlights that structured products that might have up to 100% swap counterparty exposure should not be mistaken as an ETF and that risks to investors inherent in structured products may be significantly greater.[8]

[8] https://www.moneysmart.gov.au/investing/complex-investments/exchange-traded-funds-(etfs).

Naming conventions

85 We consider that product names that more clearly reflect the nature of the product can help to alert retail investors to the type of product and associated risks.

86 To improve investor understanding of these kinds of products, issuers need to meet certain naming conventions in their product descriptions to avoid ASIC objecting to the admission of the product to trading status on the AQUA market.

87 ETF securities quoted on the AQUA market generally need to include the word '(synthetic)' at the end of their product name where, broadly, they use synthetic rather than physical holdings of the underlying instrument to ensure performance. A similar approach is taken to structured products. We have also required issuers of structured products quoted on the AQUA market—such as exchange traded commodities, exchange traded certificates and exchange traded notes, all of which are sometimes referred to collectively as 'exchange traded products'—to have '(structured product)' at the end of their name to avoid investor confusion between these products and ETFs (including ETFs based on commodities).

88 We may also consider further developing appropriate naming conventions for the structured products and managed funds markets, as new products are developed and new risks identified. We will continue to work with ASX and issuers in this regard.[9]

ETFs and other unlisted managed investment schemes

89 We expect that PDSs for ETFs, and where appropriate other promotional material, will clarify key differences between ETFs and other managed investment schemes. ETF issuers need to take care that all their sales literature meets the requirements of the Corporations Act and that it is not misleading, given that many investors may be more experienced with unquoted managed investments. Specifically, investors need to understand what investment strategy is to apply. This includes whether the ETF investment strategy is to track an index.

90 A key distinction between ETFs and many other managed investment schemes is that ETF retail investors cannot seek redemption of their units in an ETF but must sell on-market. Most Australian ETFs that have their ETF securities admitted to trading status on the AQUA market have small-to-moderate funds under management and a limited diversity of unit holders. With the relatively low turnover among retail investors, high reliance is placed on market makers

[9] In February this year, we announced measures to help ensure issuers of debt products such as debentures and notes provide investors and financial consumers with the information they need to make informed decisions about investing in these products. The measures included changes to the naming of both listed and unlisted retail debt products to better reflect the nature of the product. See MR 12-18 *ASIC warns about secured debt products*, 8 February 2012, http://www.asic.gov.au/asic/asic.nsf/byHeadline/12-18MR%20ASIC%20warns%20about%20secured%20debt%20products?opendocument.

and authorised participants to provide liquidity in the secondary market to enable other buyers and sellers to trade at prices reflecting NAV.

91 The arbitrage mechanism employed by authorised participants and market makers should ensure liquidity as there will be an incentive to trade with an investor who is willing to take market prices. This is provided that there continues to be liquidity in the underlying assets to enable hedging by the authorised participant or market maker. However, we expect that, in line with market practice, disclosure of this risk should be provided in the PDS so that investors are aware of it.

92 Our current view of the industry is that there is not a lack of general liquidity, as borne out by the moderate spreads, and no immediate concerns have been raised in relation to the activities of the authorised participants and market makers. However, we will continue to focus on market liquidity and the prevailing spreads for each ETF. Availability of liquidity is an important issue and will depend over time on the effectiveness or market making obligations and practice, and investor interest in particular ETFs and particularly on the liquidity of the underlying assets of an ETF. Additional issues would arise if the underlying assets of an ETF were illiquid (and there was no liquid derivatives market), as might occur for certain emerging equity market-referenced ETFs. We will therefore pay particular attention to liquidity in relation to any product of this kind.

ETF securities and managed fund products on AQUA

93 Managed investment schemes that have interests admitted to trading status on the AQUA market as managed fund products will be distinct from ETF securities or structured products. We consider there is a risk of confusion that arises for these managed fund products, in that retail investors might assume that the portfolio of the fund will be disclosed daily, as for an ETF.

94 We expect the PDS for an AQUA-admitted managed fund product, and where appropriate other promotional material, to be clear about the basis on which interests in the fund are quoted to avoid the possibility of confusion that the fund is an ETF. We consider that it would be misleading to refer to such a fund in its name or otherwise as an ETF, whether as an active ETF or otherwise.

95 Managed fund products can be admitted to trading status on the AQUA market if the fund is actively-managed—that is, the issuer seeks to out-perform rather than track an index or value of specified assets, or has an investment strategy that does not refer to the value of an index or specified assets.

96 No ETF on the AQUA market has an active management strategy. We will work with ASX and issuers to determine if such a product could be admitted under the AQUA rules without undue risk of investor confusion.

97 We will work with ASX and industry to ensure managed fund products are clearly distinguished from ETFs. We will also be discussing with ASX the naming conventions that should apply to these products.

Foreign ETFs

98 Foreign-originated products that are called ETFs may be listed on ASX (as an 'exempt foreign listing') or admitted to trading status on the AQUA market where the instrument traded is a security, a derivative or an interest in a managed investment scheme. A foreign jurisdiction could allow an investment structure to be referred to as an ETF, even though it is not regulated in a way that achieves substantially equivalent outcomes to Australian regulation of registered schemes that are ETFs.

99 This raises questions about the appropriateness of any new listed foreign entity referring to itself as an 'ETF'. However, it may not be possible to prevent promoters in Australia from using a product name that contains a reference to ETF, given existing foreign usage and existing products that trade in the listed environment that are not registered schemes (e.g. the issuer is a foreign corporation).

100 The only currently-listed foreign ETFs are US investment companies or trusts of a kind that ASIC has generally recognised as regulated in a way that achieves substantially equivalent regulatory outcomes. We would be concerned about the availability on Australian licensed markets of investments based on foreign ETFs that are not regulated overseas in a way that achieves substantially equivalent outcomes, given our policy in Regulatory Guide 178 *Foreign collective investment schemes* (RG 178).

101 Investor education and disclosure continue to be important to minimise confusion between different types of ETFs and to explain some of the specific risks that are relevant to a foreign ETF.

Disclosure of tracking and performance (Principles 3, 4, 5, 7 and 8)

Principle 3

Regulators should encourage all ETFs, in particular those that use or intend to use more complex strategies, or other complex techniques, to assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner and whether it addresses the nature of risks associated with such strategies or techniques.

Principle 4

Regulators should consider imposing disclosure requirements with respect to the way in which an ETF will replicate the index (or the asset basket or the reference portfolio) it tracks (e.g. physically holding a sample or full basket of the securities composing the index (or the asset basket or the reference portfolio) or synthetically).

Principle 5

Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio or other appropriate measures in order to provide adequate information to investors concerning:

- the index (or the asset basket or the reference portfolio) tracked and its composition; and
- the operation of performance tracking in an understandable form.

Principle 7

Regulators should encourage the disclosure of fees and expenses for investing in ETFs 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.[10]

Principle 8

Regulators should encourage disclosure requirements that would enhance the transparency of information available with respect to the material lending and borrowing of securities.

102 ASIC has been reviewing PDSs for ETFs to check compliance with the Corporations Act and in light of the matters referred to in these principles. The issuer has the responsibility to comply with the Corporations Act. We consider that current market practice for disclosure by ETF issuers, including in PDSs, in seeking to comply with the general disclosure obligations in the Corporations Act, does address the matters referred to in these principles as is relevant for disclosure in that form. We expect further PDSs to continue to meet these principles.

103 In addition to the general disclosure requirements of s1013D and 1013E of the Corporations Act, Principle 7 is specifically addressed by the requirements in Sch 10 of the Corporations Regulations 2001 (Corporations Regulations), which regulates disclosure of fees and expenses.

104 Further, we expect responsible entities of ETFs to comply with requirements for continuous disclosure as an unlisted disclosing entity, which generally would include disclosure of any change that may influence those who commonly invest in

[10] For more on best practice standards for fee disclosure, see IOSCO Technical Committee, 'Elements of international regulatory standards on fees and expenses of investment funds', September 2004, www.iosco.org.

securities in deciding whether to acquire an interest in the ETF, unless that change is reflected in an updated PDS. Such changes would include any material change in policy or practice in the use of derivatives or securities lending or borrowing.

105 We expect that industry (including product manufacturers and intermediaries as well as ASX) will continue educating investors about foreign ETFs and Australian ETFs with an international exposure, and the specific significant risks that may arise from ETF investment. International aspects can give rise to significant risks and disclosure of these risks in the PDS is required by the Corporations Act.

106 Most ETFs involving foreign assets that are currently traded in Australia are not hedged against currency risk. Foreign taxes may apply to investments in foreign-domiciled ETFs (even if they are traded on an Australian market such as the ASX). Again, we expect that disclosure of these specific significant risks will be required by the Corporations Act.

107 We are aware that investors need to understand these disclosures. We have issued a consumer alert on our MoneySmart website and will continue to consider if further initiatives are appropriate. In August 2011, information was published on the MoneySmart website explaining some of the key risks of both physical ETFs and synthetic ETFs for retail investors.[11] We have also consulted with ASX about educational material on ASX's website.

108 Retail investors can benefit from access to simple, low-cost ETFs, which can have an important place in their investment portfolios. However, as the ETF market continues to grow, it is important that retail investors can distinguish simple ETFs from riskier and more exotic variations. Information campaigns and investor guide publications alone will not achieve this desired outcome, and consumers will increasingly rely on effective product labelling and design.

109 Further, many retail investors trade ETFs without first receiving financial advice, including SMSF trustees using their retirement funds. This dis-intermediated nature of ETFs heightens our interest in ensuring retail investors are confident and informed. Because ETFs are also traded on a secondary market, it is likely that many retail investors do not access PDSs and this increases the possibility that they may not be aware of all the risks. We intend to discuss with ASX, major stockbrokers and, as appropriate, ETF issuers how effective disclosure might be provided as part of the process by which retail clients place orders to buy ETF units on the market (unless the disclosure has already been made).

[11] https://www.moneysmart.gov.au/investing/complex-investments/exchange-traded-funds-(etfs).

Transparency to promote arbitrage (Principle 6)

Principle 6

Regulators should consider imposing requirements regarding the transparency of an ETF's portfolio or other appropriate measures in order to facilitate arbitrage activity in ETF shares.

110 ASIC considers that current market practices are facilitating arbitrage activity in ETF securities, ensuring that the market price generally reflects NAV.

111 In Australia, market practice is for the constitution of the particular combination and amount of the underlying instruments that will be exchanged for ETF units (i.e. the creation and redemption baskets) in ETFs whose interests are quoted in Australia to be disclosed to authorised participants. Since these baskets closely reflect the portfolio, the disclosure does facilitate arbitrage activity for ETF securities.

112 NAV per unit of the underlying assets and the price at which an ETF unit can be bought and sold on-market are likely to differ, at least to some extent. The prospect for some deviation is assumed by the arbitrage mechanism involving authorised participants and market makers. However, if the differential becomes too great, it can be problematic for investors who will be trading at an 'incorrect' price. As noted in our report with ASX to the Minister for the first year of operation of the AQUA market, no material difference was found between the market price and NAV per unit for ETFs at that time. Based on various analyses by ASIC, we do not currently consider this to be a material problem.

Market making requirements

113 Responsible entities of ETFs have obligations under the AQUA rules to ensure market making. To meet ASX requirements, ETF issuers (generally through market makers appointed by them) are required to make markets by ensuring that for 80% of the trading day, a 'reasonable' bid and ask is maintained in the market. There are also other limitations on when a market maker is expected (or required) to make a market.

114 Responsible entities of ETFs have quoting obligations (generally performed through market makers appointed by them) for a maximum spread (being the offer price less the bid price, when providing two-way quotes) as well as minimum volumes. We are aware that in a stressed market, it would be predictable for market makers to widen their quotes or cease quoting as they seek to manage risk and protect themselves.

115 We have observed that market makers typically tend to provide bid and ask prices from approximately 10:30 am Australian Eastern Standard Time (AEST) onwards. This is because, for ETFs that have ASX-listed securities as their

underlying asset, each of the relevant securities only commences trading sequentially in alphabetical order on ASX after 10 am. Therefore, market makers will be reluctant to price until trading in all the index opens. This results in wide bid–ask spreads from the start of the opening single price auction (ETFs can trade from 10:00 am) until the market makers begin quoting.

116 We have noted that a number of trades during this period (constituting a very low proportion of trades by value in the overall ETF market) have deviated substantially from NAV and the previous day's close (some by more than 10%). This predominately occurs when orders 'at market' are placed in ETFs which typically have wide bid–ask spreads and thin volumes in this part of the day. The bid–ask spread then often returns to 'normal' levels after market makers begin quoting.

117 As a result, ETF charts can display price 'spikes', symptomatic of illiquid and volatile stocks. Some risk also arises during other periods of low market maker activity, such as shortly before the close of trading when market makers are seeking to adjust their portfolios.

118 While we continue to monitor this issue, the volumes and value of trades that execute considerably away from 'fair value' are not considered so significant at this stage as to affect confidence in the market. However, if the situation persists, it has the potential to undermine the confidence of investors and the integrity of the market over the long term.

119 At this stage, we are addressing the issue of 10.00–10.30 am opening prices by supporting education and reminding participants that they have an obligation to filter orders to ensure that at-market orders do not result in trade executions that do not reflect fair value. We are also taking compliance action where warranted. This issue was highlighted in a recent ASIC report.[12]

120 We have contacted several market participants through which these orders were placed. As a result, these participants have put in place new filters and processes to ensure that these orders, which are usually initiated by online retail clients, are reviewed by the participants' designated trading representatives before being released to the market. We closely monitor trading in ETFs and are continuing to consider further action on trading at anomalous prices.

121 A related issue is whether ASX should exclude ETFs from the opening auction. However, some ETF issuers are opposed to ETFs having different trading hours to other securities that trade on ASX and believe it is matter of educating investors about the issue. At this stage, there is no proposal to change the trading hours for ETFs generally.

[12] See our report *ASIC supervision of markets and participants July to December 2011* (REP 277), February 2012, pp. 7 and 12.

Importance of liquidity of underlying assets

122 ETFs may offer exposure to less liquid investments such as small companies, emerging markets or certain commodities. This can limit the ability of market makers to manage risk and take advantage of arbitrage opportunities, resulting in wider spreads and consequently, increased transaction costs to the investor.

123 To the extent that the underlying assets are of lower liquidity, to meet the requirements under the Corporations Act, we expect that the PDS would need to adequately disclose the implications as a significant risk.

Assets traded in foreign markets

124 Some ETFs track US agricultural commodities futures contracts that do not trade until 11.00 am Australian Eastern Daylight Time (AEDT). US agricultural commodity markets are more volatile than markets for US equities and fixed interest generally.

125 For Australian ETFs that reference US agricultural commodities market indices, ASX has advised that trading will commence at 11.00 am during AEDT, because this is when US futures market prices are available, to permit market makers to adequately manage risk and provide liquidity support.

126 ETFs that track an international index or assets may present the problem that the underlying reference index is not being actively priced during trading of the ETF on the ASX. As a general rule, unless the market for the ETFs referenced underlying instrument is particularly volatile, all ETFs will continue to trade during standard market hours. This is on the basis that ASX considers that there are means available to market makers to adequately price during trading hours on ASX. This could be through using derivatives or component indices if the underlying assets are not being traded. ASIC will monitor if problems arise.

iNAV and NAV

127 Publication of an estimate of current NAV (iNAV) throughout the trading day assists accurate ‘price discovery’, and material variations between iNAV and actual NAV are unlikely to be allowed to continue for any material period in normal circumstances.

128 Typically, ETF issuers can elect to provide to the market near-continuous (typically updated every six or 30 seconds) iNAV (except in limited circumstances where the underlying instruments are not trading). Most ETF issuers provide this on their websites as a matter of course to support confidence in their product. This can help retail clients and might also provide a checkpoint for authorised participants and market makers.

129 While iNAV is indicative, publication of correct NAV before commencement of trading on the following day is important to an informed market. NAV may be incorrectly calculated by the responsible entity (or its delegates) and unit pricing errors are not uncommon in managed funds generally. Also, there is a risk that NAV may not be disclosed by the responsible entity for a date on which issues or redemptions are to occur at all or in a timely manner. We consider this aspect warrants particular attention by responsible entities of ETFs in monitoring compliance arrangements, and we may continue to conduct surveillance to check compliance.

Marketing of ETFs (Principles 9–12)

Principle 9

All sales materials and oral presentations used by intermediaries regarding ETFs should present a fair and balanced picture of both the risks and benefits of such products, and should not omit any material fact or qualification that would cause such a communication to be misleading.

Principle 10

In evaluating an intermediary's disclosure obligations, regulators should consider who has control over the information that is to be disclosed.

Principle 11

Before recommending the purchase, sale or exchange of an ETF, particularly a non-traditional ETF, an intermediary should be required to take reasonable steps to ensure that recommendation is based upon a reasonable assessment that the product is consistent with such customer's experience, knowledge, investment objectives, risk appetite and capacity for loss.[13]

Principle 12

Intermediaries should establish a compliance function and develop appropriate internal policies and procedures that support compliance with suitability obligations when recommending any ETF.

130 ETFs in Australia are a relatively recent phenomenon and products have tended to be simple index trackers. With the introduction of new synthetic ETFs, structured products, fixed interest ETFs and potentially further 'exotic' ETFs, it will be all the more important for retail investors to understand the different

[13] Suitability has a broad definition: 'the degree to which the product or service offered by the intermediary matches the retail client's financial situation, investment objectives, level of risk tolerance, financial need, knowledge and experience.' See IOSCO Joint Forum, *Customer suitability in the retail sale of financial products and services*, April 2008, available at http://www.bis.org/publ/joint20.pdf.

products and risks and for financial advisers to provide balanced information and ensure suitability when making recommendations.

131 In Australia, all sales material and oral presentations are subject to the requirement that they not be misleading under the Corporations Act and the *Australian Securities and Investments Act 2001* (ASIC Act). Promotional communications that unfairly represent investment in an ETF or are unbalanced may be likely to mislead. Such activities may be inconsistent with the obligation of Australian financial services (AFS) licensees to do all things necessary to ensure they carry on their business honestly, efficiently and fairly. We have recently consulted on further guidance in the area of advertising: see Regulatory Guide 234 *Advertising financial products and advice services: Good practice guidance* (RG 234).

132 To enable sales of interests in an ETF, the responsible entity of the ETF must prepare a PDS based on the information it and certain other persons connected with the responsible entity are aware of, as required by Pt 7.9 of the Corporations Act. In general, intermediaries are not responsible for the content of the PDS and must not alter it. Intermediaries are responsible for providing disclosure about their own financial services in a Financial Services Guide where required by Pt 7.7 of the Corporations Act and ensuring that any Statement of Advice they must give if they give personal advice includes information about the advice as required by Pt 7.7. Intermediaries are also responsible for ensuring that if they pass on disclosures about ETFs prepared by others, the recipient is not misled about the extent if any that the intermediary has assessed or checked any of the disclosure, given the relevant circumstances, including the role of the intermediary in any financial product advice about the product.

133 When recommending investment in an ETF to a retail client by way of personal advice, an AFS licensee providing the advice or its authorised representative must give appropriate advice by reference to reasonable investigation of the ETF investment ('know your product') and reasonable inquiry into the client' personal circumstances ('know your client') under s945A of the Corporations Act. Knowing the client would cover relevant aspects of their experience, knowledge, investment objectives, risk appetite and capacity for loss. The nature, scale and complexity of the ETF is relevant to determining what investigation and inquiry is reasonable.

134 An AFS licensee must comply with its licence conditions, including the condition requiring it to establish and maintain compliance measures that ensure, as far as is reasonably practicable, that it complies with the provisions of the financial services laws. In particular, this includes the requirements for personal advice to be appropriate having regard to the clients personal circumstances under s945A. An AFS licensee also has supervisory functions for its representatives, and in particular has an

obligation to take reasonable steps to ensure its representatives comply with the financial services laws under s912A(1) of the Corporations Act.

Non-advised retail investors

135 There is no requirement for a retail investor to invest in an ETF only on the recommendation of an AFS licensee or authorised representative. This means the investor may lack assistance in determining the suitability of investment. This significantly increases the risk of investors making unsuitable investments, in particular where the investment is in a more complex investment product. As ETFs are listed or quoted products traded on a secondary market, it is likely that many retail investors will trade these products without having accessed or understood disclosure documents.

136 ASIC continues to monitor the introduction of any new synthetic and exotic ETFs, as they may not be suitable for the majority of retail investors. We intend to continue with investor education and awareness through our MoneySmart website and the media, as well as monitoring financial advisers and other gatekeepers to help ensure retail investors are confident and informed.

137 We will discuss with industry participants and ASX whether it is appropriate to require pre-order disclosure to certain retail clients acquiring ETF securities, such as an electronic pop-up box, as used by brokers for certain partly paid instruments. Further, if problems emerge about the extent of retail client use of ETFs that are unsuitable for the client, we may consider whether there should be a requirement for advice about suitability as a precondition to investment for retail investors. This issue is also being considered in other jurisdictions. For example, the European Union recently consulted on potential suitability tests for execution-only complex products, such as ETFs.

Inverse and leveraged ETFs

138 There are no inverse or leveraged ETFs currently on issue in Australia, although they have been proposed. The FSA in the United Kingdom has stated that such products may be unsuitable for retail investors.[14]

139 We have monitored developments in the United States (and other jurisdictions) in light of the Australian regulatory approach for inverse and leveraged ETFs. We do not consider that such products should be admitted to trading status on the AQUA market at least until the international regulatory debate is more settled. Where an ETF's investment strategy is to achieve a positive or negative multiple of the performance of a particular index or asset over a defined time period (e.g. daily), there is a significant risk that many retail clients may not understand the implications of continuing to hold an ETF security over a longer period.

[14] FSA, Discussion Paper 11/1, *Product intervention*, January 2011.

140 If such ETFs were to be permitted in Australia, we would seek to ensure retail investors' use of these ETFs was suitable, given the specific risks associated with the periodic leverage reset feature of the ETFs.

Conflicts and ETFs (Principle 13)

Principle 13

Regulators should assess whether the securities laws and applicable rules of securities exchanges within their jurisdiction appropriately address potential conflicts of interests raised by ETFs.

141 In Australia, for ETFs that are registered managed investment schemes, responsible entities are subject to a number of duties relating to conflicts. If a conflict arises between the interests of members of the ETF and the responsible entity's interests, the interests of members must be preferred under s601FC(1) of the Corporations Act, and there is a similar duty for officers of a responsible entity under s601FD(1).

142 As an AFS licensee, the responsible entity must have adequate arrangements to manage conflicts of interest under s912A(1)(aa), discussed in Regulatory Guide 181 *Licensing: Managing conflicts of interest* (RG 181). Further, there are specific restrictions on transactions with related parties providing financial benefits out of scheme property or that could endanger scheme property under Pt 5C.7 of the Corporations Act.

Index provided by associate of ETF issuer

143 Some ETFs are based on indices designed specifically for a particular ETF. In some cases, the providers that compile and revise these indices may be related parties of the particular ETF issuer. This raises the risk that material non-public information may be communicated between the ETF issuer and the affiliated index provider. Specifically, there is a risk that disclosure of the state of ETF's portfolio could result in a change to the index to disguise poor tracking performance figures.

144 Australian laws do address potential conflicts of interests raised by ETFs with indices provided by associates of the ETF issuer. ASIC expects that, under the PDS disclosure obligations in the Corporations Act, PDSs for ETFs where index providers are associated with the issuer will set out material information about the rules that govern the inclusion and weighting of securities in each index. This includes the frequency of potential updates to the index so that index change is predictable. Any material change to those rules would also require disclosure under the PDS requirements or the continuous disclosure requirements. In addition, as part of its arrangements to manage conflicts under the Corporations Act, the responsible entity would

need to address the risk of disclosures to associates that would not be in the best interests of members.

Related party swap counterparties

145 A particular conflict would arise in the case of an ETF that obtains its return through entering into an asset swap with an affiliated counterparty, such as a bank affiliated with the ETF issuer. Whether such arrangements will be permitted will be affected by any rules that may be made. In any case, if ETFs that have related party counterparties to swap agreements were to be offered in Australia, the responsible entity would be under obligation to ensure that, in entering the agreement, it was acting in the best interests of members, and that it exercised care and diligence in assessing relevant risks. The responsible entity's arrangements to manage conflicts would need to manage the conflict that such arrangements may cause. In addition, a responsible entity will have to comply with the restrictions on related party transactions in entering such an agreement.

Related party authorised participants

146 Another particular conflict could arise if related parties were authorised participants, in that the ETF issuer might have an interest in not allowing competing participants to act as authorised participants. The responsible entity's arrangements to manage conflicts would need to manage the conflict that such arrangements may cause. In Australia, predominant use of related party authorised participants is not general practice and there is no indication that ETF issuers have been inappropriately limiting authorising potential participants. The presence of multiple authorised participants would help promote liquidity and market efficiency, as well as the marketability of the ETF.

Multiple classes

147 Use of multiple classes can result in increased operational risk from errors in attributing assets and liabilities among classes. Additionally, if a class goes into negative value, assets of another class theoretically could be used by the responsible entity to cover the deficiency, depending on the terms of the constitution. This risk could place the responsible entity in a position of conflict in its duties to members of different classes.

148 The daily publication of NAV and a clear investment policy would be likely to minimise the risk of errors and result in them being identified quickly. In any event, since ETFs currently have limited borrowings and derivatives exposure, the risk of a negative value is remote.

149 Any errors would also be addressed in breach reporting. In discussions with ETF issuers, we have emphasised the high importance of accurate NAV being published and informing ASIC and the market immediately of any issues.

Counterparty and collateral risks (Principle 14)

Principle 14

Regulators should consider imposing requirements to ensure that ETFs appropriately address the risks raised by counterparty exposure and collateral management.

150 Counterparty exposure and risks in management of collateral are some of the reasons why an ETF that is managed to track an index may not perform like the index. The collapse of a counterparty could create significant losses for an ETF.

151 A responsible entity of an ETF must have adequate risk management systems. This includes systems addressing the risk that the ETF will not achieve its tracking objectives due to counterparty exposure or other factors. Other factors that may affect the performance of an ETF include transaction costs and fees, and assets held under sampling replication being incompletely correlated with the index.

152 Even the NAV of ETFs that attempt full physical replication will not exactly follow the price of the index or investments they are designed to track. The tracking error may be caused by the fees and costs of the responsible entity, dividend payments, corporate actions being reflected by the fund differently from the index, taxes, and other factors such as operational errors that cannot be rectified intraday without loss or gain.

Securities lending

153 In assessing the risk of securities lending, it is important to note that none of the Australian registered scheme ETFs currently engages in any securities lending, and based on what ASIC has been told, they do not have any immediate proposals to do so.

154 Some 'foreign' ETF products available in Australia engage in securities lending in the US market. The US prospectuses for such products describe the securities lending process and the risks associated with it. Issuers have argued that for these foreign ETFs:

- the ETF issuers appear to have well-established, long-term programs;
- typically, the size of the securities lending relative to the size of the ETFs and the ETF market generally is small; and
- in any event, securities lending is generally considered to be a low-risk activity, with a very low number of settlement failures.

155 If an ETF that is a registered scheme proposes to lend securities, we expect the issuer to explain its program to ASIC. In addition, the securities lending risk will need to be disclosed in the PDS, together with disclosure of the risk and benefits, and a description of the processes and procedures that are in

place to address the risks. If securities lending is conducted, we expect the responsible entity's duties will require there to be an appropriately planned program where credit risk is carefully monitored on a daily basis to ensure adequate and appropriate risk mitigation, such as requiring adequate collateral to be posted by borrowers.

Derivatives

156 For ETFs, our primary focus is on the counterparty risk for over-the-counter (OTC) derivatives, where the counterparty is a third party bank or asset manager.

157 Some foreign regulation permits funded swaps to achieve replication. In this situation, the ETF issuer issues interests in the ETF for cash which is invested in a collateral basket, which is then the subject of a swap agreement with a bank. The ETF has only a security over the collateral for the obligation to pay an amount reflecting the return of the index. Investors are exposed up to 100% of their investment if the bank defaults.

158 There have been concerns, including from the FSB and BIS, that banks that are active in swap-based ETFs may be a source of contagion and systemic risk in the ETF market, especially where ETFs are used as a significant source of the bank's funding.[15] We want to ensure this problem does not arise in Australia.

159 ASX saw its first 'synthetic' ETF quoted in December 2010. Admission requirements imposed by ASX (based on discussions with ASIC) are more restrictive than in some other jurisdictions. For ETF holdings of derivatives that are not novated and cleared through an appropriate central clearing counterparty, the following current admissions principles apply:

- Counterparties must be an Australian deposit taking institution (ADI) or overseas equivalent (or have the benefit of an unconditional guarantee from one of these entities).
- The ETF must be managed to ensure it does not maintain more than a maximum of 10% of the ETF's NAV in exposure, in aggregate, to the counterparties (in effect, making the fund only a maximum of 10% 'synthetic').
- The collateral provided to the ETF under the derivative must be either certain assets permitted as underlying instruments under the AQUA rules which are also consistent with the investment objective of the fund, S&P/ASX 200 securities, cash or Australian government bonds (so that, for example, in the case of an ETF tracking the ASX 200 index, any collateral does not include low-grade illiquid assets that are of limited value if the fund fails).
- There must be no liability for investors to the issuer.

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[15] See FSB, *Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs)*, 12 April 2011 and BIS Working Papers, *Market structures and systemic risks of exchange-traded funds*, April 2011, No. 343.

160 We have advised ASX that we would not support admission to trading status of ETF securities that use at least OTC derivatives as a material form of replication unless they have the word '(synthetic)' in their name: see paragraphs 85–88. We take a similar position for structured products quoted on AQUA. We have also developed consumer awareness about this label, including through material on our MoneySmart website. We are reviewing what criteria should apply more specifically to determine which ETFs and other AQUA products must be called synthetic. We will consider action taken overseas to impose similar naming conventions on synthetic products (e.g. in Hong Kong). This review will allow us to either reaffirm the naming convention or take another (or additional) course of action that appropriately ensures that investors can be confident and informed when making investment decisions.

161 For non-synthetic ETFs, the use of derivatives has been modest. If an ETF that is a registered scheme proposes to enter derivatives constituting a portion of the value of the portfolio that is not very minor, we expect the issuer to explain its derivatives program to ASIC. In addition, the derivatives risk will need to be disclosed in the PDS, together with disclosure of the risk and benefits, and a description of the processes and procedures that are in place to address the risks. Where OTC derivatives are used, we expect there to be an appropriately planned program where credit risk is carefully monitored on a daily basis, to ensure adequate and appropriate collateral is posted by the counterparties to ensure credit risk is kept to minimum levels.

Markets in ETFs (Principle 15)

Principle 15

ETF exchanges should consider adopting rules to mitigate the occurrence of liquidity shocks and transmission across correlated markets (e.g. automatic trading interruption mechanisms)

162 'Flash crash' type events (e.g. as happened in US equity markets on 6 May 2010) may occur at crucial accounting times, such as the end of the day or end of the month. This could significantly affect company accounts, possibly triggering debt covenants or other contingencies, with serious consequences for the financial system. A source of risk lies in particular market circumstances which may cause market makers to withdraw ETF liquidity support. There is no reason to believe that ETFs will necessarily be the cause of such crashes. However, if such a crash were to occur, ETF unit prices may be more affected than other securities as there is less likely to be a body of orders away from the current price that will catch any sudden price movements before other investors can react.

163 There are two mechanisms which should reduce the impact of any unjustified price change, perhaps resulting from an error in a trading algorithm:

- All cash market securities, inclusive of ETFs, are subject to the application of an extreme cancellation range (ECR), which is intended to limit or mitigate large swings in index levels resulting from temporary price dislocation among a small group of stocks and/or index-based ETFs. This operates in the circuit breaker style as it is detective in nature, rather than preventative. If a transaction exceeds the ECR, trading is halted, those trades are cancelled and the ECR may be reset.
- In addition, securities that are traded across multiple market platforms are subject to a further, narrower price movement filter, an anomalous order threshold (AOT), which is intended to limit or mitigate execution risk (essentially 'fat finger' errors) as opposed to credit risk (client exposure to the market participant). Each market is currently allowed to determine its AOTs, but generally they prevent any single order from executing more than 10% away from a dynamically calculated reference price.

Market makers

164 Market makers may engage in high frequency trading (HFT). They may enter and withdraw many unexecuted orders every trading day. A number of academic studies to date find that HFT has contributed to a reduction in bid–ask spreads, which is one among many liquidity indicators. While in good times, there is evidence that HFT adds liquidity, in bad times, there may be a risk that HF traders simply withdraw from the market (e.g. the 'flash crash' in the United States on 6 May 2010).

165 We have issued individual no-action letters permitting market makers of certain ETF products to make naked short sales of those ETF products, subject to certain conditions. One condition is that, as soon as possible after the sale, the ETF market maker must purchase or apply for the issue of equivalent ETFs to settle the sale: see Regulatory Guide 196 *Short selling* (RG 196) at RG 196.64–RG 196.66.

166 Allowing naked short selling does create some potential risk of settlement failure and market disruption involving liquidity shocks and transmission to other markets. The risk of settlement failure implies a risk to the clearing house and any clearing participant acting for the defaulting party. This failure could arise from:

- failure of the ETF creation mechanism; and
- failure of the market maker.

167 Failure of the ETF creation process is a risk and it might arise from operational failure or failure of the ETF issuer. ETF issuers have a strong incentive to avoid any failure, but nevertheless it could occur. Further, once the underlying assets have been acquired to hedge any short exposure, the market maker will be protected against most price risk and so be able to

compensate the clearing house directly or indirectly via the clearing participant acting for it.

168 There is also risk of failure by a market marker. However, in terms of the direct impact of settlement failures, this risk is likely to be no different from the risk of any other active market participant's failure. While a naked short sale creates a risk, market makers will generally immediately mitigate this risk by acquiring the underlying assets (or highly correlated assets) at the time of the naked short sale.

169 Operationally, we ask applicants for no-action letters to provide details of the number of ETF trades entered into in a specified period, including the total value of those trades, how many trades failed to settle on time (if any) and the reasons for any settlement failure. A risk for market makers arises because, while the ETF market maker may apply for the creation of new ETFs, there is generally a minimum application amount for each ETF product, which may exceed the amount that it is actually short. From a policy perspective, we will consider giving relief on the basis that the risk of settlement failure is low because ETF market makers may apply for the creation of new ETFs to fulfil settlement obligations.

170 Where an ETF market maker applies to ASIC for a no-action letter, it must address whether it ensures that its capital base increases in proportion to its potential cumulative exposures (with each additional no-action letter from ASIC permitting it to make naked short sales of additional ETF products).

Short selling

171 Internationally, concerns have been raised about ETFs which have a much larger short interest than the interests on issue. This situation can arise when particular ETFs are used at a particular time primarily as a vehicle for persons wanting short exposure. To enable such short exposure, a loan of ETF securities can be made to the short seller, who is then able to make a covered short sale.

172 ETF units may flow to the market maker directly when the market maker is buying from the short seller, or indirectly back to the market maker via sales first to other buyers, who then sell to the market maker. If the market maker is subsequently carrying too large an inventory of ETF units for its purpose, it may choose to redeem the units. The short exposure is maintained by the obligation of the short seller to re-deliver ETF units under the securities lending arrangement while the units themselves have been cancelled with a consequent reduction in size of the assets within the fund.

173 The risks to the intermediaries undertaking securities lending may be mitigated in that the borrower is likely to be institutional, collateral will be posted, and the lender may have a diversity of borrowing counterparties. The

economic effect of these transactions is that the short seller will profit from any fall in the ETF unit price or vice versa. There are no indications that short sales of ETF securities are currently of such a magnitude in Australia as to raise systemic risk concerns.

174 One concern that has been raised is that purchasers could become the holder of interests which have not been issued by the issuer.[16] This cannot arise in Australia because no person can acquire units that have not been issued—they merely have a right to have the units transferred to them.

Failure by the ETF issuer

175 If an ETF issuer fails for whatever reason (e.g. fraud, loss of liquidity as investors 'rush for the exits', a bad business model or poor risk management), members and a range of counterparties may be left facing losses. An ETF issuer's management of risks to its financial resources is an important issue for ASIC. Given the current scale of the ETF market in Australia, it is unlikely that these losses will be large enough to create systemic risk.

176 ASIC imposes financial requirements on responsible entities. Those requirements are not intended to ensure that a responsible entity will not fail. However, the requirements are expected, among other objectives, to reduce the risk of a disorderly winding-up of registered schemes. In any event, scheme property is held on trust, separately from the property of the responsible entity of the ETF, so it should be protected from the claims of creditors of the issuer that are unrelated to the ETF despite the failure of the issuer. Given the restrictions on underlying assets of ETFs, the scheme property is likely to be able to be quickly liquidated with minimal losses. In addition, under the constitution of most ETFs, especially those that offer physical replication, redemption of interests held by authorised participants can be effected by *in specie* distribution.

177 Most ETF operators are not bodies regulated by APRA. Where ETF operators are required to be licensed and are not bodies regulated by APRA, so that the obligation to have adequate resources under s912A(1)(d) applies, the operator and custodians of the ETF's assets would need to meet minimum financial resources requirements, which have recently been enhanced.

[16] Bogan, Andrew A., Ph.D, Bogan, Elizabeth C., Ph.D, and Brendan Connor, 'Can an ETF collapse?', *Financial Times* (UK), 18 September 2010, http://ftalphaville.ft.com/blog/2010/09/18/346406/can-an-etf-collapse/.

Key terms

Term	Meaning in this document
ADI	Authorised deposit taking institution
AEDT	Australian Eastern Daylight Time
AEST	Australian Eastern Standard Time
AFS licensee	A person who holds an Australian financial services (AFS) licence under s913B of the Corporations Act Note: This is a definition contained in s761A of the Corporations Act.
AOT	Anomalous order threshold
AQUA market	The market created by ASX to specifically manage the admission of ETF securities, managed fund products and structured products (collectively referred to as 'AQUA products') on the ASX market and to provide access for AQUA product issuers to clearing and settlement services provided by the ASX Group
AQUA products	ETF securities, managed fund products and structured products
AQUA rules	Operating rules introduced by ASX in 2008 to facilitate the admission to trading status on ASX of AQUA products
ASIC	Australian Securities and Investments Commission
ASIC Act	*Australian Securities and Investments Act 2001*
ASX	ASX Limited (ACN 008 624 691) or the exchange market operated by ASX Limited
Ch 7 (for example)	A chapter in the Corporations Act (in this example, numbered 7)
[CO 05/26] (for example)	An ASIC class order (in this example numbered 05/26)
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act.
Corporations Regulations	Corporations Regulations 2001
ECR	Extreme cancellation range
ETF	Exchange traded fund
ETF securities	Financial products defined as ETF securities under ASX Operating Rules
iNAV	An estimate of NAV, calculated intra-trading day, rather than at the close of trading day

Term	Meaning in this document
IOSCO	International Organization of Securities Commissions
managed fund products	Financial products defined as managed fund products under the ASX Operating Rules
NAV	Net asset value, calculated at the close of trading on the relevant day
NTA	Net tangible assets
OTC	Over-the-counter
Product Disclosure Statement (PDS)	A document that must be given to a retail client in relation to the offer or issue of a financial product in accordance with Div 2 of Pt 7.9 of the Corporations Act Note: See s761A for the exact definition.
Pt 7.9 (for example)	A part of the Corporations Act (in this example, numbered 7.9)
RG 178 (for example)	An ASIC regulatory guide (in this example numbered 178)
s912A (for example)	A section of the Corporations Act (in this example, numbered 912A)
Sch 10 (for example)	A schedule of the Corporations Act (in this example, numbered 10), unless otherwise specified
SC5	IOSCO Standing Committee 5 on Investment Management
SMSF	Self-managed superannuation fund
structured products	Financial products defined as structured products under the ASX Operating Rules

Related information

Headnotes

exchange traded funds (ETFs), ETF securities, exchange traded products, managed funds, managed fund products, structured products, ASX, ASX Listing Rules, AQUA rules, IOSCO principles, disclosure, Product Disclosure Statement (PDS)

Class orders and pro formas

[CO 05/26] *Constitutional provisions about the consideration to acquire interests*

Regulatory guides

RG 178 *Foreign collective investment schemes*

RG 181 *Licensing: Managing conflicts of interest*

RG 196 *Short selling*

RG 234 *Advertising financial products and advice services: Good practice guidance*

Legislation

ASIC Act

Corporations Act, Div 2, Pts 5C.7, 7.7 and 7.9, s601FC(1), 601FD(1), 601FF, 761A, 912A, 912A(1)(aa), 913B, 945A 1013D, 1013E; Corporations Regulations, Sch 10

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