

## Passive Investing

# Debate intensifies over ETFs' impact on markets

Massive inflows prompt regulators to examine consequences of passive fund growth

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YESTERDAY by: **Chris Flood**

Few people would be bold enough to call BlackRock a “very dangerous company” when sitting next to [Larry Fink](https://www.ft.com/topics/people/Larry_Fink), the co-founder and chief executive of the world’s largest asset manager.

[Carl Icahn](https://www.ft.com/topics/people/Carl_Icahn), the billionaire activist investor, was one of those few. His jibe was dismissed by Mr Fink as “flat out wrong” when the pair clashed at a conference in July 2015 while disagreeing about whether or not exchange traded funds could derail the US high-yield bond market.

But within weeks of Mr Icahn and Mr Fink’s spat, ETFs were at the centre of one of the wildest days of trading in US stock market history.

More than a fifth of all US-listed ETFs were forced to stop trading on August 24 after the Dow Jones Industrial Average dropped nearly 1,100 points in the first few

minutes of the day and then rebounded by almost 600 points minutes later.

US regulators are still struggling to understand how to prevent a repeat of the event, which left many retail investors nursing losses.

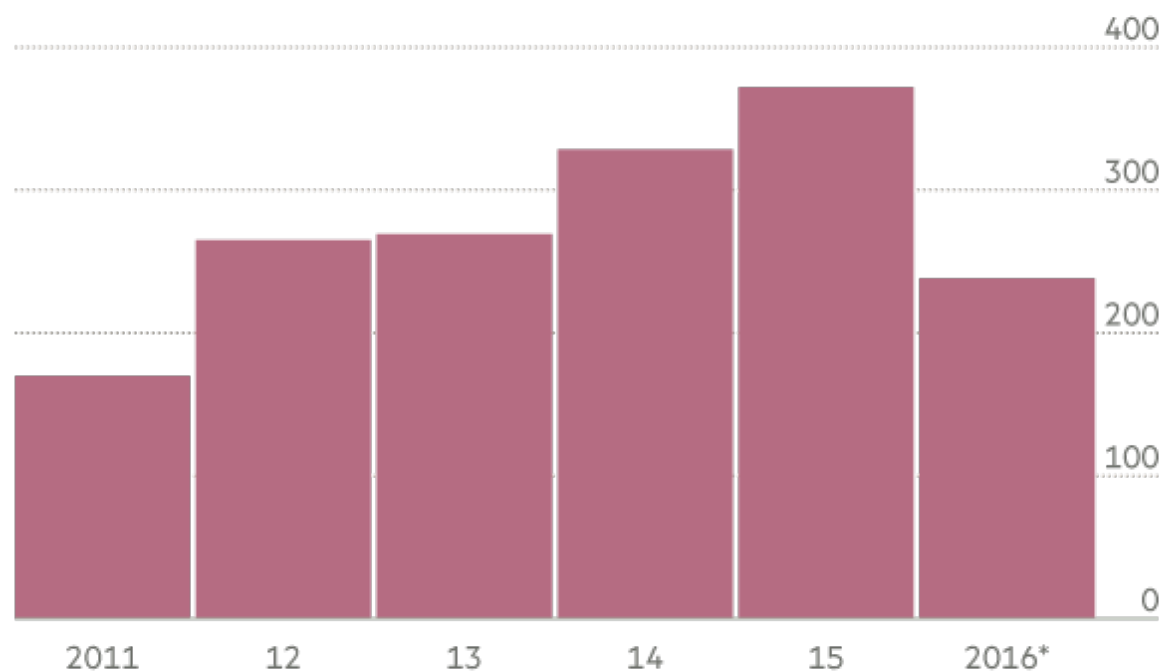
The Securities and Exchange Commission, the US regulator, is now preparing a root-and-branch review of the industry amid fears that massive inflows into ETFs may be exacerbating volatility in financial markets.

Exchange traded funds and products have attracted more than \$2tn in net new inflows globally over the past eight years, and worldwide ETF assets have grown to \$3.4tn over the same period, according to ETFGI, a London-based consultancy.

“It should come as no surprise that the SEC will take a deep dive into the world of ETFs in light of the dramatic growth in assets over the past few years,” says Jay Baris, chairman of the investment management practice at Morrison & Foerster, the law firm.

### Investor inflows into ETFs

\$bn



\* Year to date  
Source: ETFGI

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ETFs account for a third of all US equity trading volumes and even more during periods of high volatility. Ensuring that trading remains orderly is therefore of critical importance to the overall stability of the US stock market.

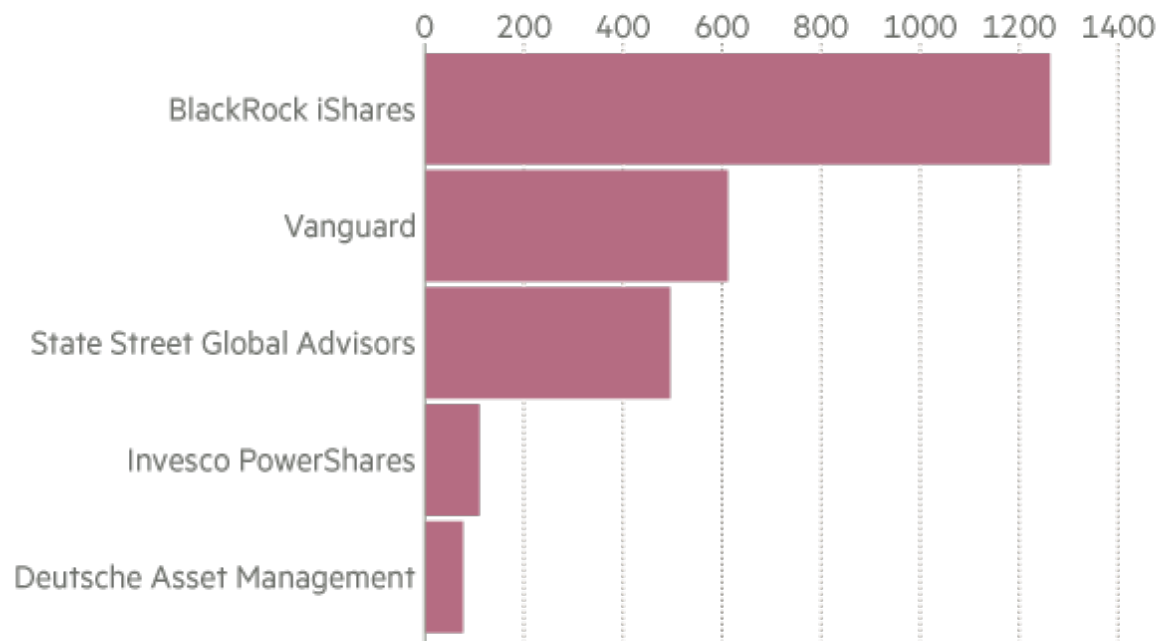
A number of providers of ETFs agree that some regulatory changes are necessary,

but it is the exchanges that need reforming, they say. The trading of ETFs is spread across more than a dozen exchanges and other private trading venues known as [dark pools](https://www.ft.com/topics/themes/Dark_Pools) ([https://www.ft.com/topics/themes/Dark\\_Pools](https://www.ft.com/topics/themes/Dark_Pools)).

Inconsistencies in how exchanges restarted trading once stock suspensions were lifted on August 24 led to long delays before normal market business was able to resume fully. It also caused problems in identifying which ETF trades were valid and which should be cancelled.

BlackRock, which oversees more than \$1tn of ETF assets, has urged regulators to tighten exchange trading rules, rather than focus on weaknesses in the structure of ETFs.

Top five ETF managers ranked by assets  
\$bn



Source: ETFGI

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Three of the largest exchange operators, Bats Global Markets, Nasdaq and the New York Stock Exchange, have tabled proposals to harmonise trading rules, particularly in periods of higher market volatility.

One suggestion is that the main exchanges should follow agreed processes when reopening to business after a trading halt.

Others believe the problems in the ETF market go further than issues around how the products are traded.

Do we really need that extra liquidity that is provided by ETFs?  
Is it really necessary?

**Professor Itzhak Ben-David**

Academics at the universities of Ohio, Lugano and Villanova published a paper last year arguing that ETFs have brought a “new layer” of volatility to the US equity market by attracting more short-term traders.

Itzhak Ben-David, finance professor at Ohio State University, says some of these short-term traders move to the sidelines when the market becomes volatile, so the liquidity they provide in good times proves illusory when conditions turn bad.

He sees the additional liquidity provided by ETFs as a “double-edged sword”, and says ETFs can increase volatility in the pricing of the stocks they own, and raise volatility at an overall market level.

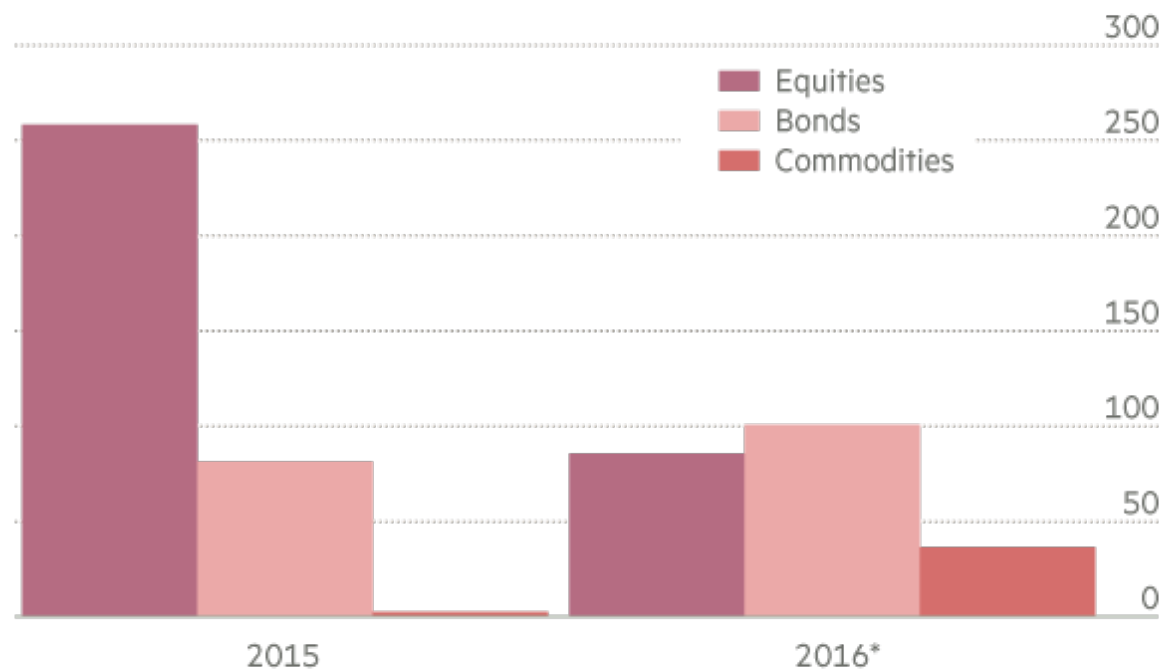
“Do we really need that extra liquidity that is provided by ETFs? Is it really necessary?” he says.

Academics are not alone in their concerns. Last year Luis Aguilar, a commissioner at the Securities and Exchange Commission, raised concerns among providers when he asked: “Should we consider curtailing the growth of ETFs?”

Mr Aguilar added: “Why ETFs proved so fragile that [August] morning raises many questions and suggests it may be time to re-examine the entire ETF ecosystem.”

## Investor inflows into ETFs by main asset class

\$bn



\* Year to date  
Source: ETFGI

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Legendary investor John “Jack” Bogle, who founded Vanguard, the world’s second-largest asset manager, told FTfm last year: “Mark me as a member of a small group of cohorts who are dubious about the utility of ETFs for long-term investors.”

Passive fund houses firmly reject such criticisms.

Joel Dickson, global head of investment research and development at Vanguard, insists buy-and-hold investors have driven the growth in ETFs, rather than short-term traders.

“The average holding period for an ETF among Vanguard’s retail investors is around three years,” says Mr Dickson.

It is a mistake to assume that just because there is a lot of ETF trading, that somehow there is also frenzied activity happening with the underlying assets of the ETF

**Joel Dickson, Vanguard**

“Most ETF transactions take place without requiring any trading in the underlying stocks. It is a mistake to assume that just because there is a lot of ETF trading, that somehow there is also frenzied activity happening with the underlying assets of the ETF,” he says.

Mr Dickson also rejects the notion that

overall market volatility has been affected by the growth of ETFs, which now account for 5.6 per cent of the US stock market, according to research from Credit Suisse, the Swiss bank.

Mr Dickson says: “During the 2007/08 financial crisis, volatility measures in both the Japanese and US equity markets spiked higher. But there were virtually no equity ETFs trading in Japan at that time.”

Passive fund managers further argue that ETFs provide a valuable “price discovery” function that can help investors manage their portfolios more efficiently.

During the Fukushima nuclear disaster in 2011, Japanese ETFs listed in the US and Europe continued to trade while the Tokyo market was closed, enabling investors to make portfolio adjustments in response to updates about radioactive leaks from the power generator.

The growing debate over the role of ETFs in financial markets led US regulators to launch a public consultation in June 2015.

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Industry observers have been surprised that no policy recommendations have yet followed, but Mary Jo White, the outgoing chairwoman of the SEC, emphasised ETFs remain a significant concern in a speech in May.

Ms White said the SEC needed to look at the “unique and pressing challenges” arising from the structure of ETFs, and warned that “further regulatory steps” might be needed to improve investor protection standards.

She added that regulators would examine the relationships between ETF share pricing and their underlying portfolio holdings and the impact on investors when these connections broke down.

The SEC declined to comment on when the preliminary findings of its review would be

made public.

Despite these pressures, the ETF industry appears on course to continue growing rapidly.

Last month EY, the consultancy, published research indicating the size of the ETF market will double over the next four years to account for \$6tn of assets.

EY, too, has its concerns. “Unfortunately, the same market conditions that make ETFs attractive also pose challenges,” it says.

“No one in the industry expects ETFs to create or even contribute to a crisis. But a significant minority clearly believes that ETFs may suffer, perhaps unfairly, from events beyond the industry’s control,” it said.

### **‘ETFs are growing like bunnies’**

The US Securities and Exchange Commission is gearing up for a root-and-branch review of the rapidly growing exchange traded fund industry amid concerns that massive flows into ETFs may be exacerbating volatility in financial markets.

In the US alone, ETF assets stand at \$2.4tn, and globally they hold \$3.4tn, according to ETFGI, a data provider.

The SEC is expected to examine every aspect of the industry and the consequences of its growth. These range from issues such as the implications of an ever-greater share of the US stock market being dictated by ETF flows, to structural concerns around such instruments tracking bonds.

The SEC has done “bits and pieces” in its assessment of the industry, but is now “laying the groundwork for a bigger review”, said a person briefed on the matter.

“ETFs are growing like bunnies. It’s a great success story, but as a forward-looking regulator the SEC has to be on top of any potential issues that may arise in the future.”

A working group of at least a dozen people from across the SEC’s divisions was formed about a year ago to examine ETF products, said another person briefed on the matter.

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