ASIC

Australian Securities & Investments Commission

REPORT 583

Review of exchange traded products

August 2018

About this report

This report is for issuers of exchange traded products (ETPs), market operators and persons facilitating ETP trading. It may also be of interest to advisers of retail investors. It sets out the findings and recommendations from our review of ETPs in Australia.

About ASIC regulatory documents

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Regulatory guides: give guidance to regulated entities by:

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- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

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Reports: describe ASIC compliance or relief activity or the results of a research project.

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Examples in this report are purely for illustration; they are not exhaustive and are not intended to impose or imply particular rules or requirements.

Contents

A Executive summary

Exchange traded products (ETPs)

1 Exchange traded products (ETPs) are open-ended investment products that are traded on a securities exchange market. ETPs trade and settle like shares and give investors exposure to underlying assets without owning those assets directly. ETPs differ from listed funds because they are open-ended: this means that the number of units on issue may increase or decrease daily depending on investor demand.

2 ETPs, especially exchange traded funds (ETFs), are increasingly popular with retail investors and self-managed superannuation funds (SMSFs). This is because of their accessibility, perceived low cost, transparency, intraday liquidity, diversification benefits and ability to provide exposure to new asset classes. There has been steady growth in both funds under management and the number of ETP products available on the market in Australia.

Note: An overview of the Australian ETP market is set out in Section C.

3 In light of the growing investment in ETPs and the type of investors in these products, we conducted a review to test whether the Australian ETP market is functioning well and delivering on promises to investors.

4 Our review had two main purposes:

(a) to check whether some of the perceptions about ETPs are consistent with how ETPs are operating—for example, the perception that ETFs are readily tradeable; and

(b) to examine how well ETPs are operating in Australia, especially in relation to their distinctive features, such as tracking errors, trading spreads, market making systems, and the role of authorised participants. We also looked at the liquidity of ETPs and considered information about indicative net asset values (iNAVs).

Focus and scope of our review

5 The review focused on two types of ETPs:

(a) passively managed ETFs with an investment objective to track an index or benchmark; and

(b) funds that are actively managed to outperform a benchmark or to achieve an absolute return objective (referred to as ‘active ETFs’ and ‘managed funds’).

Note: Our findings and recommendations in this report relate to both of these types of ETPs—except where we specify or where it is clear from the context that we mean otherwise.

6 Our review also looked at other issues that may affect retail investors, including:

(a) the marketing materials and product disclosure documents of issuers;

(b) the extent to which issuers are exercising stewardship of the underlying assets of the ETP; and

(c) the removal of ETPs from quotation on the relevant market.

7 Our review did not examine:

(a) the net asset value (NAV) of any particular ETP;

(b) any concerns about the rise of ETPs creating distortions in underlying markets (particularly in overseas markets where ETP trading and funds under management are more significant as a proportion of the underlying markets); or

(c) particular features of exotic products, such as structured products or exchange traded notes, although these are referred to throughout the report.

8 See Appendix 1 for details of our review methodology.

Key findings

9 Our review found that the Australian ETP market is generally functioning well and is delivering on promises to investors, but there are potential risks that require monitoring by issuers and oversight by market operators.

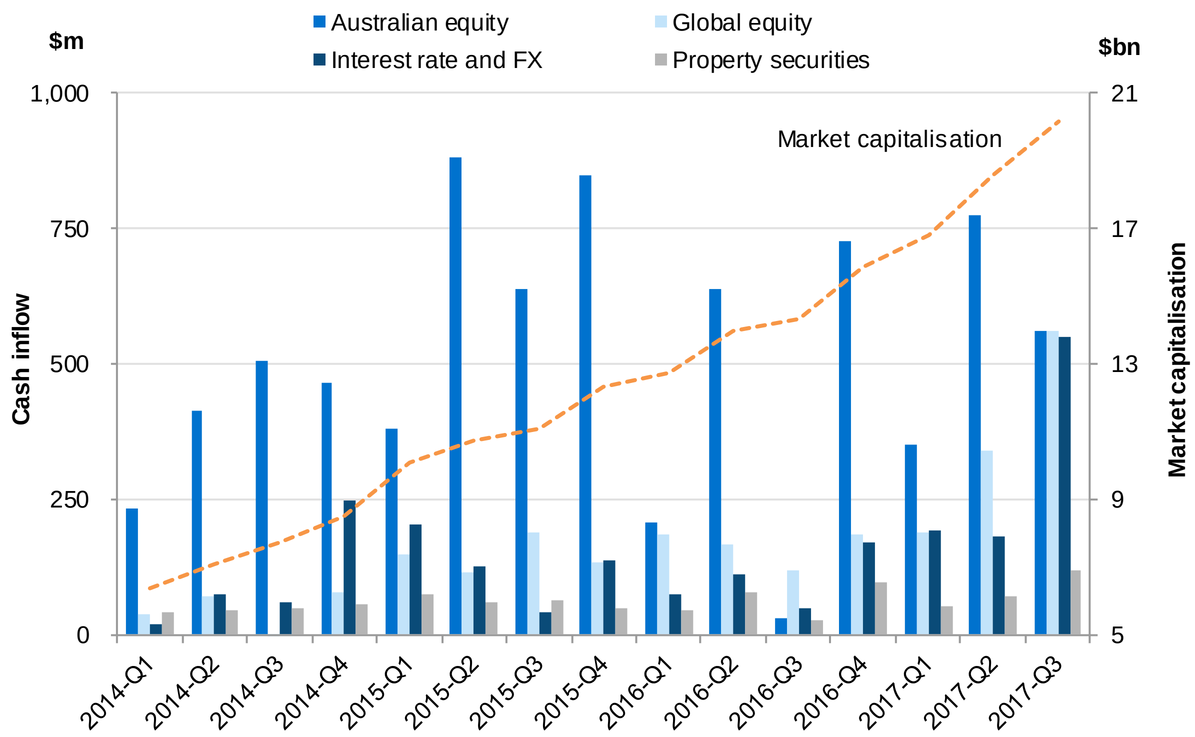
10 We found that ETP trading is generally liquid, bid–offer spreads are narrow and secondary market prices are generally close to the NAV of ETP units. However, this does not necessarily apply to all products, at all times. In particular, we observed that spreads do temporarily widen in some circumstances, meaning individual transactions may involve a higher spread than an investor may consider desirable. As the spread may significantly affect investor return, it is important that investors understand the size of the spread and its potential impact on their return when buying and selling ETPs.

11 Table 1 summarises our key findings. Our findings are based on data that we gathered from stakeholders from 1 January 2016 to 30 September 2017, as well as ETP trading data from ASIC’s market surveillance system for the period 2014–17.

Note: In Table 1, we mention a ‘market maker’. A market maker is a trading participant of the market where the ETP is traded. Market makers perform a fundamental role in ensuring that ETPs which do not have sufficient natural liquidity function efficiently. Market makers seek to provide continuous liquidity to the market by quoting buy and sell prices throughout the trading day—these prices are updated continually to reflect price changes in the underlying securities.

42 Figure 3 shows the quarterly cash inflow and market capitalisation of Australian quoted ETPs by the type of underlying assets.

Figure 3: Quarterly cash inflow and capitalisation of Australian quoted ETPs by type



Source: ASIC market surveillance system (MAI), January 2014 – September 2017.

Note: Excludes ETFs that are CHESS depository interests (CDIs) and feeder funds into international ETFs.

Note: See Table 4 in the appendix for the complete data used in this figure (accessible version).

Retail participation in the ETP market

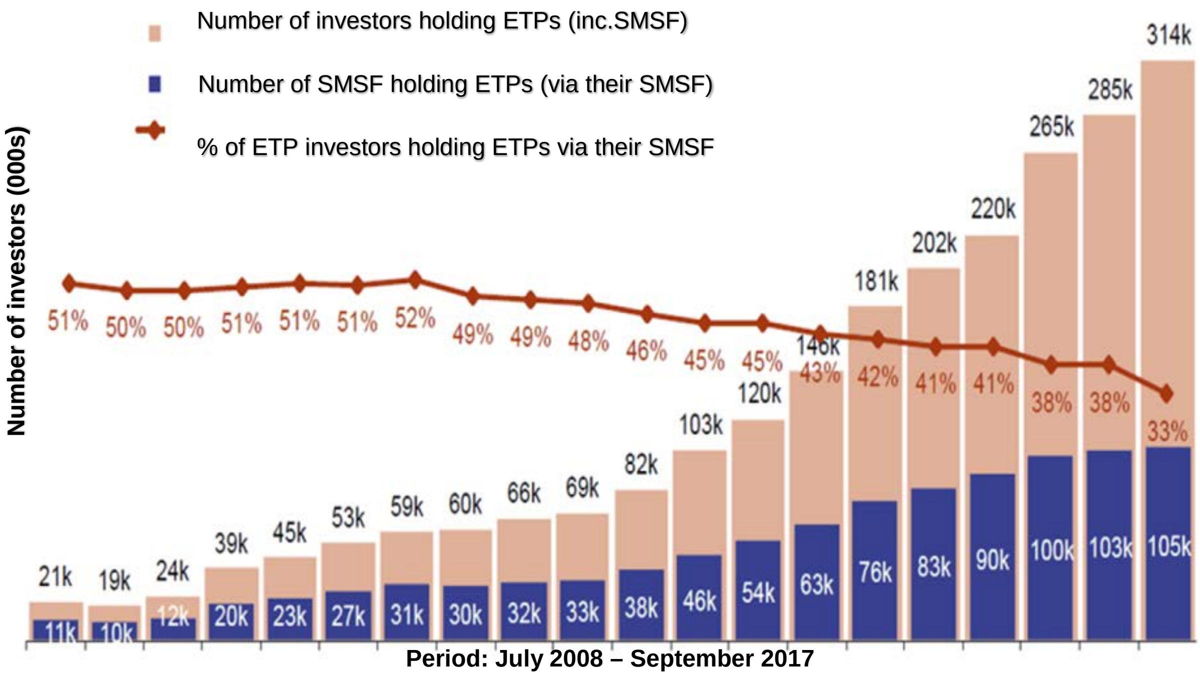
43 There is significant retail participation in the Australian ETP market, particularly from SMSFs. SMSF ownership of ETPs quoted on the ASX AQUA market represent more than 60% of the total ownership: see the ASX Australian investor study 2017. SMSFs were initially the key drivers in the uptake of ETPs as a cost-effective way of diversifying. While they still have a strong presence in the market, the next stage of growth is increasingly seeing more involvement from other self-directed investors and institutional investors.

44 By contrast, the investor composition in the American, Canadian and European ETP markets is very different from Australia because institutional investors are a large share of the market in those jurisdictions.

45 Figure 4 demonstrates overall growth in the number of investors holding ETPs, including the proportion of these investors that are SMSFs. While the

total percentage of ETP investors made up by SMSFs has moderated, they still remain a significant proportion of overall ETP investors.

Figure 4: ETP market size among SMSFs



Source: Investment Trends, *September 2017 exchange traded funds report*, survey concluded: September 2017 and report released: December 2017, p. 25.

Note: See paragraph 45 for an explanation of the trends shown in this figure (accessible version).

Retail investors' attraction to ETPs

46 The number of retail investors in the Australian ETP market continues to grow at a strong rate. The number of retail investors in the ETP market grew by 18% to 314,000 in the 12 months to 30 September 2017. While the survey indicates some limited attrition of ETP investors, it also reveals a growing wave of future investors likely to invest in ETPs.

> Note: The data for paragraphs 43–46 was taken from Investment Trends, *September 2017 exchange traded funds report*, survey concluded: September 2017 and report released: December 2017.

47 ETPs use features of both listed shares and traditional unlisted funds which make them an attractive option for retail investors. Like many unlisted funds, ETFs generally provide broad exposure to entire markets within an index. This provides diversification benefits when compared to buying an individual company's shares.

48 Like many listed shares, ETPs are generally liquid and can be bought and sold intraday. Investors in ETPs usually have transparency and flexibility as

to what price they may pay or receive for their ETP units. Investors can buy or sell different ETPs through their broker trading accounts in the same way they trade shares, with brokerage costs charged per trade. This ease of access is an important feature that attracts retail investors to ETPs.

49 Other key attractions of ETPs are the perceived lower fees than unlisted managed funds. Of the ETFs quoted on the ASX AQUA market, based on the management costs disclosed in each Product Disclosure Statement (PDS), the management expense ratio (MER) ranges from approximately 7 basis points (or 0.07%) to 74 basis points (or 0.74%) per annum.

50 There are also managed funds quoted on the ASX AQUA market with an active, hedge fund or alternative investment strategy that are more complex or higher risk than tracking an index—these funds typically charge a higher MER than passive ETFs and may also charge a performance fee. As at the time of the review, MERs for managed funds range from 49 basis points (or 0.49%) to 205 basis points (or 2.05%) per annum, and some charge performance fees of up to 20% of the amount by which the NAV produces an excess return above an appropriate benchmark for the asset class in question.

51 However, it is worth noting that the MER for ETPs does not include the following (all of which reduce investors' returns):

(a) transactional and operational costs paid out of the ETFs; or

(b) the brokerage costs paid and bid–ask spread incurred when buying or selling units on market.

52 In some instances, it would be cheaper for an investor to access a fund not quoted on an exchange with the same investment strategy as an ETP.

53 ETPs also allow retail investors to access certain international markets or strategies. From our conversations with issuers, we understand that this was a key initial attraction of ETPs.

54 As outlined in Figure 5, it appears that, given the lower return and interest rate environment that has persisted for some time, low costs and diversification are the key, current attractions of ETPs. Figure 5 shows that the main attraction of ETFs for retail investors are:

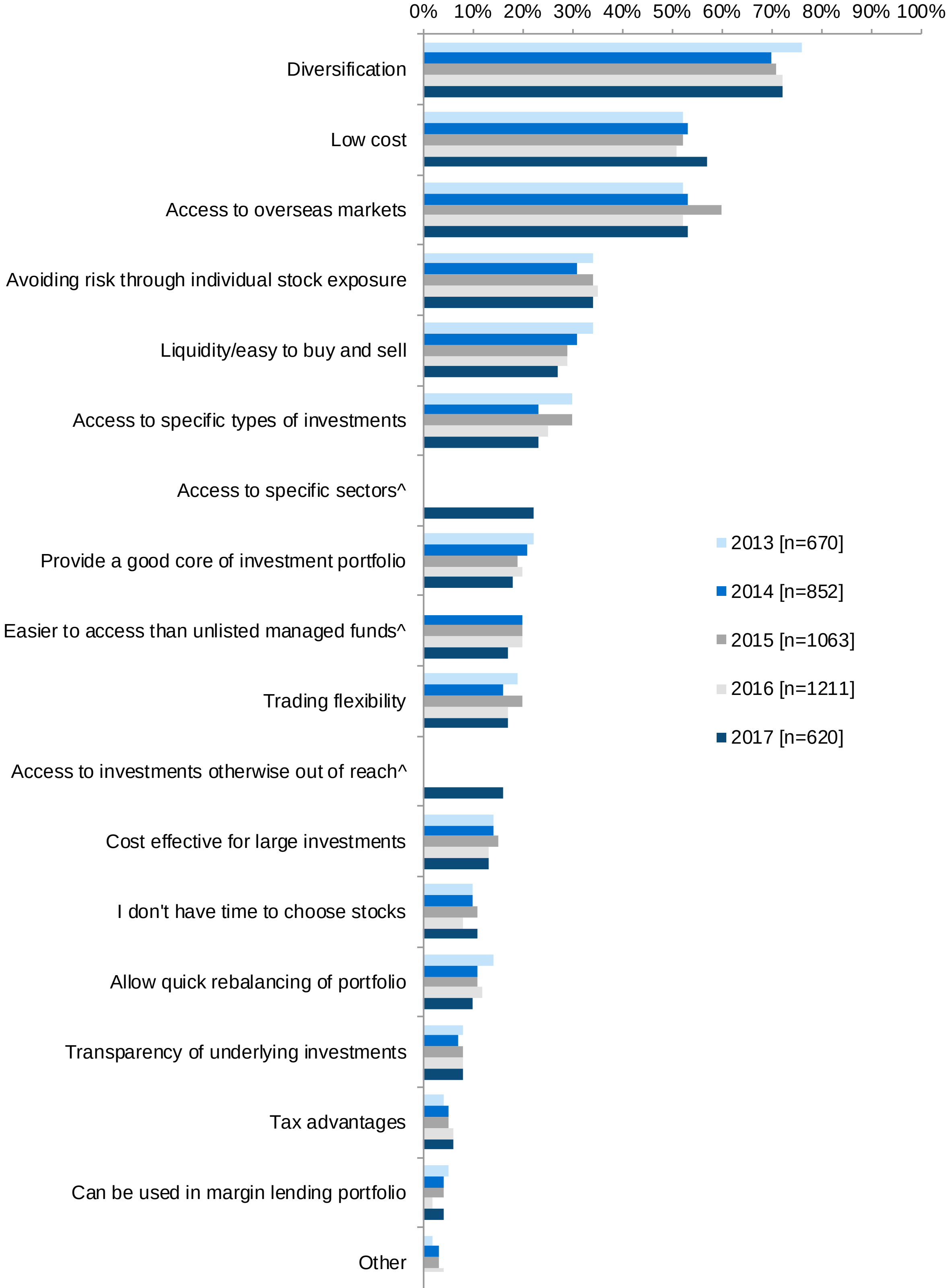
(a) low management costs;

(b) capability to diversify small, invested amounts easily;

(c) rapidity of transacting; and

(d) market liquidity.

Figure 5: Key drivers of ETF usage among investors in Australia



Source: Investment Trends, *September 2017 exchange traded funds report*, survey concluded: September 2017 and report released: December 2017.

Note 1: ^ Denotes new option added to the survey question.

Note 2: ‘n’ represents the sample size of Australian investors.

Note 3: See Table 5 in the appendix for the complete data used in this figure (accessible version).

Other investors in ETPs

55 In addition to retail investors, domestic institutional investors are increasingly using ETPs in Australia. However, this remains considerably less than in other more developed ETP markets such as Europe, the United States and Canada. As the range of products broadens—liquidity improves and fees are lowered through competition—we are seeing institutions show increased interest in ETPs.

56 ETPs are not typically held as long-term investments by institutions. However, ETPs are being used tactically to:

(a) access liquidity in certain fixed income or other less liquid markets; or

(b) assist transition management to allow investors to accumulate a market exposure quickly—whereas purchasing positions in a range of underlying holdings takes more time.

57 Some institutions may also use ETFs instead of futures contracts to hedge or gain exposure to parts of the market—as the cost of using certain derivatives has increased. This is because of new banking regulations which have increased risk capital charges.

Growth of ETPs globally

58 While the Australian market has shown strong growth in recent years, it is still relatively small and in an earlier growth stage compared to more mature markets, such as the United States and Europe. Globally, there has been huge growth in ETPs and a proliferation in the different types of funds. According to ETFGI's *Global ETF and ETP industry insights: December 2017* report, as at 31 December 2017 there was approximately US$4.84 trillion in funds under management, which was an increase of about 25% over the previous 12 months. There were also 7,178 ETPs managed by 352 providers on 70 exchanges.

59 There has also been increased regulatory focus on the ETP market globally, given its growth and size. Regulators are focusing on the distinctive risks of ETPs (in particular, ETP liquidity), the overall impact of these risks on market liquidity, the risks inherent in the ETP structure, and the different and more complex types of ETPs and their features. Some of the complexity in product types seen in overseas markets is not yet present in the Australian market, but we are monitoring international developments closely.

D Publication of valuation and performance information: iNAVs and tracking error

Key points

There is no consistent market approach of issuers in publishing iNAVs for ETPs. We encourage issuers to make iNAVs available throughout the trading day when they are reliable and accurate.

To provide investors with information about performance of ETFs, issuers should disclose the tracking difference over time, not just the tracking error.

Similarly, we think that disclosure of return against a targeted benchmark or absolute return is important information for investors in relation to other ETPs.

iNAVs

What is an iNAV?

60 Traditionally, ETPs aim to provide investors with exposure to a particular group of underlying assets. For investors, understanding to what extent the value of the ETP is a reflection of the value of the underlying assets is important.

61 The iNAV provides an estimate of the intraday indicative value of an ETP based on the market values of its underlying net assets. An iNAV should provide a reference point to investors during the day to assist them in understanding if they are purchasing or selling ETP units at or close to the NAV per unit.

62 Given the large retail investor base in the ETP market, we consider that an iNAV provides a useful point of reference to assist investors throughout the trading day to ensure that they are purchasing or selling ETP units at, or close to, the NAV of the fund (i.e. at 'fair' value).

Calculation, timing and publication of the iNAV

63 The value of the underlying securities is generally calculated by an independent data vendor or index calculation agent. Market operators may also offer iNAV calculation services where all the underlying securities are available for trading on its market and there is no separate data vendor or calculation agent. The issuer will generally calculate its own iNAV for internal verification purposes. The iNAV is then published on the issuer's website and via market data feeds on a frequent basis—as frequently as every 15 seconds.

64 There is no prescribed standard calculation methodology for iNAVs. However, there is an express requirement in the Australian market to calculate and/or publish an iNAV for ETPs in the following circumstances:

(a) every 15 minutes during each trading day where required as a condition of relief in [CO 13/721]. The publication of an iNAV is required where the issuer of an index-tracking ETF provides information to authorised participants, one day ahead of members, and is intended to ensure that the market is kept informed about the underlying NAV; or

(b) where the issuer chooses not to disclose portfolio holdings daily. Under the conditions of admission of the market operator, the issuer is required to publish a frequent iNAV, which is typically updated at least every 15 seconds.

Note: [CO 13/721] relieves the issuer from the obligation in s601FC(1)(d) to treat all unit holders equally, to enable the issuer to provide portfolio information to authorised participants ahead of other members. See paragraphs 152–155 for an explanation of, and the conditions attached to, the relief granted by [CO 13/721]. Also see paragraphs 98–107 on internal market making.

Situations where the iNAV may not be accurate

65 There may be situations where the iNAV, when calculated on its usual basis, is no longer an accurate estimate of the value of units in the ETP. For example, this may occur if:

(a) there is a material change in the portfolio holdings during the day—as in the case of actively managed ETPs; or

(b) there is a major market event/move.

66 The iNAV represents the issuer's estimate of the current NAV of the fund at the time of publication. It is misleading to publish an iNAV that does not reflect the issuer's reasonable estimate.

67 The iNAV should be updated to reflect live market prices and any material changes in the intraday portfolio holdings. If the issuer is not able to meet the requirement to make a reasonable estimate, it should temporarily remove the iNAV from publication. The issuer should make the exchange and/or investors aware of the reasons for this and should also consider if it should seek a trading halt.

68 If spreads are increasing, this may indicate that there is uncertainty about the accuracy of the iNAV. In such circumstances, it may be prudent for investors to consider delaying buying or selling units in the ETP until the spreads have narrowed to more usual values.

Other jurisdictions

69 Internationally, there is no consistent approach to iNAV calculation, timing and publication requirements. For example, in the United States, issuers of ETFs are required to publish an iNAV, but there are no similar regulatory requirements in Europe. However, the relevant exchange may require an iNAV to be published as a condition of being admitted to trading. For example, Deutsche Börse, Borsa Italiana and Euronext require ETFs to publish an iNAV.

Note: In the United States, the rules of exchanges trading ETFs require an intraday value to be disseminated by one or more major market data vendors during regular trading hours—updated at least every 15 seconds (for domestic index and fixed income ETFs) or every 60 seconds (for ETF indexes containing non-US stocks). Similarly, for actively managed ETFs, exchange rules require that an updated portfolio indicative value be widely disseminated by one or more major market data vendors at least every 15 seconds during trading hours.

70 In the United States, the NYSE Arca Exchange and NASDAQ require issuers to provide a regular intraday indicative value for all ETPs. On the Euronext Paris market in France, a fund's iNAV is required as part of a circuit breaker mechanism to halt trading where there is a significant difference between the traded price of an ETP and its iNAV based on the underlying basket of securities.

In practice

71 As part of our review we sought to better understand the provision of iNAVs by issuers and evaluate their usefulness to retail investors.

72 The majority of issuers in our review provide iNAVs for Australian equity and fixed income ETPs, but not for any international equity or fixed income ETPs. These issuers were of the view that iNAVs can have significant limitations when the ETP trades in a different time zone to the underlying securities. The iNAV may be inaccurate if the underlying asset prices used in the iNAV calculation are effectively 'stale'—that is, the iNAV is calculated using the last traded price in the closed overseas market while the Australian market is open for trading. Some issuers were of the view that providing an iNAV on that basis may be misleading to investors. We believe that responsible entities should consider an alternative basis to enable estimates of the value of the underlying assets in these situations.

73 The view from a number of issuers is that the best indication of the fundamental value per unit of an ETP is the prevailing market price when there are bids and offers from multiple independent market makers who are competing with one another. However, this may be unreliable in periods of market disruption.

74 Some issuers highlighted that data providers, like iNAV calculation agents, could potentially provide the capability to produce an iNAV that is equity–beta adjusted to include relevant proxies, such as futures markets, for after-hours market movements (where available). Some issuers currently publish an 'adjusted iNAV' using this method. We understand this would improve the accuracy of iNAVs for ETPs with significant international assets.

75 There have also been instances, due to changes in market conditions, where issuers of active ETFs reduced their reliance on the iNAV for market making because the iNAV was not reasonably accurate, yet they continued to publish the iNAV to the market. As discussed in paragraph 67, in these circumstances, the issuer should temporarily remove the iNAV from publication, make investors and the exchange aware of the reasons for this, and consider a trading halt.

Tracking difference

76 A key value proposition of ETFs is that the benchmark index is tracked accurately and consistently. Tracking difference measures the actual performance of an ETF compared to its benchmark, before fees are deducted. Tracking difference is defined as the difference in total return between a fund and its benchmark over a certain period of time.

77 Our view is that tracking difference can be useful for investors to gauge the long-term performance of the ETF against the target index. We provide relief to issuers under [CO 13/1200]. This relief requires them to provide regular information to investors on the performance of the ETP relative to its investment objective: see paragraphs 156–160. Investors should note that, net of fees, the return of a fund will generally be lower than the benchmark.

Tracking error

78 Tracking error is a different but related metric which measures how consistently and accurately the ETF tracks its underlying reference index. It is typically expressed as an annualised standard deviation of tracking data points (e.g. using daily performance of the ETF and the underlying index as a data point). A small tracking error indicates that the ETF tends to follow its benchmark very closely over the course of a year, whereas a large tracking error indicates the opposite. The tracking error helps to provide information about the quality of the replication on a day-to-day basis.

79 Tracking error can be calculated by the ex-post (realised) and/or the ex-ante (targeted) method.

> Note: For information on calculating the tracking error, see IOSCO's report, *Principles for the regulation of exchange traded funds* (PDF 825 KB).

80 We found that, while tracking error (whether ex-post or ex-ante) is used internally by issuers for portfolio management purposes, there is a widely held view that it is not a useful measure to disclose to retail investors. This is because it is a complex concept, which is a point-in-time calculation, and may not always provide a fair indication of how accurately and consistently the benchmark is being followed.

81 One issuer indicated that daily tracking error may be important for investors that hold their investment in an ETF for a short period of time. It may also be relevant for comparing different issuers who are broadly offering the same investment exposure. Tracking difference is considered a more useful measure for investors that hold an ETP for a longer period.

Recommendations

82 Our recommendations for iNAV publication include:

(a) *Making the iNAV available*: in addition to existing regulatory or market operator requirements, we encourage issuers to make the iNAV for any ETP available when it is practicable to calculate an estimate that is materially reliable in its accuracy, including for products that invest in international assets and fixed income.

(b) *Withdrawal of inaccurate iNAVs:* if the iNAV is published but is not reasonably accurate, the iNAV should be temporarily adjusted or removed (and consideration should be given to suspending trading).

(c) *Use of proxies*: we consider the practicability and accuracy of using proxies based on derivatives markets should be considered for after-hours movements (where available). This would improve the accuracy of international iNAVs.

(d) *Education*: we also encourage issuers, advisers, promoters and market operators to provide investors with education about the existence of the iNAV, and how to access and use it, as well as education about any limitations it may have.

83 For index tracking ETFs and those ETPs which seek to outperform a benchmark or deliver a non-index-based return to investors, we consider that it is useful for retail investors if issuers disclose tracking difference, and possibly tracking error as well, on a regular basis to allow investors to better comprehend how well an investment manager is meeting their stated investment strategy.

E ETP liquidity and market making

Key points

Market makers and authorised participants can be critical of the viability of an ETP where there is insufficient natural liquidity in that ETP. Currently, there are only a small number of market makers that support ETPs.

Internal market making has developed as a practice used when there is a need to protect intellectual property in relation to the portfolio composition. This section discusses some of the risks and benefits of using internal market making.

The data we reviewed shows that there is a greater diversity of liquidity sources in Australian equity and property securities relative to fixed income and foreign exchange focused ETPs.

This section considers the role of market makers and authorised participants.

Overview of liquidity tools

84 One of the objectives of our review was to better understand how the market making system for ETPs is operating in practice in Australia.

Supervision of the market making system

85 Section B provides an overview of the framework for the provision of liquidity for ETPs. Supervision of the market making systems has three elements:

(a) ASIC is responsible for the supervision of trading on Australia's domestic licensed markets for compliance with the Corporations Act and the ASIC market integrity rules. This responsibility includes undertaking real-time monitoring of orders and trades in ETPs.

(b) A market operator is responsible for monitoring market makers and issuers for compliance with their commitments to the market operator associated with admission, including their commitment to provide liquidity. To date, this has typically been undertaken as a periodic evaluation of market maker performance against the parameters of a market operator's market making incentive scheme.

(c) Issuers are responsible for complying with the relevant market operating rule requirements and agreements with the market operator. This involves monitoring spreads regularly and assessing whether market makers are complying with their obligations to the issuer.

86 As the market making requirements may vary depending on the type, size and structure of an ETP, we found that different issuers approach the appointment of market makers differently. There is consensus that there should be at least one formally appointed market maker in those products not deemed by the market operator to already have sufficient liquidity. Depending on the fund, some issuers may engage with two or more market makers—these include contracted market makers and voluntary liquidity providers. One issuer was of the view that there should be at least two active market makers/liquidity providers as competition between the market makers will ensure competitive spread pricing.

87 In Australia, most issuers specify that a market maker makes a market with an agreed minimum quote quantity and maximum spread for not less than 85% of active continuous trading, between 10.15 am and 4.00 pm on each Australian trading day.

Remuneration of market makers

88 There are differences in how market makers in ETPs are remunerated. This is purely a commercial decision, as there are no regulatory or market operator requirements for if and how a market maker should be paid. Issuers need to meet their duties as a responsible entity to determine the extent of any remuneration, and they should consider investor expectations about NAV-based pricing.

89 Some issuers may not directly compensate the market maker to make a market. When there is no direct compensation, the market maker relies on:

(a) the market operator fee incentives; and

(b) the possibility of making a financial gain through undertaking quoting activities.

90 Other issuers pay the market maker to ensure that there is a continuous flow of quotes, and to quote within certain bands. One reason cited for paying a market maker is that the fund in question may be too small to otherwise entice market makers. When market makers are paid, this can be done in a variety of ways, including through a fixed fee or variable fee based on assets under management, or through a reduction in trading, creation and redemption costs.

Authorised participants

91 We observed that a number of authorised participants enter into an agreement with an issuer across the entire suite of products of the issuer, but they may only regularly transact in the primary market by creating or redeeming units in certain products. A key role of the authorised participant is to deliver or accept baskets of securities—so experience and capabilities in

trading the underlying securities is an important factor in issuers selecting authorised participants for particular ETPs. Certain authorised participants are therefore more prevalent in certain asset classes such as fixed income, currencies and commodities.

Creation and redemption process

92 There are differences between how issuers permit creations and redemptions, with some requiring that the relevant forms be submitted through a web-based portal and others requiring that the physically signed form be submitted. Various authorised participants noted that further automation of the creation and redemption process would make the primary trading process more efficient, and would reduce operational risk and processing times.

93 When conducting primary market transactions in different products, authorised participants, registered market makers and issuers use different processes. Some apply different cut-off times for creations and redemptions, and others are flexible in how certain issuers allow creations and redemptions—for example, after a designated cut-off time on a shorter settlement cycle (i.e. T+1), or for a transaction size that is less than the minimum creation size.

Concentration risk

94 The Australian market making system has a small number of players (seven separate trading participants) and is dominated by two main market makers. This structure raises some risk—that a sudden withdrawal by a dominant participant from the market will have a significant adverse impact. Lack of market maker competition may also mean that the spreads may not be as narrow as they could be, and the market may be less efficient: see Section F for data about spreads. Similar market dominance is also observed from our discussions with overseas regulators, including by the Autorité des marchés financiers (AMF) in the French ETP market and by the Bank of Ireland in relation to the few market makers in Ireland.

95 This risk was highlighted by some of the issuers in their responses to our review, but there were varied views. Issuers generally expressed high confidence in the ability of the market making system to provide liquidity to investors and thought that the system was operating well, despite the limited number of formal market makers.

96 We acknowledge that a limited number of market makers may deter new issuers and funds in Australia because less liquidity in the secondary market may increase spreads and reduce the attractiveness of an ETP. The specialist skills and high capital costs of running a market making business may make it difficult for new players to quickly commence.

97 The issuers noted that the market making system was still evolving and they are encouraged by the arrival of potential new players which should provide additional sources of liquidity. Under the existing structure, the current market makers are driven by the potential profits from market making, as well as by the incentives from issuers and exchanges. This situation could change with changes in the market cycle and with other commercial drivers of supply and demand. Several stakeholders indicated that the ETP industry in Australia was still in its relative infancy and as it evolves—with increased growth in the number of products, funds under management and liquidity—it is likely to have a more developed market making ecosystem.

Internal market making

98 'Internal market making' is something that has been permitted by a market operator in limited circumstances and occurs when the issuer undertakes the market making directly or by instructing a market participant to act as its agent and trade on its behalf. With internal market making, the market operator:

(a) reviews the market making arrangement to ensure that it will conform with the issuer's liquidity obligations for the product; and

(b) ensures that the issuer has the requisite expertise, resources, capabilities and adequate systems to properly perform this function and manage conflicts of interest.

Note: INFO 230 outlines some of the factors a market licensee should consider in assessing whether an internal market making arrangement is adequate.

99 Internal market making occurs in relation to 'active ETFs' that delay or limit disclosure of the fund's portfolio holdings to persons other than the issuer. The issuer makes the market for its fund, either by themselves or by instructing an agent to act on their behalf. As the actual portfolio composition is not publicly disclosed each day, it is difficult for an independent market maker (who does not know the portfolio composition) to compete in market making. This may tend to lead to spreads for non-transparent active quoted managed funds which are larger than those for a transparent ETP with underlying securities in the same asset class. A more concentrated underlying portfolio is also likely to contribute to wider relative spreads. According to the ASX market making schedule and relevant issuer PDS documents, as at 30 June 2018, there are 20 products that have been admitted to the ASX AQUA market with this liquidity arrangement.

100 During market trading hours, issuers are required to frequently publish the iNAV to give investors an indication as to the value of the fund. As part of their internal market making processes, issuers use the iNAV, in addition to other information, to determine the bid and offer prices that are quoted to the

market. One issuer explained that because the iNAV is an important disclosure to investors, as well as an input into internal market making, they use three separate sources to calculate it and to verify that it is accurate: their own calculations and two other external providers' calculations.

101 We are interested in continuing to understand internal market making practices generally, given this does not appear to be common internationally.

Conduct expectations

102 As with third party market makers, an internal market maker has the ability to vary the spreads according to the trade flows and to profit from this. As the daily portfolio holdings are not publicly available, there is potential for the fund to have an informational advantage over investors who are not in a position to estimate the NAV. The provision of the iNAV reduces this risk to a degree. Also, the internal market maker should not trade if it is in possession of confidential, price sensitive information. Before trading, internal market makers must ensure that they disclose any information that may impact on the value of their portfolio holdings.

103 When buying or selling on market, an issuer or its agent must not trade on the market to set a certain price and must do so only to profit the fund for the benefit of unit holders. Therefore, they will only be likely to bid below the issuer estimate of NAV.

Views of issuers

104 There are mixed views in the market about the benefits of internal market making. For example, one issuer considers that transparent ETPs which can redeem at or close to the NAV (as transparent ETPs have authorised participants doing creations and redemptions) is the optimal structure for investors.

Conflicts of interests

Profit

105 We have concerns that the profit generated from internal market making is not well understood by investors and may lead to inherent conflicts and unequal treatment among different groups of investors, if, for example, an unfavourably low bid price was set for selling members. We consider that it is important for issuers to have appropriate frameworks around internal market making to manage conflicts, even when the amount of profit earned from the internal market making is small relative to the size of the fund.

Performance fee

106 If profits from internal market making were included in the performance fee calculation, it would be a source of potential conflict as it would increase the incentive for the internal market maker to widen the spreads to generate a higher performance fee (even though this might make it more costly for investors to enter and exit the ETP).

107 For this reason, when the issuer receives a performance fee, market making profits should be excluded from performance fee calculations. More generally, to increase investor understanding about the ETP's performance, profits from market making should be disclosed separately in the performance reporting of the fund'.

Liquidity analysis

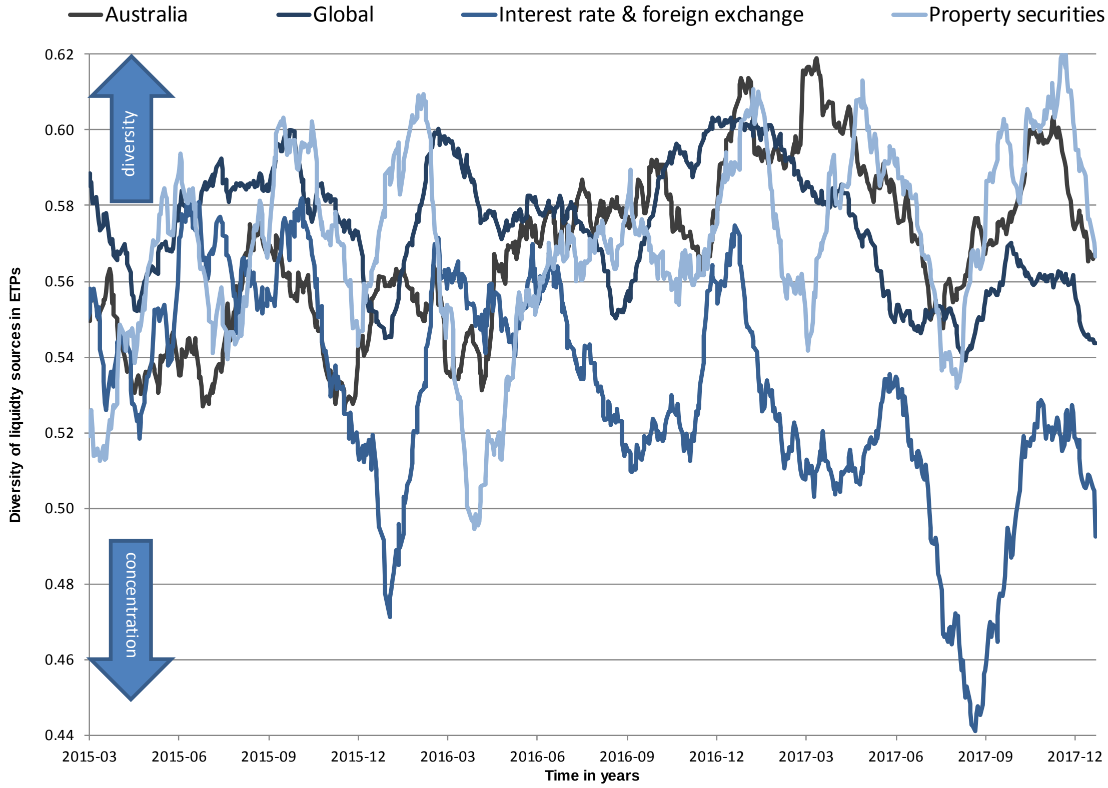
108 We reviewed the diversity of on-market liquidity provisions using our market surveillance system (MAI). We analysed the number and diversity of accounts which offer passive liquidity in ETP products across the market. Proffered liquidity arises from a mix of professional market makers and investors seeking to exit existing positions or to enter new positions.

109 We measured diversity on a scale of zero (100% concentration in a single source of liquidity) to one (an equal mix of liquidity between all passive accounts that were successfully offered on market). All estimates were calculated on a stock-day basis, turnover weighted and averaged out into half-year periods. Figure 6 illustrates some of our findings, it provides an estimate of the diversity of those accounts, and shows movements in the average number of distinct accounts seeking to offer liquidity across the spread.

110 Figure 6 shows that there is greater diversity of liquidity in Australian equity and property securities relative to fixed income and foreign exchange focused ETPs. We found that diversity in the liquidity provision has been falling for Australian equity, global equity and bond ETPs. Over the past three years, despite a marginal rise in turnover, the on-market sourcing of liquidity in property securities ETPs has diversified strongly.

111 As the liquidity feature is a key attraction of ETPs, issuers tend to pay close attention to the spreads and regularly monitor them. When the spreads widen or diverge from the iNAV, issuers generally take corrective action by raising the matter with the market maker.

Figure 6: Analysis on levels of passive liquidity by accounts in various ETPs by asset class



Source: ASIC market surveillance system (MAI), March 2015 – December 2017.

Note: See paragraphs 109–146 for a description of the trends in this figure (accessible version).

Recommendations

112 Ongoing dialogue between ASIC, issuers, market operators and market makers may assist in identifying any impediments to more diversified sources of liquidity in the ETP market.

113 *Best practices to facilitate primary transactions:* we encourage issuers to develop standardised and best-practice processes to facilitate primary transactions in ETPs. This will reduce operational risk and increase efficiency by reducing the cost of trading.

114 *Market operator oversight:* we recommend that market operators undertake the following steps to enhance oversight of liquidity and the market making system:

(a) Market operators should periodically review the liquidity commitments of market makers and issuers to assess whether the current spread requirements are appropriate in the context of each ETP's structure and underlying assets, and to take account of market developments. This should be informed by proactive monitoring of average spreads, quote size and the proportion of the day market makers are quoting.

(b) Market operators should assess whether there are differences between the liquidity arrangements for issuers with internal market making arrangements compared to those with third party arrangements. For new ETPs with internal market making arrangements, market operators should consider the appropriateness of the internal arrangements in both the context of the proposed ETP and the arrangements of existing ETPs.

115 *Risk management for concentration risk:* market operators and issuers should be considering and dealing with market making concentration risk as part of their risk management for ETPs.

116 *Monitoring of internal market making:* we expect issuers who use internal market making to monitor the operation of the internal market making arrangements to ensure that investors are able to trade at or close to the NAV during normal circumstances. If this cannot be reliably achieved, the issuer should consider removing the fund from quotation on market or ultimately winding up the fund.

117 *Separate disclosure of internal market making profits:* profits from internal market making should be disclosed separately to investors in periodic statements. When the issuer receives a performance fee, market making profits should be excluded from the performance fee calculations.

118 As internal marking making practices are not common internationally, we are interested in continuing to further understand and consider these practices.

F ETP spread monitoring and analysis

Key points

The size of the bid–offer spreads vary according to the nature of the underlying asset of the ETP, with Australian equities having the tightest spreads: at six basis points or less, around 50% of the time. ETPs over global products tend to have spreads that are approximately three times as wide.

While spreads tend to widen in some circumstances, generally, spreads in the Australian market are broadly consistent with other markets. Issuers and market operators need to monitor market spreads for ETPs. This is important as wide spreads may adversely affect investors' returns of the ETP.

Impact of spreads

119 One risk for investors is that the bid–offer spreads may be so wide that they materially add to the cost of investing in an ETP and undermine the low cost rationale for SMSFs and other investors in relation to some ETP products. However, investors may not be able to identify that the spread level is high, especially without relevant comparisons for the spreads of similar products.

120 Investors do not necessarily trade interests in an ETP at the NAV. In the primary market, redemptions and applications made by authorised participants are processed at the NAV less transaction fees and any buy/sell spread charged by the responsible entity. On the secondary market, however, the price traded is determined by supply and demand and can deviate from an ETP's NAV published from the previous day or from the currently published iNAV.

Management of spreads in the Australian ETP market

121 Bid–offer spreads are a key commercial incentive for market makers to provide liquidity in the market. In addition, market makers may receive fees from the issuer, or rebates from the market operator. The ETP spreads generally reflect the liquidity of the underlying assets so that ETPs over less liquid assets, such as bonds or emerging market shares, usually have higher spreads. Spreads may also be higher for a newer fund until it becomes more established.

122 Spreads reflect the day-to-day trading intentions of investors and market makers. Spreads may temporarily widen from sudden increases in buying or selling, but they tend to stabilise after the event. Unusually wide spreads rarely persist in the presence of market makers who may take advantage of any mispricing in the market.

123 As narrow spreads are an important part of the value proposition of ETPs, in our review, we found that they are closely monitored by issuers. There are various ways issuers do this, such as using a proprietary monitoring system or using alerts set in Bloomberg to identify bid–offer spreads exceeding a specified threshold.

124 The 'extreme trade range' market controls are no substitute for an issuer monitoring spreads and taking action if these are problematic. Under the ASIC Market Integrity Rules (Competition in Exchange Markets) 2011, market operators are required to have controls in place for equity market products (which include ETPs) to minimise transactions executing in the extreme trade range for a particular product. Orders that occur within the range may be cancelled if requested by a trading participant and there may be a trading reset or pause. While these controls apply to ordinary equities and ETPs, the extreme trade ranges are very wide, so in the context of ETPs, they are unlikely to be triggered in practice.

Analysis of spreads in Australian ETPs

125 We undertook a detailed analysis of the bid–offer spreads across all ETPs. The market spread is an important factor for investors as it is an additional cost on final realisation of an ETP investment. Issuers provide no guarantee on the cost of entering or exiting their product—they place reliance on the efficient operation of the market to minimise this component.

126 The issuers we spoke to were confident that the spreads are low, and we found from empirical evidence that, most of the time, market spreads for quoted ETPs are not excessive. Across all ETPs, as expressed on an effective turnover-weighted basis, ETPs are quoted on a spread of nine basis points or less, approximately 50% of the time. Figure 7 breaks this estimate down further across the four broad ETP product classes. It shows the distribution of bid–offer spreads, on a cumulative basis, from January 2016 to November 2017. By comparison, buy–sell spreads on unlisted funds vary, but will typically range from approximately 0 to 50 basis points, depending on the investment strategy and asset classes held.

127 We found that ETPs over Australian equity securities are quoted with the tightest spreads—at six basis points or less, around 50% of the time. ETPs over global products tend to have spreads that are approximately three times as wide—at 20 basis points or less, around 50% of the time. These figures compare with our findings in Equity market data for quarter ending September 2017 where the estimated effective bid–ask spread was 10 basis points for the ASX 200, and 20 basis points for the wider equity market.

128 Figure 7 also shows that the spreads can widen for a small percentage of time, so investors need to be wary of overpaying for the cost of transacting

in ETPs. The widening of the spreads may occur for various reasons, such as:

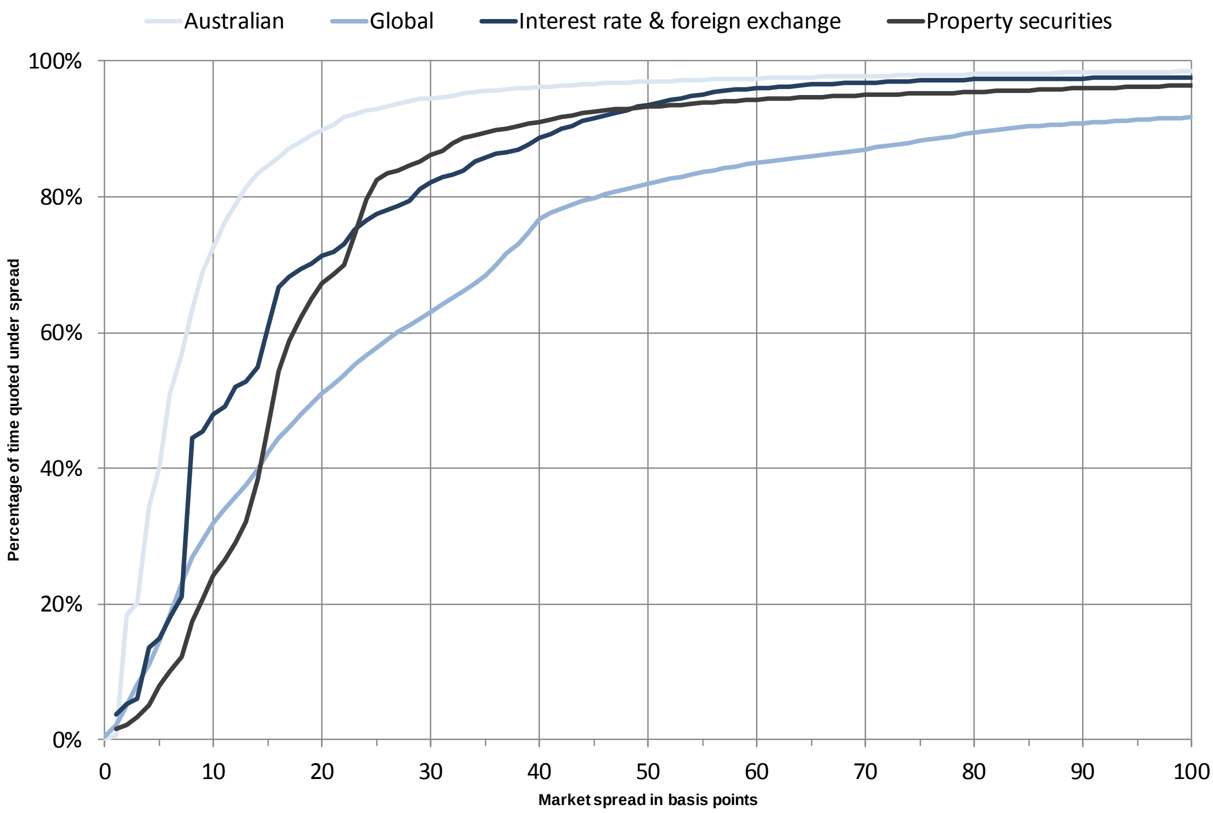
(a) market makers are often committed to making markets for only 80% of the time, meaning that for up to 20% of the time there may be no market maker quotes;

(b) volatility of the underlying securities which may cause the market makers to widen the spreads;

(c) insufficient natural demand for the ETPs may limit liquidity when the market maker is not there; or

(d) unavailability of certain underlying securities for trading around market open or close which may cause the market maker to widen spreads (see Figure 8).

Figure 7: Market spreads for quoted ETPs expressed on a cumulative basis: grouped by product type and weighted by turnover



Source: ASIC market surveillance system (MAI), January 2016 – September 2017.

Note 1: See paragraphs 125–128 for a description of the trends in this figure (accessible version).

Note 2: We analysed spreads across a range of products and factors to understand how these related to tighter spreads. Selected factors included fund capitalisation, product turnover, volatility and price, the number of active market markers, diversity of passive liquidity accounts/sources, and a series of test variables identifying the broad product category.

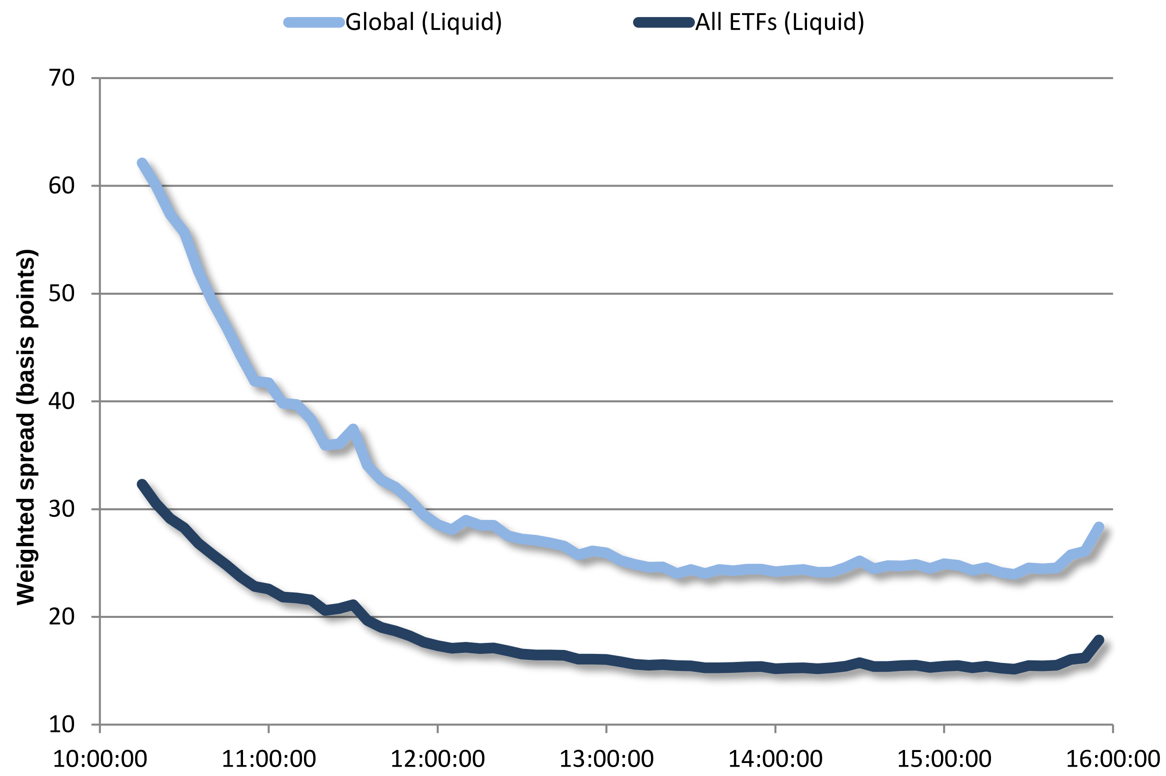
129 We found that spreads tend to be tighter in larger and more liquid funds but can widen when traded products are subject to greater volatility—this may emerge from wider market volatility or through product selection within the individual ETP. The number of market makers active in the specific ETP is another factor, with some connection to spreads. Both the number of individual market makers and greater relative share of market turnover are associated with tighter spreads. This points to the role of competition as a driver for tighter spreads.

130 We considered the variation in intraday spreads by looking at the turnover-weighted average spreads for more liquid ETPs. Spreads tended to be wider in the morning following the open but decreased towards a steadier state: see Figure 8. The ASX has a phased or staggered opening of securities in 5 alphabetic groups between 10.00 am and 10.10 am. Market makers and other market participants may be less active in ETPs until the markets for the underlying securities have all opened and are available for trading. The rates of decay are fairly gradual (i.e. there is no sudden influx of orders narrowing spreads) in both global ETPs and all ETPs, but it could be inferred that Australian ETF spreads do not decay quite as much between 10.00 am and 12.00 pm. There is also some increase in global deviation around 12.30 pm which is when many of the Asian markets open.

131 Our analysis suggests that ETPs over Australian-based equity securities tend to trade with tighter spreads than the other categories. Despite the tight spreads evident in some of the interest rate and foreign exchange based ETPs, after adjusting for their lower volatility, higher unit prices and lower fund capitalisation, we found their spreads trade at relatively higher levels.

132 There are other times when spreads may be wider than the typical or average spread, such as during the closure of foreign markets or during a staggered open of the Australian market when not all of the underlying assets are open for trading. During this time, market makers may wait until they have more certainty around the underlying prices, but they may still quote at wider spreads to reflect this uncertainty. As a result, retail investors should consider trading at a limit price around the market open or close, or, alternatively, wait until the market has settled after opening, particularly during times of increased volatility. MoneySmart's Exchange traded funds (ETFs) page provides retail investors with basic information around the timing of trades for index tracking ETFs that may lead to better investor outcomes.

Figure 8: Intraday market spreads for quoted ETPs on a cumulative basis



Source: ASIC market surveillance system (MAI), January 2016 – September 2017.

Note: See paragraphs 129–132 for a description of the trends in this figure (accessible version).

Management of spreads in overseas markets

133 In certain jurisdictions that we reviewed, the difference between the price an ETP actually trades at on an exchange and its prevailing iNAV—which is an indication of 'fair value'—is generally very close to zero, except in periods of stress. For example, according to the study by the AMF, *ETFs: Characteristics, overview and risk analysis—the case of the French market*, nearly 90% of trades on Euronext are made at prices that are less than 0.25% away from the iNAV price, and more than 95% are made at prices that are less than 0.50%.

134 Individual stock exchanges often play an important role by imposing rules on market makers about minimum and maximum spreads. This indirectly limits any divergence between the NAV of ETP units and their traded price.

135 In the French ETF market, if a product's price moves away from the regularly calculated iNAV by more than the set tolerance (e.g. 1.5% or 3.0%), the exchange, Euronext Paris, imposes a regulatory halt for a short period until pricing is re-established back to within a reasonable range. These circuit breaker halts may be repeated by Euronext throughout the

trading day each time the threshold is triggered to ensure that trading occurs at or near the NAV.

136 On other leading European markets (including the London Stock Exchange and Deutsche Börse’s Xetra) a circuit-breaker model applies to ETFs, and is similar to an ‘extreme trade range’ that exist for equities. It consists of a temporary halt or suspension based on a specified movement away from the reference price of the last trade, irrespective of the iNAV. This suspension may allow for certain trades to be cancelled.

Recommendations

137 *Monitoring spreads:* we recommend that issuers continue to monitor spreads to ensure that spreads each day are within investors’ reasonable expectations. Market operators who admit ETPs should undertake a proactive review of the liquidity commitments of market makers and issuers, as well as monitoring quoted spreads so that ETPs generally continue to trade with tight spreads.

138 *Investor understanding:* it is important for issuers, advisers and promoters of ETPs to ensure that educational and marketing material informs retail investors about the spreads that they will pay when buying or selling ETPs on market. Investors need to know that liquidity in ETPs is not always constant and spreads may vary and increase significantly from time to time. Issuers’ PDSs should also disclose the impact of the spreads as one of the risks of investing in their ETPs.

G Other issuer obligations relevant to retail investors

Key points

This section sets out our observations and key findings relating to:

- issuer marketing materials and advertising;
- corporate governance arrangements around proxy voting;
- policy and procedures for the closure or winding up of ETPs; and
- compliance with relevant legislative instruments for ETPs.

Misleading or deceptive advertising

139 We reviewed a sample of issuers' marketing and promotional materials and marketing processes to ensure that they are not potentially misleading or deceptive. We considered whether they were consistent with Regulatory Guide 234 *Advertising financial products and services (including credit): Good practice guidance* (RG 234).

140 We found that most issuers have implemented systems and processes for the accurate advertising of financial products. We found that issuers, in our view, had good practices, incorporating an appropriate review process (including a sign-off before release) on all forms of advertising and marketing materials, not just PDSs.

141 However, we did find examples of issuers disseminating or publishing misleading material on their websites aimed at retail investors or advisers. This misleading material included:

(a) *underlying asset characteristics*—statements that the fixed income securities underlying the ETPs were investment grade and involved secured assets, where this was not universally the case; and

(b) *term deposit comparison*—statements comparing the ETP to an asset class with different and lower risk characteristics, without making it clear that the risk attributes were different.

142 The issuers amended these statements after we raised our concerns. We are currently considering further action in relation to some misleading material we have identified about ETPs.

Engagement with companies in which the ETP is invested

143 We asked issuers about their approach and policy for engaging and influencing companies and managed investment schemes held as part of the underlying assets of the ETP. An issuer has a responsibility to look after the interests of investors in the fund and we wanted to explore the extent to which issuers of ETPs were actively engaging with the investments of the ETP, including by exercising member powers, such as voting. We received a range of responses from issuers. Issuers indicated that they engage by:

(a) developing and implementing corporate governance and voting policies;

(b) analysing issues relevant to investee companies;

(c) exercising power through voting and corporate action; and

(d) embedding environmental, social and governance practices.

144 In relation to holding shares and interests in listed companies or schemes, an issuer should consider what engagement is in the best interests of their investors and undertake it with reasonable diligence. We do not think that the mere fact that the ETP has a passive investment strategy means that no consideration needs to be given to engagement with the issuers of underlying investments comprising the ETP's assets.

Unsuccessful funds and quotation

145 In more mature ETF markets overseas there is a history of terminating funds that do not achieve a critical level of funds under management (these are therefore unable to achieve their stated objectives). For example, in the United States, since inception to the end of October 2017, approximately 704 ETPs have been wound up.[1]

146 Our discussions with issuers, overseas regulators and others suggest that the following features are associated with funds that have been wound up or removed from quotation:

(a) *Higher fees*—ETPs with higher fees may be more likely to fail. This may be for several reasons, including reduced returns and higher fees are more likely to be associated with more complex or esoteric strategies (see paragraph 146(c)).

(b) *Issuer differences*—different issuers have different approaches to product development, and some may be more considered than others. In the United States, some issuers have wound up many ETPs while others have never closed any. The overall strength of the issuer should also be considered when evaluating whether a low funds under management fund may be at risk of closure.

[1] B Johnson, '[Common characteristics of failed exchange-traded products](#)', *Morningstar Research—News*, 16 February 2018.

(c) *Fund strategy/exposure*—ETPs over very niche or esoteric exposures may be more of a passing trend, rather than a core part of a more diversified portfolio or longer-term investment strategy and may not attract sufficient investors. Also, ETPs with complex or esoteric strategies may struggle to acquire sufficient assets to make them viable.

(d) *Fund rank in segment*—if a particular ETP is the least popular (by funds under management) relative to several ETPs in an oversaturated market offering a similar exposure, it may be more likely to wind up than an ETP with similar funds under management that is the only ETP that offers exposure to a particular sector/country/strategy.

(e) *Complexity of products structure*—many ETNs and leveraged and inverse ETPs have failed. Leveraged and inverse ETFs with a daily reset function are not currently permitted in Australia.

147 We are concerned that some ETPs may have very low funds under management and may remain quoted on the exchange, despite poor liquidity and fees eroding returns. This could lead to very poor investor outcomes, and undermine investors' confidence in the ETP market over the long term. In such a situation, ETPs may be offered with unusually large spreads. We expect that issuers and market operators have a clear strategy about the nature of products they seek to launch and have quoted on their market. They should be guided by domestic and global market trends and relevant emerging risks.

148 We asked issuers whether they have a strategy to deal with unsuccessful ETPs. Most issuers reported that they take great care in deciding to launch a new ETP, including by conducting considerable market research and testing so that they have not been in a position where they have had to contemplate the removal of a fund from quotation. We agree that prevention is the best way of dealing with the potential risk. Market operators also need to consider this risk in admitting new ETPs.

149 However, issuers did recognise that there may be situations where the assets underlying an ETP are insufficient to manage the ETP efficiently and achieve the requisite investment objective.

150 A decision to remove a fund from quotation would reduce liquidity and must be consistent with the duty of the issuer as the responsible entity to act in the best interests of all members. A possible related consideration is whether the fund should be wound up after the removal from quotation. As with any winding-up proposal, the issuer should only proceed if the winding-up is in the best interests of members or required by the Corporations Act.

151 Some overseas market operators and regulators are increasingly implementing strategies to manage poor performing ETPs—for example, to have funds wound up where they fail to attract sufficient investors and/or

funds under management within a reasonable period to be viable over the longer term. While we appreciate that there have been relatively few ETP funds wound up in Australia, we consider it prudent that Australian market operators consider the indicators that may cause them to review the ongoing suitability of an ETP for quotation and the relevant steps for an orderly wind-down.

Compliance with relevant legislative instruments

[CO 13/721]

152 [CO 13/721] aims to facilitate the quotation of certain types of ETFs on the AQUA market by overcoming the practical difficulties of complying with the Corporations Act faced by issuers of quoted managed investment products.

Note: [CO 13/721] generally applies to ETFs which engage in passive investment strategies.

153 [CO 13/721] provides conditional relief for responsible entities of ETFs from Corporations Act provisions including:

(a) to relieve the issuer from the obligation in s601FC(1)(d) to treat all unit holders equally, to allow the issuer to:

(i) provide portfolio information to authorised participants ahead of other members; and

(ii) permit only authorised representatives to withdraw from the ETF; and

(b) to relieve the issuer from the obligations in s1017B requiring significant event disclosure by the issuer to investors in relation to the ETF, provided that they comply with the continuous disclosure obligations for unlisted entities under the Corporations Act.

154 Where issuers rely on [CO 13/721], we require issuers to publish an iNAV to inform investors. [CO 13/721] also modifies the reporting requirements in relation to relevant interests under s609 and 671 to allow the ETF to operate.

155 We tested compliance with a number of the provisions of [CO 13/721] as part of our review, and no breaches were identified or disclosed by issuers.

[CO 13/1200]

156 In order to facilitate the trading of quoted ETPs, [CO 13/1200] allows issuers to disclose information in periodic statements on a modified basis. The relief in [CO 13/1200] takes into account that issuers may not know the price at which interests have been traded—this information is needed to accurately report the return of an investor's investment in periodic statements, as required under the Corporations Act.

157 Issuers relying on [CO 13/1200] are required to include information in the periodic statement about the performance of the registered scheme relative to its investment objectives. We consider that information about an ETP's performance relative to the investment strategy set out in its PDS is information that members require in order to understand their investment and make decisions about retaining or exiting their investment: see Report 373 *Response to submissions on CP 196: Periodic statements for quoted and listed managed investment products and relief for AQUA products* (REP 373).

158 We also tested compliance with the provisions of [CO 13/1200] as part of our review. There were a few examples of good practice. However, we found that compliance with the disclosure requirements of [CO 13/1200] fell short of our expectations. In particular, we found that the majority of issuers merely included statements in their periodic statements that referred members to their website for information about the performance of the ETP relative to its investment objectives, rather than disclosing this information in the actual periodic statements.

159 In light of the policy behind s1017D, which requires members who acquired their interests as retail clients to be specifically given information in a periodic statement to enable them to understand their investment, we do not consider that merely referring members to a website for information about the performance is sufficient.

Note: See the Explanatory statement for [CO 13/1200].

160 We also consider that the inclusion of a written explanation in a periodic statement assists members in making decisions about their investment in an ETP. It is consistent with the intention of [CO 13/1200].

Note: See the Explanatory statement for [CO 13/1200].

Recommendations

161 *Marketing material and advertisements:* we encourage issuers to continually ensure that any advertising is consistent with RG 234. Advertisements that do not fairly represent the product, features and risks are misleading and/or deceptive, and we will take appropriate action against this.

162 *Engagement with issuers of investments held:* we consider that, regardless of strategy, issuers must comply with their fiduciary duties to exercise their powers with reasonable diligence and act in the best interests of members, which may include considering active engagement with companies or listed funds who have issued investments held as part of the underlying assets of the ETP.

163 *Unsuccessful funds:* we encourage issuers and market operators to develop:

(a) strategies that may prevent a fund from being unsuccessful due to low funds under management or other reasons; and

(b) policies for dealing with unsuccessful funds. This may include de-quoting or winding up those funds.

If a fund is unsuccessful, an issuer needs to be focused on the investors' interests, which may include an orderly de-listing or winding up of the fund.

164 *Periodic statements:* we consider that the inclusion of a written explanation in a periodic statement of performance of the ETP against its investment objectives assists members in making decisions about their investment in an ETP and consider such a statement is consistent with the intention of [CO 13/1200].

H ASIC's other work and next steps

Key points

We have released guidelines for the admission of ETPs, as well as guidance about risk management systems of responsible entities (including issuers).

We will continue engaging with the ETP industry about the monitoring of spreads on a more regular basis.

We will also continue monitoring the development of the ETP market and its treatment of retail investors.

Our other work relevant to the ETP industry

165 In December 2017, we released INFO 230, which sets clear and consistent standards for all licensed market operators seeking to admit ETPs—including ETFs, managed funds and structured products—to their market. The guidelines in INFO 230 largely reflect our existing expectations and current exchange market practice relating to:

(a) approving issuers;

(b) pricing of underlying assets of ETPs;

(c) exposure to derivatives;

(d) disclosure of portfolio holdings;

(e) liquidity provision and market making;

(f) securities lending;

(g) ongoing supervision of ETPs and issuers;

(h) waivers;

(i) product naming/labelling considerations; and

(j) other types of ETPs.

166 ETPs can vary considerably depending on the investment strategy and underlying assets held or referenced. They may be active or passive in their investment strategy, index based or non-index based, have material exposure to derivatives, and/or are structured in a way to provide the financial exposure to the performance of the underlying instruments without holding these directly. The naming convention policy in INFO 230 encourages appropriate naming of various ETPs to help retail investors clearly differentiate between the different types of ETPs with different risk characteristics.

167 We have also issued RG 259, which gives tailored guidance about improving the risk management systems of responsible entities. In establishing an effective system of risk management, responsible entities of registered schemes that are ETPs should consider RG 259.

Next steps

168 We will continue to monitor the development of the Australian ETP market and assess the outcomes for investors in this market. Specifically, we propose to:

(a) engage with novel issuers or issuers offering novel products;

(b) review a selection of PDSs and advertising material; and

(c) monitor reports of misconduct.

169 The continuing growth in ‘active ETFs’ is likely to be an area of continuing interest. We will continue engaging with the ETP industry, including issuers and market operators, to try and achieve a strengthened system for monitoring spreads on a proactive basis.

170 We will also continue engaging with international regulators and with IOSCO regarding its ongoing ETF work.

Appendix 1: Review methodology

171 We sought information using ASIC's information-gathering powers under s912E and had discussions with:

(a) most of the Australian financial services (AFS) licensees who currently offer quoted ETPs (i.e. issuers);

(b) ASX Limited (ASX) and Chi-X Australia Pty Ltd (Chi-X)—the market operators; and

(c) market makers and authorised participants who have agreements with issuers.

172 We also had discussions with:

(a) the SMSF Association, to seek its views about the level of participation and understanding of its members about the ETP market and associated matters;

(b) various service providers, such as data providers and consultants; and

(c) international regulators, including the U.S. Securities and Exchange Commission (SEC), the Hong Kong Securities and Futures Commission (SFC), the Bank of Ireland and the French Autorité des marchés financiers (AMF).

173 Our review methodology involved:

(a) analysing the information obtained from issuers under s912E notices and from the two market operators;

(b) meeting directly with the issuers' executive management and operational staff; and

(c) analysing additional information (provided orally and in written format) from other meetings referred to in paragraphs 171–172.

174 The information sought under the s912E notices covered:

(a) the issuers' compliance with the requirements of legislative instruments that have an impact on ETPs that are admitted to quotation ([CO 13/721] and [CO 13/1200]);

(b) the adequacy of resources deployed by issuers in their ETP operations;

(c) the calculation of tracking error, particularly for funds seeking to deliver the performance of an index;

(d) the issuers' arrangements in relation to market makers and internal market making, including monitoring and any remuneration arrangements with the market makers;

(e) management of conflicts of interest, particularly where the issuer is the internal market maker;

(f) breach handling arrangements;

(g) compliance with continuous disclosure obligations;

(h) compliance with periodic statement requirements;

(i) details of authorised participants engaged by the issuer;

(j) dealing with the removal of funds from quotation or closure of underperforming funds; and

(k) marketing and advertising.

175 In addition, as explained throughout the report, we performed analysis on market data available to ASIC as a consequence of our role in supervising financial markets and we made reference to publications concerning ETPs, including information about international practices.

Appendix 2: Accessible versions of figures

This appendix provides accessible table data for the figures presented in this report.

Table 3: Number of ETPs available on the ASX AQUA market and growth in total funds under management (March 2010 to December 2017)

Date	Market capitalisation of ETPs	Number of ETPs
March 2010	$3.88 billion	27
September 2010	$4.61 billion	33
March 2011	$5.35 billion	41
September 2011	$4.95 billion	50
March 2012	$5.42 billion	58
September 2012	$5.73 billion	62
March 2013	$7.20 billion	66
September 2013	$8.97 billion	63
March 2014	$10.70 billion	73
September 2014	$12.97 billion	75
March 2015	$17.78 billion	110
September 2015	$19.32 billion	128
March 2016	$21.30 billion	128
September 2016	$24.00 billion	146
March 2017	$27.40 billion	155
September 2017	$31.99 billion	167
October 2017	$33.24 billion	168
November 2017	$35.25 billion	174
December 2017	$35.69 billion	175

Source: ASX Limited, *ASX investment products monthly update*, March 2010 – December 2017.

Note 1: The single asset ETPs have been excluded from the total number of products and funds under management.

Note 2: This is the data contained in Figure 2.

Table 4: Quarterly cash inflow and capitalisation of Australian quoted ETPs by type

Date	Australian equity cash inflow	Global equity cash inflow	Interest rate and FX cash inflow	Property securities cash inflow	Market capitalisation
Quarter 4, 2014	467	80	247	56	8
Quarter 1, 2015	381	149	203	75	10
Quarter 2, 2015	883	117	128	60	11
Quarter 3, 2015	638	188	44	63	11
Quarter 4, 2015	849	134	140	50	12
Quarter 1, 2016	207	186	75	44	13
Quarter 2, 2016	638	167	111	79	14
Quarter 3, 2016	30	119	48	27	14
Quarter 4, 2016	729	185	170	98	16
Quarter 1, 2017	352	191	195	53	17
Quarter 2, 2017	775	341	180	70	19
Quarter 3, 2017	561	561	551	119	20

Source: ASIC market surveillance system (MAI), January 2014 – September 2017.

Note: Excludes ETFs that are CHESS depository interests (CDIs) and feeder funds into international ETFs.

Note: This is the data contained in Figure 3.

Table 5: Key drivers of ETFs usage among investors in Australia

Reasons	2013 (n=670)	2014 (n=852)	2015 (n=1063)	2016 (n=1211)	2017 (n=620)
Diversification	76%	70%	71%	72%	72%
Low cost	52%	53%	52%	51%	57%
Access to overseas markets	52%	53%	60%	52%	53%
Avoiding risk through individual stock exposure	34%	31%	34%	35%	34%
Liquidity/easy to buy and sell	34%	31%	29%	29%	27%
Access to specific types of investments	30%	23%	30%	25%	23%
Access to specific sectors Note: New option added to survey questions.		–	–	–	22%
Provide a good core of investment portfolio	22%	21%	19%	20%	18%

Reasons	2013 (n=670)	2014 (n=852)	2015 (n=1063)	2016 (n=1211)	2017 (n=620)
Easier to access than unlisted managed funds Note: New option added to survey questions.	0%	20%	20%	20%	17%
Trading flexibility	19%	16%	20%	17%	17%
Access to investments otherwise out of reach Note: New option added to survey questions.	–	–	–	–	16%
Cost effective for large investments	14%	14%	15%	13%	13%
I don’t have time to choose stocks	10%	10%	11%	8%	11%
Allow quick rebalancing of portfolio	14%	11%	11%	12%	10%
Transparency of underlying investments	8%	7%	8%	8%	8%
Tax advantages	4%	5%	5%	6%	6%
Can be used in margin lending portfolio	5%	4%	4%	2%	4%
Other	2%	3%	3%	4%	2%

Source: Investment Trends, *September 2017 exchange traded funds report*, survey concluded: September 2017 and report released: December 2017.

Note 1: ‘n’ represents the sample size of Australian investors.

Note 2: This is the data contained in Figure 5.

Key terms

Term	Meaning in this document
AFS licensee	A person who holds an AFS licence under s913B of the Corporations Act
AQUA market	ASX Quoted Assets 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 issuers to clearing and settlement services provided by the ASX Group
ASIC	Australian Securities and Investments Commission
ASX	ASX Limited or the exchange market operated by ASX Limited
authorised participant	In relation to a registered scheme (i.e. an ETF quoted on the AQUA market), a person who is either a trading participant or has engaged a trading participant to act on its behalf to acquire and dispose of interests in the registered scheme and: • has an agreement with the responsible entity of that registered scheme in relation to making applications to acquire and withdraw interests in the scheme; and • has notified the responsible entity in writing that the person expects they will be an Australian resident for tax purposes for the financial year of the scheme in which the notification is made and for each subsequent financial year, and has not subsequently notified the responsible entity to the contrary
Corporations Act	*Corporations Act 2001*, including regulations made for the purposes of that Act
equity market product	An equity market product means: (a) a share in a body; (b) a financial product referred to in in s764A(1)(b)(i) or s764A(1)(ba)(i) of the Corporations Act; (c) a right (whether existing or future and whether contingent or not) to acquire, by way of issue, the following under a rights issue: (i) a share covered by paragraph (a); or (ii) a financial product covered by paragraph (b); (d) a CHESS depository interest; or (e) a transferable custody receipt, admitted to quotation under a market’s operating rules, but does not include a CGS depository Interest

Term	Meaning in this document
ETF	Exchange traded fund—a type of investment fund that can be bought and sold on a securities exchange market. ETFs are classified as either an ordinary ETF which passively tracks an asset or index, or an active ETF which seeks to outperform the market or index to achieve a different objective
ETP	Exchange traded product—the family name for the group of products comprising ETFs, managed funds and structured products
extreme trade range	An extreme trade range event occurs when: • a buy order enters a market and the price is within the upper extreme trade range; • a sell order enters a market and the price is within the lower extreme trade range; or • a transaction is executed on a market at a price that is within the extreme trade range
iNAV	The indicative net asset value is calculated in the following way: • for an ETP that is quoted on AQUA, the indicative total assets of the ETP less the indicative total liabilities of the ETP (disregarding any liability to a member of the ETP as a member), divided by the number of interests in the ETP; and • for a class of interests in an ETP that is quoted on AQUA, the indicative total assets attributable to that class of interests less the indicative total liabilities attributable to that class of interests (disregarding any liability to a member of the ETP as a member)
internal market making	An arrangement where the issuer or its agent, rather than a third party, performs the role of the market maker, usually by the issuer appointing a market participant to act as an agent to provide bids and offers throughout the day
issuer	A person who issues interests in an ETP to another person
liquidity provider	A person that voluntarily makes offers to buy and sell securities/units and seeks to profit from this activity, but who is not contractually required to do so
managed investment scheme	Has the meaning given in s9 of the Corporations Act
managed fund	A collective investment that is a registered scheme, the interests of which are admitted to quotation as securities of a managed fund by a market operator
market integrity rules	Rules made by ASIC, under s789G of the Corporations Act, for trading on domestic licensed markets

Term	Meaning in this document
market maker	A person who has entered into an agreement with the issuer to make a market for an ETP
NAV	Net asset value of an ETP
operating rules	The business rules and guidelines for the relevant market
PDS	A Product Disclosure Statement—a document that must be given to a retail client for 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.
registered scheme	A managed investment scheme that is registered under s601EB of the Corporations Act
REP 282 (for example)	An ASIC report (in this example numbered 282)
responsible entity	A responsible entity of a registered scheme as defined in s9 of the Corporations Act
retail client	A client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations
retail investor	An investor who acquires their interest in an ETP as a retail client. In this report, the phrase 'retail client' may include a self-managed super fund or other investors ordinarily considered to be 'retail' notwithstanding that they may not qualify as a 'retail client' under the Corporations Act as discussed above
RG 259 (for example)	An ASIC regulatory guide (in this example numbered 259)
SMSF	A self-managed superannuation fund
structured product	A financial product where the investment strategy is embedded in it. The investment strategy may be based on a single security, a basket of securities, debt, indices, commodities or derivatives
tracking difference	The actual differences in the returns between an ETP and its underlying reference index over a period of time
tracking error	The volatility (as measured by a standard deviation) of the differences in the returns between an ETP and its underlying reference index over a period of time
trading participant	Has the meaning given by rule 1.4.3 of the ASIC Market Integrity Rules (Securities Markets) 2017
wholesale client	A client who is not a retail client as defined in s761G of the Corporations Act and Div 2 of Pt 7.1 of the Corporations Regulations

Related information

Headnotes

authorised participant, ETF, ETP, exchange traded fund, exchange traded product, managed fund, market making, structured product

Class orders

[CO 13/721] *Relief to facilitate quotation of exchange traded funds on the AQUA Market*

[CO 13/1200] *Periodic statements relief for AQUA quoted and listed managed investment scheme managers*

Regulatory guides

RG 234 *Advertising financial products and services (including credit): Good practice guidance*

RG 259 *Risk management systems of responsible entities*

Legislation

Corporations Act, s601FC(1)(d), 609, 671, 912E, 1017B, 1017D

Market integrity rules

ASIC Market Integrity Rules (Competition in Exchange Markets) 2011

Information sheets

INFO 230 *Exchange traded products: Admission guidelines*

Consultation papers and reports

CP 196 *Periodic statements for quoted and listed managed investment products and relief for AQUA products*

REP 282 *Regulation of exchange traded funds*

REP 373 *Response to submissions on CP 196: Periodic statements for quoted and listed managed investment products and relief for AQUA products*

Other documents

Autorité des marchés financiers (AMF), *ETFs: Characteristics, overview and risk analysis—the case of the French market*

ETFGI, *Global ETF and ETP industry insights: December 2017*, report, January 2018

Investment Trends, *September 2017 exchange traded funds report*, survey concluded: September 2017 and report released: December 2017

IOSCO, *Principles for the regulation of exchange traded funds* (FR06/13), (PDF 825 KB), report, June 2013

Johnson B, 'Common characteristics of failed exchange-traded products', *Morningstar Research—News*, 16 February 2018