

SECOND GENERATION ETFs IN BRAZIL

Welcoming international innovation with responsibility

The Exchange Traded Funds (ETFs) industry in Brazil may profit from current global trends. International market players recently moved on to develop new product types, such as actively managed and leveraged, derivative-based strategy ETFs. Brazilian market participants should discuss benefits and risks involved.

BACKGROUND AND POLICY DEVELOPMENTS

- ETFs were launched in the U.S. 25 years ago. The industry currently amounts to around USD 1.7 trillion.
- ETFs are financial products that have features of both open- and closed-end funds. Like all funds, they are pooled investment vehicles. ETF shares can be issued and redeemed, usually through the delivery/withdrawal of securities, similarly to open-end funds. Besides, they are traded in a secondary market, like closed-end funds.
- Initially, only passive ETFs that replicate a publicly available market index (such as the S&P 500) were traded. These products offer high liquidity, easy access to global financial markets for individual and institutional investors, low costs, simple distribution, and enhanced market efficiency and price discovery.
- Afterwards, decoupling from benchmarks gave birth to non-passive "second generation" ETFs, such as synthetic (based on derivatives), customized (addressing specific investor's needs), leveraged (aiming at delivering index multiples), smart beta (based on indexes with non-conventional weights), and fully active ETFs.
- Instruction no. 359/02 from Brazil's *Comissão de Valores Mobiliários (CVM)* regulates the local Indexed Funds industry. Such funds are similar to ETFs but only passive funds are allowed.
- Despite recent local regulatory developments (e.g. the possibility to establish fixed income-based ETFs "cash creation", which allows fund managers to accept cash for payment and redemption of fund shares), the basic features of the Indexed Funds remain the same.

FURTHER READINGS

- CFA Institute. *A Comprehensive Guide to Exchange-Traded Funds (ETFs)*. Found at www.cfainstitute.org, section "Research".
- ETF.com: www.etf.com.
- CVM regulation on Indexed Funds: Instruction no. 359/02 (in Portuguese). Found at www.cvm.gov.br/legislacao/inst/inst359.html.
- Balchunas, Eric. *Goldman Sachs to Turn Its Hedge Fund Research Into an ETF: A new frontier for ETFs?*. Found at www.bloomberg.com/articles.

CFA SOCIETY BRAZIL VIEWPOINT

- Regulation in Brazil is restrictive as it limits the tracking error and the portfolio composition to assure that the fund is considered an Indexed Fund. Moreover, it explicitly prohibits leverage, short positions, ETFs that are inverse to an index, and synthetic (derivatives-based) ETFs.
- ETFs are an undeniable global trend, posing many advantages. The use of second generation ETFs is a recent development and an important innovation in international markets. As long as regulation restricts the range of ETFs offered to investors, it may be a factor contributing to the still low interest in the product domestically.
- CFA Society Brazil acknowledges that second generation ETFs present specific risks. Benchmark mismatches, gap risk (ancillary to the use of options), and increased difficulty to arbitrate are examples.
- In this scenario, a regulatory reform is recommended. Enhanced disclosure, the creation of appropriate market infrastructure, education and suitable financial advice are tools that may be used to cope with risks. The possibility of having local ETFs investing in foreign ETFs (already granted by CVM in exceptional cases) could be extended.
- The development of the local capital markets is a key objective of CVM's mission. Responsible changes towards the creation of new financial products will be welcome by market participants and will enhance the profile of Brazil's financial market.