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MANAGING DIRECTOR, HEAD U.S. ISHARES PRODUCT
BEFORE THE
UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES, INSURANCE AND INVESTMENT
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Thank you Chairman Reed and Ranking Member Crapo for the opportunity to appear today before this Subcommittee to discuss Exchange Traded Funds ("ETFs"), which have become an important investment product for investors large and small. My name is Noel Archard and I am a Managing Director at BlackRock with responsibilities for product development in our ETF business which operates under the name iShares.

BlackRock is one of the world's leading asset management firms, offering clients a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. BlackRock employs more than 9,700 people, including 5,500 in the U.S. Our client base includes corporate, public, union and industry pension plans; governments and official institutions; banks and insurance companies; endowments, foundations and charities; and individuals.

BlackRock, through iShares, is the market leader in the ETF industry both in the U.S. and globally, with iShares assets under management in the U.S. of $470 billion and $632 billion globally. We began managing our first ETFs in 1996 and subsequently launched the iShares brand in 2000. We seek to provide financial products that serve the best interests of our clients.

ETFs are one of the most dynamic and investor value-enhancing market developments of the last 25 years. They offer investors a low-cost, flexible and efficient way to invest in portfolios of stocks that track indices and diversify portfolio risk.

While the first ETFs were straightforward, tracking relatively broad benchmarks such as the S&P 500 or individual country indexes, today some sponsors have introduced new products of increased complexity that carry greater risk and may not be appropriate for retail "buy and hold" investors. Products which raise such concerns include so-called leveraged and inverse funds (described in greater detail below), products that are backed principally by derivatives rather than physical holdings. These products require a greater deal of disclosure and up-front work with clients for them to understand investment and structural risks and BlackRock believes that they should not be labeled ETFs.

If there is one over-arching principle that we at BlackRock believe should guide all participants in the growing ETF marketplace, it is transparency in all aspects of the product structure. It is incumbent on our industry and its regulators to ensure that investors who purchase ETFs—and any financial product—know what they are buying and appreciate the risk and costs associated with those products. That is why BlackRock welcomes the focus of this Subcommittee on ETFs, as we believe that more knowledge and more information about ETFs will benefit investors and the general public alike.

In this vein, we have called for new standards for ETFs and "Exchange Traded Products" (ETPs) more broadly to enhance transparency and investor protection. Clear labeling combined with disclosure of fees and risks is a critical starting point to achieving the better clarity investors need to understand various structures.

For the U.S. marketplace, BlackRock and iShares specifically recommend the following:

- Clear labeling of product structure and investment objectives
    - A standard for funds using the ETF label to <u>exclude</u> from that classification any leveraged or inverse products and any primarily derivatives-based products currently described as "ETFs"

- Frequent and timely disclosure for all holdings and financial exposures
- Disclosure of all fees and costs paid, and
- Adoption of an ETF rule for the U.S. ETF market by the SEC encompassing:
    - Clear and consistent product structure guidelines
    - Enhanced disclosure for higher risk products, and
    - Codification of routine exemptive relief that has been granted multiple times over many years.

The Value of ETFs to Today's Investors

ETFs exist across a range of asset classes, including many not readily available through other investment products, thereby permitting investors to diversify their risk easily and efficiently by accessing different areas of the global markets within one investment portfolio. ETFs have made it convenient for investors to tailor a financial portfolio based on their financial objectives.

In addition, by holding a basket of securities, rather than a single stock or bond, ETFs represent broad diversification within an asset class. Looking at ETFs trading on U.S. exchanges today, the top 50 funds by assets under management represent 60% of the ETF market and overwhelmingly represent broadly diversified portfolios with an average of 580 securities per fund.

Unlike traditional mutual funds, which are priced once daily, ETFs trade like stocks, and, like stocks, can be traded throughout the day, which provides increased investment flexibility to both professional and retail investors.

Also, unlike typical mutual funds, which disclose their holdings only quarterly and with a substantial time lag, most ETFs disclose all or substantially all of their portfolio holdings frequently, often daily, so investors can readily understand what they own.

ETFs utilize an innovative "creation and redemption" process which helps keep an ETF's market price in line with the price of the fund's underlying assets or net asset value per share ("NAV"). Through the creation and redemption process, a group of certain broker-dealers and market makers called "authorized participants" ("APs") work with ETF sponsors to (a) create new shares of an ETF if demand for shares in the secondary market exceeds supply or (b) redeem shares if the secondary market supply exceeds demand. APs generally manage the supply of ETF shares by delivering the underlying securities that make up the ETF to the fund in exchange for shares of the ETF, which the AP may then make available for trading in the secondary market. This process also works in reverse. APs can readily redeem a block of a specific ETF's shares by gathering enough shares of the ETF and then exchanging for the underlying securities held by the ETF. The creation and redemption process not only helps the ETF trade in line with its underlying value, but also reduces the portfolio turnover and related transaction costs at the fund level, so that ETF investors are less impacted by portfolio activity (as compared to a traditional open-end mutual fund).

Benefits Have Led to Rapid Adoption

Investments in ETFs by both institutional and retail investors has increased year over year, with global ETF assets now estimated to be $1.4 trillion, of which $969 billion is in the U.S. market. Each time the financial markets and the financial industry has experienced a severe disruption—the tech sector bubble bursting in 2000, the mutual fund market timing scandals, the 2008 credit crisis, last year's "Flash Crash" and this year's credit crisis—ETF flows have subsequently grown. This is because investors value the transparency, efficiency and simplicity of ETFs.

Individual investors now use ETFs in a variety of ways: to build a balanced portfolio through careful asset allocation, for example, or to engage in tactical investing among sectors. ETFs help individuals manage their investment costs, understand what they own and diversify a portfolio. This in turn helps them build a nest egg, prepare for retirement, or save for their children's education.

Institutional investors use ETFs for a variety of strategies as well, including hedging and achieving exposure to otherwise difficult to access markets. This helps institutions such as large pension plans, foundations and endowments to manage their risks and meet their financial obligations.

Concerns Raised with the ETF Market Today

In the past few years, ETF sponsors have introduced increasingly complex exchange traded products that in some cases have failed on investors' expectations or failed to maintain appropriate standards of transparency and simplicity. This has introduced new risks to investors that may not be fully understood or, importantly, may not be appropriate for long-term investors. Calling such products ETFs causes investor confusion and regulators should require a different label. Products which raise this concern include:

- Daily-rebalance leveraged and inverse products
- Products principally backed by derivatives rather than physical holdings

While these products currently make up less than 10% of the ETF assets in the U.S., they have generated created magnified and questionable concerns about the role of <u>all</u> ETFs in the marketplace, including ETFs that do not use inverse and leverage strategies or invest principally using derivatives. Nevertheless, these concerns must be addressed by the ETF industry and regulators in order to ensure the benefits to investors provided by the majority of ETFs continue to be realized.

Leveraged and Inverse Funds

As noted above, a specific type of derivatives-based ETF has introduced further complexity by seeking to provide returns that are (a) a multiple of the underlying index through the use of leverage (which can magnify gains or losses) or (b) the inverse (or a multiple of the inverse) of the underlying index (resulting in an ETF that attempts to profit from the decline in the value of the underlying benchmark).

Leveraged and inverse ETFs typically seek to maintain a specific ratio of leverage to the benchmark each day and therefore have to increase or decrease their exposure each day in response to market movements. This daily rebalancing process keeps daily leverage at the desired level, but over longer periods performance may be significantly different than the unleveraged performance of the benchmark index multiplied by the fund's specified leverage (or inverse leverage) ratio. The use of leverage results in significantly different risks than traditional ETFs, which should be clearly disclosed and reflected in the name of the product category.

Use of Derivatives Rather than Physical Securities

Much of global regulatory focus has been on, among other issues, ETFs that use derivatives to replicate the performance of a given benchmark rather than holding the physical assets (such as actual stocks or bonds) that comprise that benchmark. Our view is that physical-backed ETFs are typically a better choice for investors because physical-backed funds provide investors with least amount of risk relative to holdings in the fund—the fund is literally comprised of securities fully-owned by the fund with little or no counterparty risk. We recognize that derivative-backed products can have a valid role in an investor's portfolio when an underlying asset class is hard to access or less liquid and therefore ETF exposure to the asset class can only be provided efficiently through derivatives. It is important to note that over 90% of the ETF assets in the U.S. today are primarily backed by physical holdings.

Market Volatility

Many questions have been raised over the past year regarding the connection between the growth of ETFs and various market dynamics. Some theories have tried to link macro-market volatility to the rise in ETFs, while others have pegged end-of-day volatility to the use of leveraged and inverse ETFs.

Our analysis of the data does not suggest that ETFs increase market volatility. Any action that might be undertaken to address increased market volatility would be counterproductive unless hard data shows that ETFs in fact lead to increased market volatility. The historical evidence available to us shows that the broad dynamics of market volatility are reflective of overall macroeconomic uncertainty. Current levels of volatility are not unprecedented and have been observed in past periods of high macroeconomic uncertainty including well before ETFs and other similar instruments were available in the market. During periods of volatility, market participants look for mechanisms to trade on broad economic and market news and ETFs provide an effective mechanism to do so. This explains why we see increased ETF usage in times of increased volatility, but that does not mean that ETF usage is the cause of increased volatility. Indeed, all evidence suggests that the primary cause of volatility lies with the fundamental macroeconomic uncertainty that then gets priced into the market in the form of market volatility.

A number of questions have been raised about the role of leveraged and inverse ETFs in creating end-of-day volatility. This should be addressed in two parts.

The first type of volatility we have seen in the markets recently is when the market swings dramatically in opposite directions near the close of the market. Leveraged and inverse ETFs which rebalance daily must do so structurally in line with market direction, meaning that when the market is down, they must adjust their positions in the same fashion as the market (*i.e.*, down) rather than against it. Arguments put forward that instances when the market is down 2% 15 minutes before the close and then up 2% at market close are perpetrated by the presence of leveraged or inverse rebalancing seems counter-intuitive.

A second type of the volatility focuses more on the potential for leveraged or inverse funds to create a greater directional impact to market moves in a particular direction (either up or down) at the close. While it is possible that certain narrow market segments may be impacted by such daily rebalancing activity, the fact that most leveraged and inverse ETFs do not transact in physical securities suggests that further analysis will be necessary before any conclusions can be drawn about the impact of these types of funds on end-of-day volatility.

Recommendations for Reform of the ETP Marketplace

While ETPs all share certain characteristics, “ETF” has become a blanket term describing many products that have a wide range of different structures. This has led to confusion among investors. It is important for investors to understand the differences among products that are all described as “ETFs” despite exposing investors to different types and levels of risk. The ETF industry today, both in the U.S. and globally, is not doing a sufficient job in explaining those differences consistently.

Transparency is the one overarching principle that should guide all participants in the ETF industry. When they were first introduced more than two decades ago, ETFs helped bring a new level of transparency to the financial industry. While most ETFs continue to provide clear and transparent information about risks, holdings and fees, ETF transparency can and should be improved for the benefit of investors. This means transparency regarding the structure and risks of products;

transparency regarding the holdings of products; and transparency about fees charged.

Like all securities, ETFs are regulated by various government agencies. Regulations, however, may need to further adapt to the rapid changes in the marketplace. BlackRock believes that clarity of labeling and what constitutes an "ETF" are essential and has made the following recommendations to enhance investor protection. Our focus is on ETFs that are index or passive vehicles—the vast majority of the market—rather than active ETFs.

1) Clear Labeling of Product Structure and Investment Objectives

Investors should know what they are buying and what a product's investment objectives are. This can be achieved by establishing a standard classification system with clear labels to clarify the differences between products. As previously noted, Exchange Traded Product or "ETP" should be the broad term used to describe products that trade on an exchange. ETF should refer only to a specific sub-category that meets certain agreed standards. The attachment to this statement summarizes our recommended classifications for exchange traded products.

At the most basic level, and with respect to what an investor expects of an exchange traded fund, a product defined as an ETF should mean that the product is regulated as a publicly offered investment fund (in the U.S., a registered investment company regulated by the SEC) and is appropriate for a long-term retail investor. Products that are designed only for professional or short-term investors, such as exchange traded products that use leveraged or inverse strategies, would not be permitted to use the "ETF" label. Regarding derivatives usage, any significant use of derivatives, including swaps, should be clearly disclosed. This is why having an ETF rule that sets forth consistent standards in the U.S. is so important.

BlackRock recognizes that different regulators around the world have different views about what is permissible within a fund. U.S., European and Asian regulators, for example, are taking different stances on the permissibility of using derivatives (including swaps) in ETFs. A standardized classification system would benefit all investors in understanding what they are buying, and such a system can also assist regulators in developing appropriate rules in each jurisdiction. Foreign regulators have already sought comment on addressing issues of fund categorization for exchange traded products. We believe the SEC should convene a working group of industry participants to agree upon the criteria for a standardized classification system and then issue a rule to assure uniform adoption. This type of classification will also provide the necessary framework for other disclosure standards that we believe are necessary as described below.

2) Frequent and Timely Disclosure of All Holdings and Financial Exposures

Just as investors should understand the structure of any exchange traded product they are buying, they should also understand what that product holds. To that end, sponsors should be required to provide a clear picture of what the product holds and any of its other financial exposures. Ideally, the goal should be daily disclosure of holdings and exposures, but we recognize that there are currently practical, technical and legal constraints that may prevent full disclosure of all portfolio holdings in some products.

3) Disclosure of All Fees and Costs Paid

As some funds have become more complex, the fees associated with some of them have also become more complex. Investors should have complete clarity regarding all the costs and revenues associated with any fund they buy, so they can clearly establish the total cost of ownership. Thus, in addition to clearly stating the management fee paid by the fund to the sponsor, the disclosure should include any costs or fees that affect the investors' holdings and returns. For example, some exchange traded products provide exposure to foreign currencies by investing in non-U.S. dollar bank deposits, which may or may not pay a market rate of interest. We believe that if investors are receiving a return below the market rate of interest that is a hidden cost that should be disclosed.

4) Adoption of an ETF Rule for the U.S. ETF Market by the SEC

The vast majority of ETFs traded in the U.S. are regulated under the Investment Company Act of 1940 (the "1940 Act"), the same as mutual funds, but receive dispensations from the SEC so they can trade on exchanges and create and redeem shares only with APs. Because ETFs are a hybrid of conventional mutual funds and closed-end funds, they do not fit neatly within the 1940 Act. As a result, in order for ETFs to operate in the U.S., they must obtain exemptive relief from the SEC. This exemptive relief can take years to obtain, and, as a consequence, ETF sponsors may receive similar, but sometimes different, SEC relief. It appears that a great deal of the SEC's limited resources devoted to ETF regulation, however, are expended on what are now routine exemptive applications for identical and/or substantially similar products from different sponsors. Using as its foundation the ETF rule proposed in 2008, we urge the SEC to convene a public working group of market participants to develop clear, consistent regulations for U.S. ETFs that establish criteria for classification, take into account the ETF transparency recommendations set forth above and promote the aspects of the ETF market that create the greatest investor utility. In addition to enhancing investor protection, this would create greater efficiency for the SEC and promote competition.

We believe the SEC should, after consultation with ETF market participants, adopt an ETF rule that provides uniform treatment of ETFs and enhances disclosures, particularly for complex and higher risk products such as leveraged and inverse funds. In our view, having consistent rules applicable to ETFs in the U.S. would help investors to better understand differences in these products and make more informed investment decisions.

Conclusion

As the global leader in exchange traded funds, BlackRock welcomes the Subcommittee's focus on ETFs and related products. We explicitly support uniform standards on labeling, transparency and disclosure that will improve investor protection and help ensure that investors understand precisely the risks and attributes of the ETFs they are purchasing. BlackRock is committed to working with regulators, other market participants, this Subcommittee and other policymakers to help ensure that these important enhancements are made on a timely basis by all participants in our industry.

Recommended Classifications for Exchange Traded Products

ACRONYM	NAME	DEFINITION
ETP	Exchange Traded Product	• Catch-all term for any portfolio exposure product that trades on an Exchange. • ETFs, ETCs, ETNs, and ETIs, are all subsets of ETP.
ETF	Exchange Traded Fund	• The product is regulated as a publicly offered investment fund and can be appropriate for a long term retail investor • Funds with daily leverage and inverse strategies should not use the ETF label. • Funds whose exposure is achieved via a swap should use the best practices detailed below.
ETN	Exchange Traded Note	• Debt securities that may be structured as notes or trusts depending on their domicile. • Backed by the credit of its issuer (often an investment bank) which may or may not be collateralized. • The extent of regulatory oversight of these products currently varies region by region.
ETC	Exchange Traded Commodity	• Limited to products that only hold physical commodities. • In the U.S., these are highly regulated under the Securities Act of 1933 • Securities that provide exposure to physical commodities but are structured as debt instruments and not backed by the physical underlying should not be considered an ETC.
ETI	Exchange Traded Instrument	• A type of ETP that describes any portfolio exposure product traded on an exchanged that is not outlined above. • The buyer should exercise increased due diligence.