Speech

SEC-NYU Dialogue on Exchange-Traded Products

Commissioner Michael S. Piwowar

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Good morning, and thank you, Scott [Bauguess], for that kind introduction. It is a pleasure to be with you all.

Thanks also to Alexander Ljungqvist and others from the Salomon Center for the Study of Financial Institutions at New York University, as well as the staff in the Commission's Division of Economic and Risk Analysis, for all of the preparation required to make an event like this happen.

Today's SEC-NYU Dialogue brings together practitioners, academics, and regulators to discuss and exchange ideas on an issue that has received considerable attention over the last few years — the current state of, and outlook for, exchange-traded products ("ETPs").

Exchange-Traded Products are securities that allow investors to invest in a portfolio of assets or in the performance of a benchmark. Types of ETPs include exchange-traded funds ("ETFs"), exchange-traded notes ("ETNs"), and exchange-traded commodity funds ("commodity ETFs"). In many ways, they are similar to traditional open-end mutual funds, but with one major difference. Unlike mutual funds, investors can trade ETP shares throughout the day. This allows investors, both retail and institutional, to tailor their portfolios to take advantage of changing market conditions that occur throughout the day.

The market for ETPs has seen enormous growth since the introduction of these products in 1993, when State Street launched the Standard & Poor's Depositary Receipts ("SPDR") Trust. In the United States alone, there are nearly 2,000 ETPs — with over $2.7 trillion in invested wealth. While the market for ETPs is still only a fraction of that invested in open-end mutual funds — as of September 2016, there was over $13.8 trillion in mutual fund assets under management — ETPs are among the fastest growing asset classes. Relative to other investment vehicles, like open-end mutual funds, exchange-traded products have seen a tremendous growth on an annual basis. For example, in 2016, the assets under management for ETPs grew at a rate of over 30%, compared to only 9.5% for mutual funds.

ETPs are among the most significant financial innovations in recent decades and have shaped financial markets as we know them today. Their rise in popularity as a trading and investment vehicle stems from several sources. First, ETPs allow anyone with a brokerage account easy access to a broad range of asset classes. This is particularly attractive to investors that might not otherwise have easy access to certain types of assets, such as currencies or commodities — thus, facilitating increased portfolio diversification for investors. Second, because the vast majority of ETPs closely track indexes — and are thus passive investments — the costs associated with trading ETPs are often very low. These features have made ETPs tremendously popular with retail investors. ETPs, however, have also become useful trading tools for institutional investors as well. Facets of ETPs, such as the ability to lend ETP shares, sell them short, and trade them on margin have made ETPs attractive vehicles to implement sophisticated trading strategies.

Secondary market trading of ETPs continues to grow at a rapid pace. Today, ETPs constitute 30% of all trading volume, meaning that there are a lot of investors —retail and institutional — actively trading these securities every day. Given the importance and influence of this market, it is crucial for the Commission to think critically about ETPs and to identify emerging issues that will be relevant to investors and market participants.

Many ETPs follow strategies that are easy for investors to understand, such as tracking a particular broad-based index. But over time, some products have become more sophisticated, allowing informed investors to pursue unique economic exposures that may not otherwise be possible. In economic terms, this helps 'complete' markets: a benefit of financial innovation.

The benefits afforded to investors through investments in ETPs often rely on certain institutional market participants — mostly large broker-dealers — to engage in arbitrage trading. Arbitrage trading ensures that the prices at which ETPs trade reflect the intrinsic value of the product's underlying assets or the benchmark it tracks. If the price of the ETP deviates too much from the price of the underlying basket of securities, this creates an arbitrage opportunity. For example, large broker-dealers could buy the cheap ETP and short sell the underlying basket. The broker-dealer would then deliver the ETP shares to the fund in exchange for the underlying basket, which would then be used to close out the short sale. This process helps ensure that ETPs trade near their intrinsic value — a benefit to all investors.

Keeping prices of the ETPs in line with their underlying portfolios can be challenging for some types of ETPs. For example, deviations are more likely to occur when an ETP's reference assets are illiquid — such as certain bonds — or not traded concurrently with the ETP — such as certain foreign securities. In addition, it is possible that arbitrage trading temporarily halts altogether during periods of extreme market stress. For example, ETPs were disproportionately affected by unusual price volatility on August 24, 2015. Nearly one-fifth of ETPs fell by at least 20%, compared to only 5% of the underlying stocks.[1] As a result, ETP prices may deviate from the value of the underlying securities or benchmark for limited periods of time. But, as evidenced by the August 24, 2015 event, even short-term deviations can have large effects on the value of the securities.

ETPs may also affect the values of the underlying securities and the overall quality of financial markets — a concern that both industry and academic studies have recently expressed. One of the issues at the forefront of this discussion has been the question of whether ETPs — which have helped accelerate the trend towards index investing — are leading to reduced capital market efficiency. So far, the evidence appears mixed. On the one hand, there is research that shows that securities' prices reflect available information more efficiently when they are included in ETPs.[2] This appears intuitive, as ETPs allow investors to trade easily on information that is relevant for large segments of the markets. On the other hand, there is evidence that prices of securities with stronger ETP ownership are more volatile, reflecting increased noise rather than information.[3]

These issues are important and — given the growth in ETPs — need to be addressed. Further, while this discussion has focused on the state of the current market, the Commission thinks about the innovations that are happening in the ETP space as well. Although we have seen an increase in the level of research about the effects of ETPs on capital formation, market efficiency, and investor protection, it is still a nascent field, and one in which we need more discussion and discovery. In fact, that's part of why we chose to hold today's Dialogue on ETPs. As a former academic and SEC economist, I think the importance of rigorous academic study on this important asset class cannot be emphasized enough. We are also eager to hear about ETPs from investors and the industry.

I hope that today's SEC-NYU Dialogue will provide interesting insights and ideas about ETPs. This Dialogue will focus on three aspects of exchange-traded products: first, how ETPs affect the efficiency and quality of financial markets; second, the potential implications for investors who hold ETPs; and third, the future of ETPs. In all three panels, we have eminent scholars and practitioners who have been directly involved in various facets of the market for exchange-traded products, and therefore, can provide unique and valuable insights to the Commission. I look forward to hearing the discussions, analyses, and recommendations that will come out of today's event.

Thank you all for agreeing to spend your time with us so that we can benefit from your insights. I wish you a day full of enjoyable and fruitful discussions.

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[1] *See* Research Note: Equity Market Volatility on August 24, 2015 prepared by the Staff of the Office of Analytics and Research, Division of Trading and Markets, U.S. Securities and Exchange Commission, December 2015, *available at* https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf.

[2] *See* Lawrence Glosten, Suresh Nallareddy, and Yuan Zou, 2016, ETF Activity and Informational Efficiency of Underlying Securities, Working Paper, Duke University.

[3] *See* Ben-David, Itzhak, Francesco Franzoni, and Rabih Moussawi, 2017, Do ETFs Increase Volatility? Working Paper, The Ohio State University.