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Resolutions

How regulations and taxes are shaping the future of ETFs

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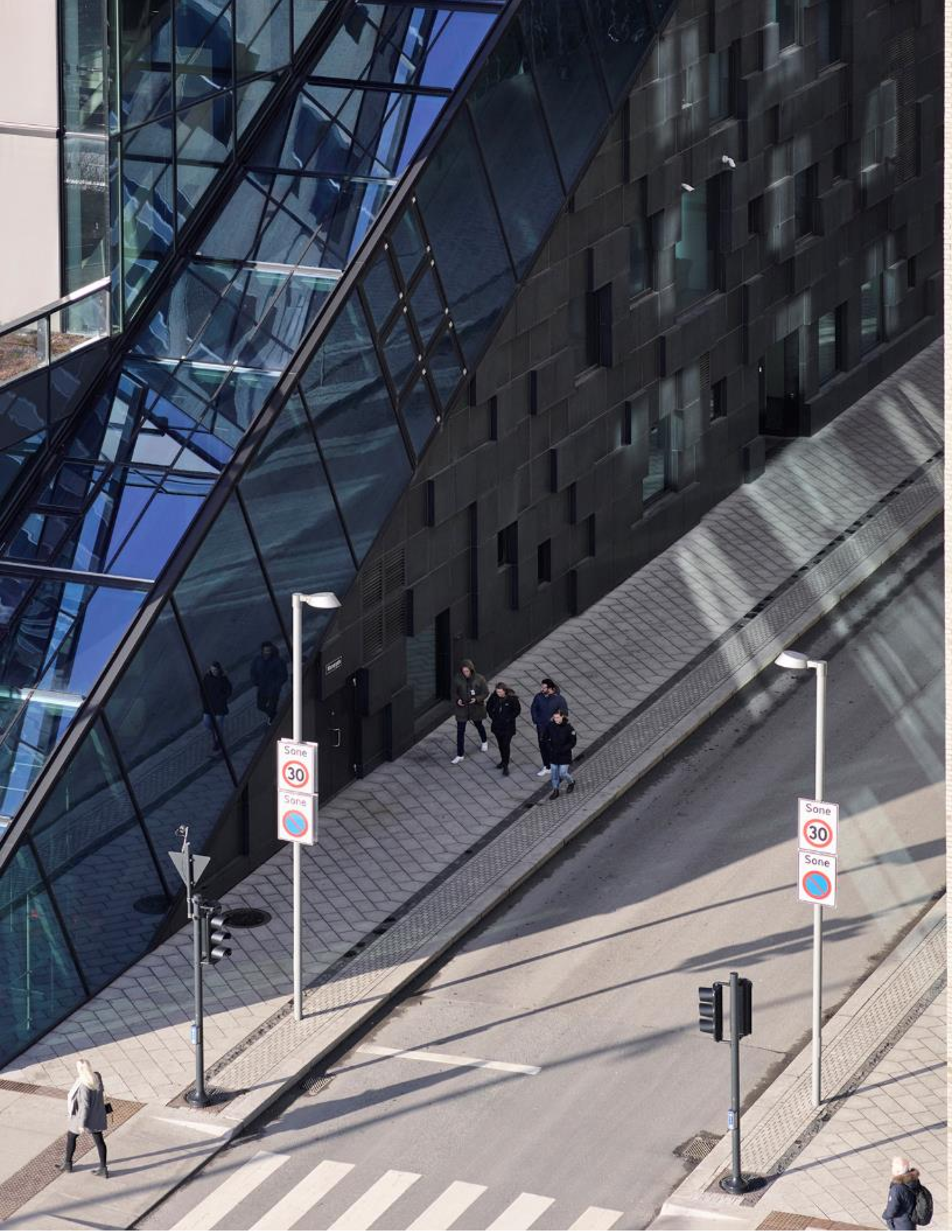
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Executive summary

Skyrocketing popularity often comes at the price of sharp scrutiny, as the fast-growing exchange traded funds (ETF) industry is learning. With the number and variety of ETFs rapidly increasing, and total assets under management at an all-time high, ETFs have earned an extra level of scrutiny from regulators globally. Regulators appear to be committed to making sure that safeguards exist for accurately identifying and communicating risks and costs, as well as ensuring up-to-date compliance practices for ETFs.

Whether such directives dampen growth and innovation—or steer funds toward new opportunities—may depend on how well ETF sponsors manage risks and disclosures while also accommodating changing distribution technologies and new investment products.

The continued growth in ETF assets will also be matched by increased complexity. In addition to traditional ETFs, which passively track market benchmarks, there are actively managed versions, and smart beta ETFs (which measure stock holdings based on factors other than market capitalization) as well as derivatives-based synthetic ETFs—and an ever-expanding array of others, some of them less diversified and, therefore, riskier.

An increasing number of ETF sponsors will explore geographic markets outside of their home territories, according to a recent PwC study. The survey, which drew global responses from more than 65 ETF managers, sponsors and service providers, asked respondents where they plan to expand, and which regulatory and tax obstacles they anticipate encountering. The survey-takers, whose firms collectively represent approximately 80% of global ETF assets under management, consist of ETF managers/sponsors (68%), service providers (20%), and market makers and other authorized participants (9%). Whether in search of institutional or retail investors, ETF firms are increasingly seeking to grow their global footprint well beyond their home markets. Based on our survey results, North American (86%), Europe (88%) and Asia & Oceania (70%) participants expect to launch ETFs outside of their home markets over the next two years (see Figure 1). These survey results are consistent with the discussions we have had and continue to have with many asset managers who recognize that the growth opportunities for ETFs are significant across the globe.

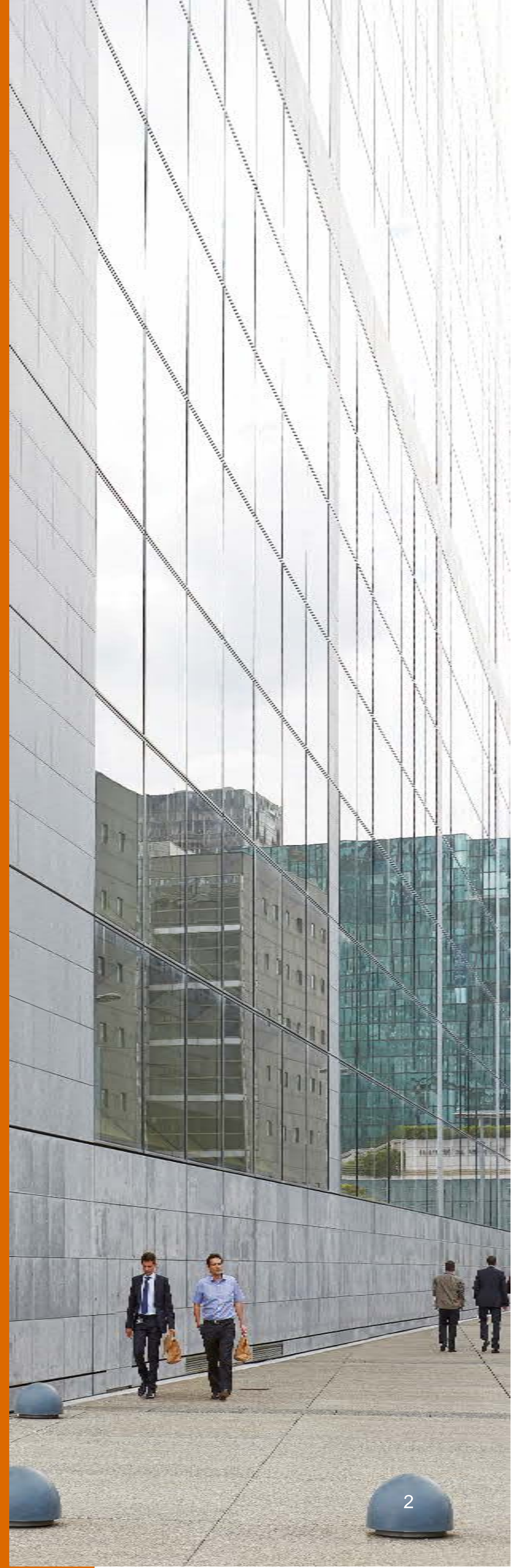
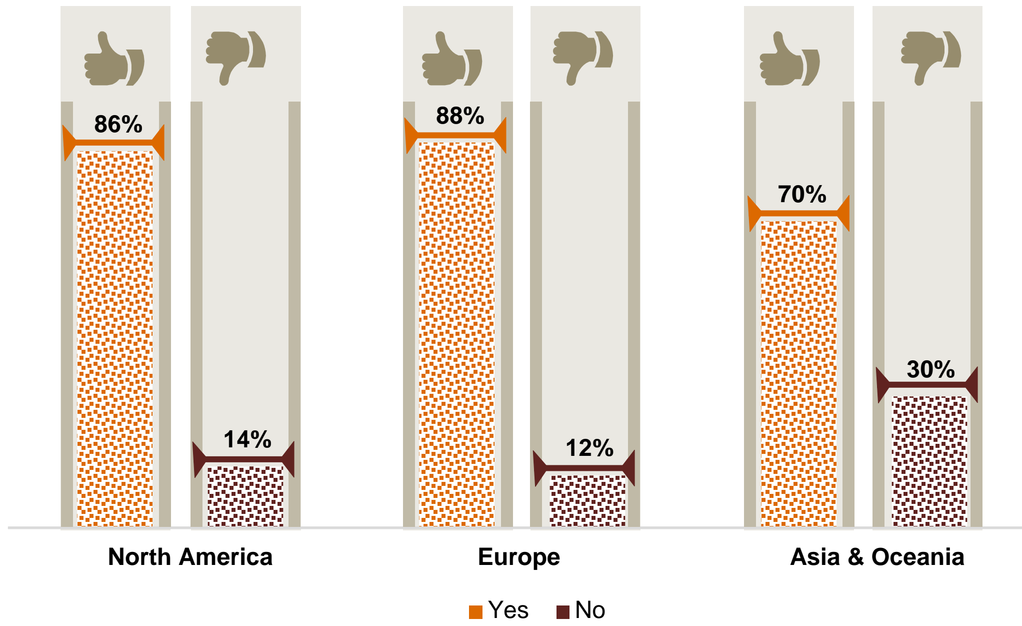
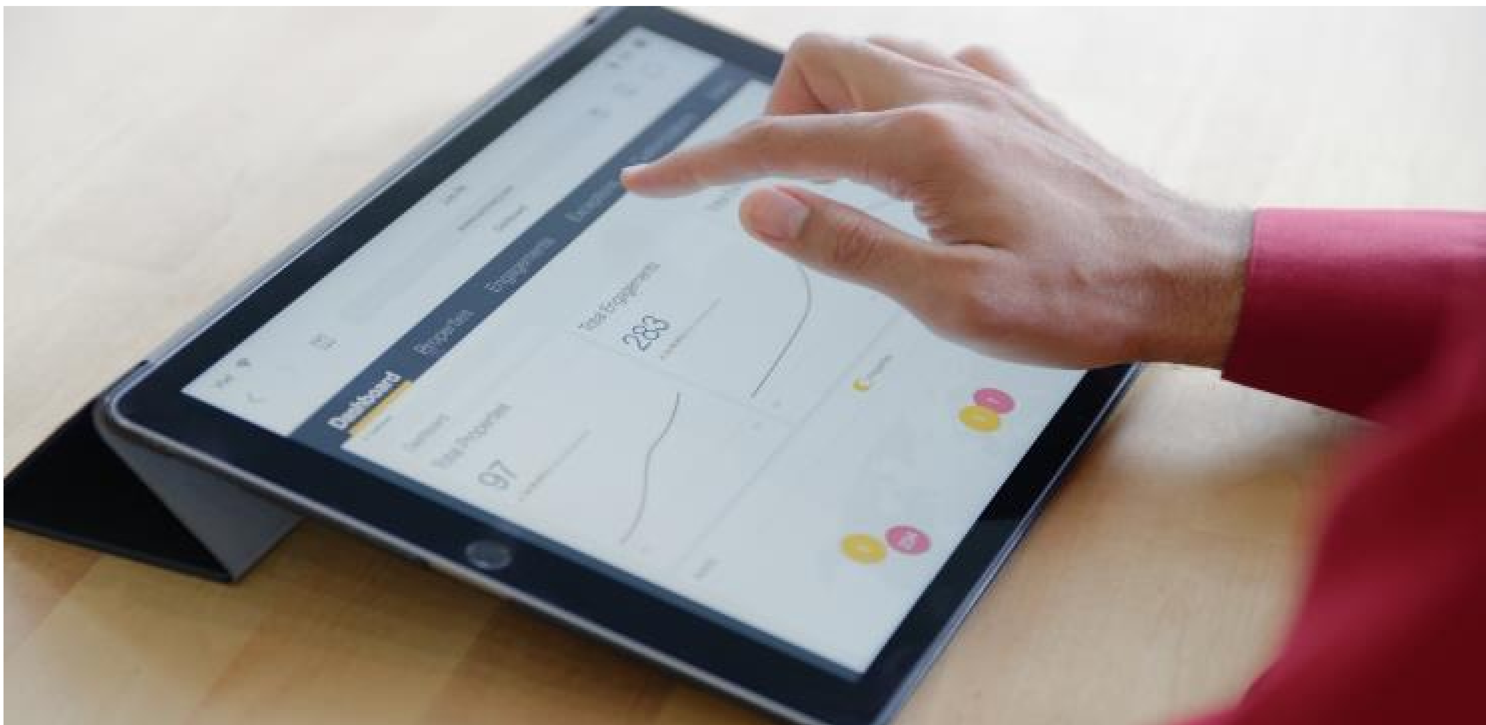


Figure 1. Globalization of ETFs
Do you expect to see any significant launches of ETFs by firms outside your home market over the next two years?



Source: PwC 2016 Global ETF Survey

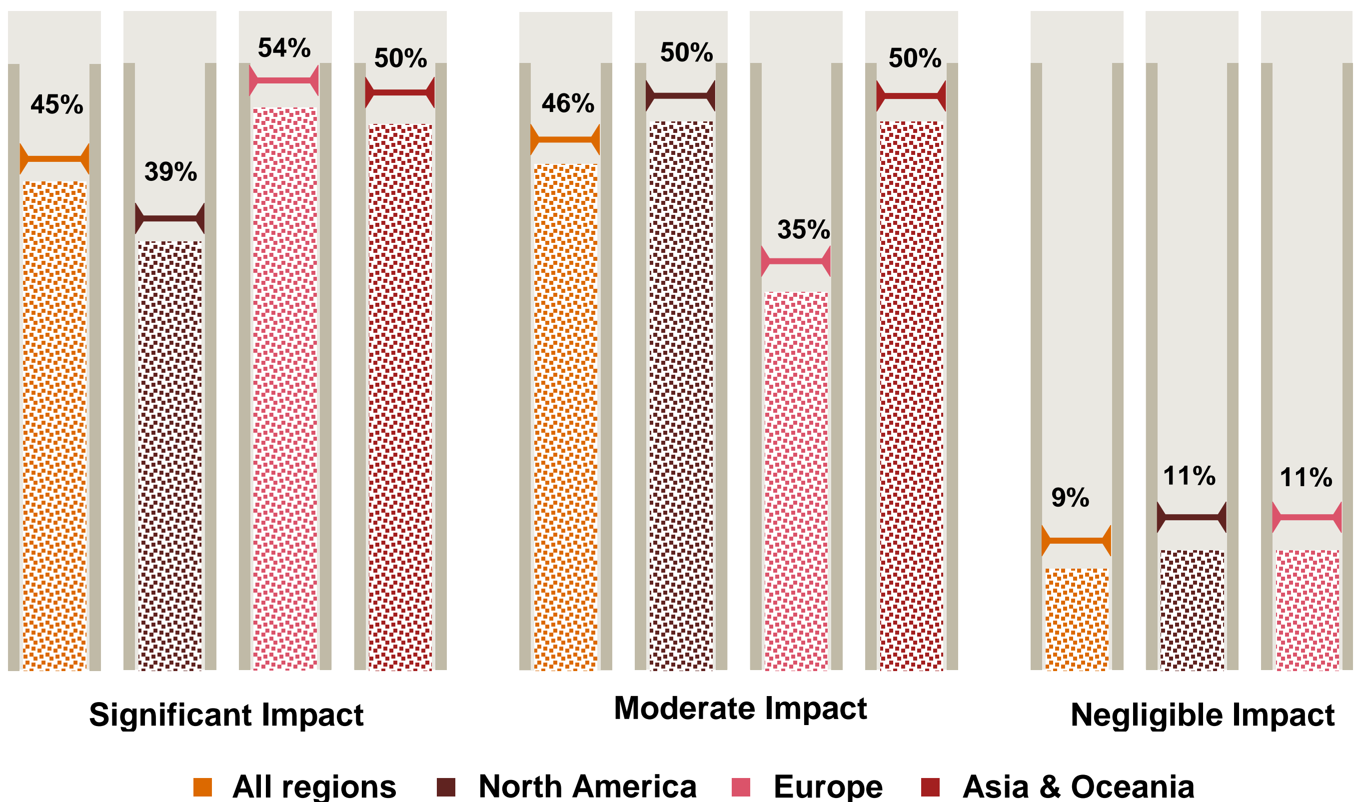


How regulations and taxes impact the growth and innovation of ETFs

ETF sponsors aren't expecting to have a smooth landing in any market they decide to enter. New markets invariably deliver fresh challenges, from identifying the appropriate distribution channels to assessing—and filling—the need for more investor education. Given that minimizing tax impact is a central selling point for many ETFs, sponsors will have to shape their product offerings according to the tax structures of specific markets. They'll also have to understand, and adapt to, unfamiliar regulatory regimes.

The growth and innovation of ETFs have already been impacted by the regulatory and tax environment, for better and worse. Among survey respondents across North America, Europe and Asia & Oceania, almost 90% believe that regulations and taxes have had either a significant or moderate impact on ETF growth and innovation (see figure 2). This is consistent with our point of view with respect to regulations and taxes having an impact on the growth and innovation of ETFs, which will likely continue for many years to come.

Figure 2. Impact of regulations and taxes on ETFs
How has the growth and innovation of ETFs been impacted by regulatory and tax considerations?



Source: PwC 2016 Global ETF Survey

Impact of regulations on ETFs

Navigating regulatory environments, particularly outside of your firm's home base, can create challenges from a regulatory and compliance perspective. Following is a summary of recent or proposed regulations and tax rules which will impact ETFs in the coming years.

Focus by regulators and industry bodies on ETF growth

The record levels of growth and inflows to ETFs in recent years has prompted increased focus by many regulators. Given their structure, ETFs have historically straddled regulations applicable to investment funds as well as to equity investments. Recent consultations by the International Organization of Securities Commissions (IOSCO), the Central Bank of Ireland (CBI) and the Securities and Futures Commission (SFC) of Hong Kong show the increasing scrutiny of these products and the potential impact of their growth on underlying global markets. **Impact:** Regulatory bodies are focused on understanding the risks which may arise from the unprecedented levels of growth in ETFs and ensuring that their processes for authorising and supervising ETFs are sufficiently robust to protect investors, maintain fair and efficient markets and seek to address possible systemic risks.

Focus on fee transparency and investor-driven advice

United States

Department of Labor (DOL) Fiduciary Rule: This rule establishes new requirements for advice provided to retirement investors. Under the rule, investment advice provided to an employee retirement plan or an individual retirement investor is considered fiduciary advice and thus must be in the "best interest" of the investor. The DOL implemented the Fiduciary Rule on June 9, 2017, with a July 1, 2019 implementation date. **Impact:** The DOL Fiduciary Rule has already benefitted ETFs and will likely continue to do so as many advisors have shifted allocations to low cost investment products such as ETFs. The Securities and Exchange Commission (SEC) is also drafting a proposed fiduciary standard rule which is expected to be issued sometime over the next 18 months that would consider all investment account types.

Canada

Client Relationship Model-Phase 2 (CRM 2): These sets of rules will include new disclosures in 2017 for investors, including dealer charges associated with their investments and investment performance. **Impact:** This increase in transparency of expenses and dealer compensation is expected to drive investors towards fee-based advisors and lower cost investment products, such as ETFs.

Proposal to ban embedded commission**:** In January 2017, the Canadian Securities Administrators (CSA) issued a consultation paper proposing to ban embedded commissions, such as trailer commissions on mutual funds. **Impact:** Should this proposed ban on embedded commissions be approved, it will likely cause a shift towards fee-based compensation and investment in lower cost investment products such as ETFs.

Targeted reforms and best interest standards: In April 2016, the CSA issued a consultation paper proposing to establish a regulatory conduct standard for registrants. As drafted the standard is not significantly enhanced from current expectations and specifically is not a fiduciary standard. Only two of thirteen securities administrators appear to support the proposal. **Impact:** As written, the proposal may not be approved widely by regulators, but if approved is expected to have limited impact on the market for ETFs. Concern exists that the CSA may attempt to revise the standard closer to a fiduciary standard, which could drive more investors to fee-based advisors and lower cost investment products, such as ETFs.

Europe

Markets in Financial Instruments Directive (MiFID) II: MIFID II, effective from 3 January 2018 will prohibit any MiFID portfolio management firm, or independent advisory firm, from accepting and retaining any payment or benefit from a third party in relation to the provision of those services, apart from "minor non-monetary benefits" that: (i) are capable of enhancing the quality of the service provided; (ii) do not impair compliance with the firm's duty to act in the best interests of the client; and (iii) are clearly disclosed. **Impact:** It is thought MIFID II will level the playing field for products like ETFs that do not pay commissions— and should boost their attractiveness to investors.

Regulatory impact on product structures

United States

***Consideration of periodically disclosed active ETFs*:** There continues to be growing interest in periodically disclosed active ETFs (also known as "nontransparent active" ETFs). The SEC is evaluating different periodically disclosed active ETF models. Among U.S. survey respondents, 43% see the approval of periodically disclosed active ETFs as being most impactful to the U.S. ETF industry. **Impact**: The growth and innovation of ETFs could be significantly impacted with the approval of one or more of the proposed periodically disclosed active ETF models.

Europe

Europe ESMA share class paper: ESMA issued a share class paper on January 30, 2017 which contains 4 high-level principles: Common investment objective; Non-contagion; Pre-determination and Transparency. While the ESMA paper identified certain requirements and limitations around the purposes for usage of separate share classes, for instance share class level currency hedging, it did not comment on the concept of establishing exchange traded classes of mutual funds, which has drawn some debate within Europe in recent years. **Impact:** Focus will return to local regulators to review this matter. European ETF sponsors would save time, capital and resources if their local regulators approve them to issue separate ETF share classes.

Solvency II & Accounting changes: Solvency II has imposed on insurers risk-based capital requirements around their investment portfolios. Solvency II applies a "look through approach" for investment funds, including ETFs that follow fixed income strategies. This would give fixed income ETFs an equal footing to a direct bond holding, rather than being classified as an equity holding, thus requiring lower capital charges. This is bolstered by some forthcoming changes to International Accounting Standards (specifically, IFRS 9) which will remove the impact of volatility in ETF investments from profit and loss statements and put ETFs on an equal footing with other instruments for certain investors. **Impact:** Regulatory and accounting changes have the potential to enhance the attractiveness of ETFs for certain European investors, including insurance companies.

Asia

Hong Kong developments: In February 2016, the Securities and Futures Commission in Hong Kong (SFC) issued a "Circular on Leveraged and Inverse Products" setting out the requirements applicable to leveraged and inverse products structured as ETFs seeking authorization for public offering in Hong Kong. **Impact:** Given the appetite for more complex ETF products in Asian markets, the focus of the SFC on liquidity and localization of the underlying indices is a move to ensure risks are minimized.

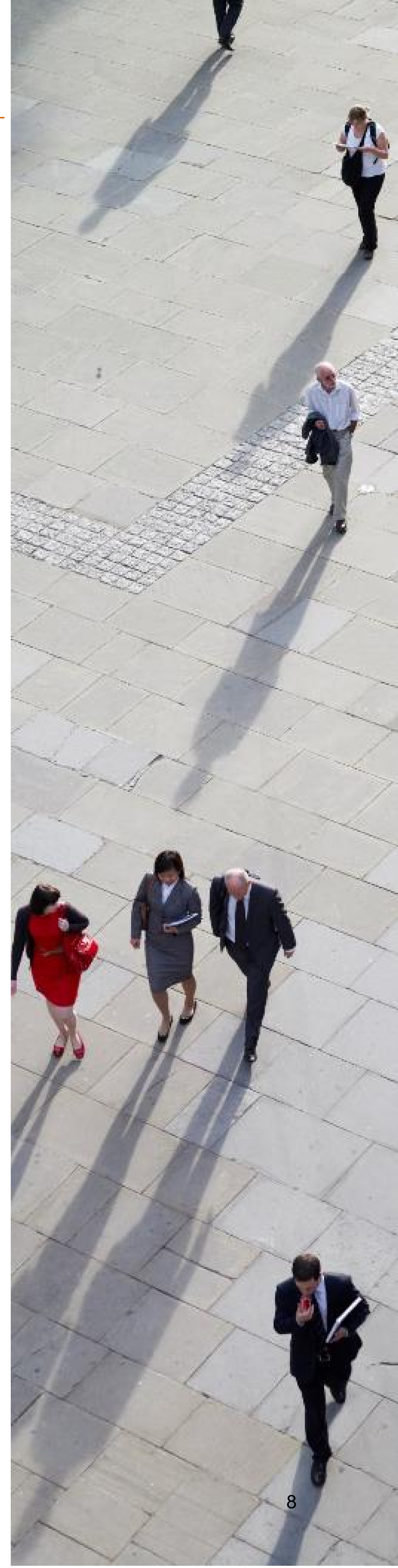
Singapore developments: Over the last two years, the Monetary Authority of Singapore introduced the concept of Excluded Investment Products (EIPs) in addition to the existing Specified Investment Products (SIPs). Previously all ETFs were classified as the latter which restricted the investments into ETFs as investors would have to be assessed for investment knowledge and experience before investing. Now, ETFs that make limited use of derivatives for efficient portfolio management fall under the EIP classification and can be invested in without prior assessment of investor knowledge and experience. This change effectively made 80% of the assets under management by ETFs listed on the Singapore Exchange Limited (SGX) accessible to non-institutional investors. **Impact:** These regulations have made most ETFs more attractive in Singapore to non-institutional investors.

Increased compliance and disclosure requirements

United States

Investment Company Reporting Modernization Rule ("Reporting Modernization Rule"): In October 2016, the SEC finalized the Reporting Modernization Rule. This rule will enhance the SEC's ability to collect, analyze and monitor portfolio composition, returns, as well as provide more detailed information about derivatives. There will be a new form N-CEN, on which funds will report census-type information to the SEC, which will require ETFs to provide details on their exchange listing, listing of authorized participants and activity, information about creation units, and transaction fees. **Impact:** The cost to establish controls and procedures to comply with these new disclosure requirements will increase for ETFs.

Investment company liquidity risk management programs: The SEC has adopted a new liquidity risk management program requirement for mutual funds and ETFs. ETFs will be required to adopt a written liquidity risk management program designed to manage and assess liquidity risks, including the effectiveness of ETF arbitrage, authorized participant activity and the composition of creation and redemption baskets. **Impact:** The cost to establish controls and procedures to comply with the liquidity risk management programs will increase for ETFs.



Market infrastructure changes

Europe

Post-trade transparency reporting under MiFID II: MiFID II substantially expands the pre- and post-trade transparency regime for financial instruments traded in the European Union (EU). These regulations will apply to both equities and non-equities and equity-like instruments (including ETF's). **Impact:** Currently, the majority of ETF trading in Europe occurs over the counter as opposed to on an exchange and liquidity is therefore less visible. Despite the challenges that remain as a result of the fragmented market infrastructure in Europe, with multiple exchanges and clearing mechanisms, this increased reporting is a positive step in more accurately reporting the liquidity of European ETFs.

Benchmarking regulation: EU Regulation 2016/1011 issued on June 8, 2016 introduced a common framework to ensure the accuracy and integrity of indices used as benchmarks in financial instruments and financial contracts, or to measure the performance of investments funds in the Capital Markets Union (CMU). This regulation applies to the provision of benchmarks, the contribution of input data to a benchmark and the use of a benchmark within the Union. **Impact:** Given the extensive use of indices by ETFs, increased assurance of the integrity of those benchmarks will have a positive impact on passively managed ETFs.

Asia

ETF Connect between China and Hong Kong: Following the launch of the Shanghai-Hong Kong Stock Connect in 2014 and Shenzhen-Hong Kong StockConnect in 2016, Hong Kong and Chinese financial regulators are reviewing whether mutual market access programs can be extended to ETFs. **Impact:** While there are a number of differences between trading systems and other matters which will have to be worked out, there are potential growth opportunities for ETFs in China and Hong Kong should ETF Connect be approved.

Taxes and impact on ETFs

Market and legislative change dictating tax outcomes

Investor preferences have driven change and innovation in ETF products that have tax implications. Recent legislative developments and broader tax framework shifts may also significantly impact the overall tax effects of ETF structures. While ETFs are typically not subject to tax in their home domiciles, managing tax impacts from a portfolio perspective is crucial. This is consistent with the results of our 2016 survey whereby 60% of global respondents noted tax as having a significant impact on the cost of structuring and operating ETFs. Those survey results are also consistent with the discussions we are having with many of our clients with respect to tax structuring considerations.

Impact of investor preferences and structural landscape changes

Existing regulatory daily security disclosure rules prevent almost all active managers from launching more cost effective equity ETF variations which have less tax impact in both European and U.S. markets. Meanwhile, money flowing to low-cost passive ETFs with better tax outcomes is putting pressure on active managers who are responding by increasing operational efficiencies and decreasing tax impacts while passive managers are expanding through smart beta offerings by carefully managing withholding taxes on income, capital gains taxes, stamp duties and other transfer taxes.

Furthermore, as many non-U.S. players shift from the synthetic model to physically replicating ETFs, the structural ability to minimize exposures to withholding taxes, capital gains taxes and transfer taxes through use of swap-based models is eliminated. Similarly, the physical replication model also requires compliance with local tax filing requirements in certain markets where stocks are held, particularly in the emerging markets space, thus triggering additional administrative and compliance requirements for the ETF sponsor to manage.

As such, structural changes driven by investor demand have the potential to significantly impact the tax outcomes of the ETF product structure.

Active managers are responding by increasing operational efficiencies and decreasing tax impacts while passive managers are expanding smart beta offerings by carefully managing withholding taxes on income, capital gains taxes, stamp duties and other transfer taxes.

Period of unparalleled global and local reform

Recent years have seen an unprecedented level of change from a tax perspective, both in terms of local legislative updates and broader reform of the global tax landscape. ETFs are not beyond the reach of such changes and many have had— and will continue to have— an impact on the tax outcomes and structural development of ETF products. Key tax areas which may impact ETFs are highlighted below.

Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan: The OECD BEPS Action Plan to minimize global tax avoidance puts forward proposals limiting the ability to claim benefits under tax treaties in certain circumstances. While full clarity has yet to emerge as to the implications of these proposals for widely-held funds, the proposals suggest the use of a model which would look through to the residence and treaty entitlements of a fund's investor base. Secondary market trading of ETF shares would pose a challenge in this regard.

Another area of BEPS is the lowering of the threshold for creation of a taxable presence in a jurisdiction, which will require ETF sponsors to be mindful that their sales and portfolio teams' activities in local markets may give rise to taxable presence for their organization. **Impact:** ETF sponsors will need to work closely with their tax advisors to monitor tax developments with respect to both product structuring and ongoing tax compliance with respect to the OECD BEPS Action Plan. ETF sponsors should also focus on record keeping and data integrity, particularly in digital platforms, to validate the investors' domiciles and determine tax treaty eligibility.

Bi-lateral tax treaties: There has also been an increase in the appetite for renegotiation of bi-lateral tax treaties. Given the impact that the ability to access reduced rates of withholding tax under double tax treaties can have on the overall tax impact in an ETF structure, any changes to the current status quo will clearly be watched closely by ETF sponsors looking to enter a foreign market. **Impact:** ETF sponsors will need to carefully monitor possible changes in bi-lateral tax treaties in determining which countries to domicile and distribute their ETFs. ETF sponsors should also focus on record keeping and data integrity, particularly in digital platforms, to determine eligibility for bi-lateral tax treaties.

Localized rules

Germany

Germany recently introduced new tax rules regarding holding periods of stocks which significantly affects the ability to undertake stock lending of German stocks. This curtails the ability of non-locally domiciled ETFs to compete with German domiciled ETFs as there is a withholding tax differential. **Impact:** The benefit for German domiciled ETFs will be relatively short-lived as the overall reform of the German tax regime for funds came into effect from January 1, 2018 on will provide for equal treatment of foreign and domestic funds.

United States

Developments in US tax legislation can have an impact on foreign-domiciled ETF products gaining exposure to the US. For example, the Dividend Equivalent rules introduced under the HIRE Act, effective as of January 2017 have impacted synthetically replicating ETFs outside of the United States by bringing payments under swaps referencing U.S. equities into the change to U.S. withholding tax (at rates of up to 30%) for the first time, subject to limited carve outs. **Impact:** ETF sponsors with non-US domiciled products gaining exposure to underlying US equity strategies through swaps and other derivative instruments need to evaluate the structure of their funds and commercial arrangements.

Emerging markets tax developments and transfer tax opportunities

With the significant growth in the market share of ETFs and other passive funds in the emerging markets equity and fixed income space, ETF sponsors competing in this arena should closely monitor the continued application and expansion of the scope of capital gains taxes to equity and fixed income investments in emerging markets. Recent developments in India, Brazil, Colombia and Peru, among others, have the potential to increase the tax burden on ETFs that focus on emerging markets and the requirements for local tax agents and tax filings in certain emerging markets can also increase the overall cost structure of such products. Furthermore, careful management of transfer taxes, which can be particularly relevant in the context of in-kind transactions, can provide an important source of tax outcomes. **Impact:** ETF sponsors should work closely with their tax advisors to monitor the tax

developments on foreign capital gains and withholding taxes as well as opportunities to manage potential transfer taxes.

With the backdrop of unprecedented levels of global tax changes, it is not surprising that almost half of survey respondents said the management of withholding, capital gains taxes and transfer taxes is a significant tax issue for their business. This is also a consistent theme in many of our discussions with ETF clients.

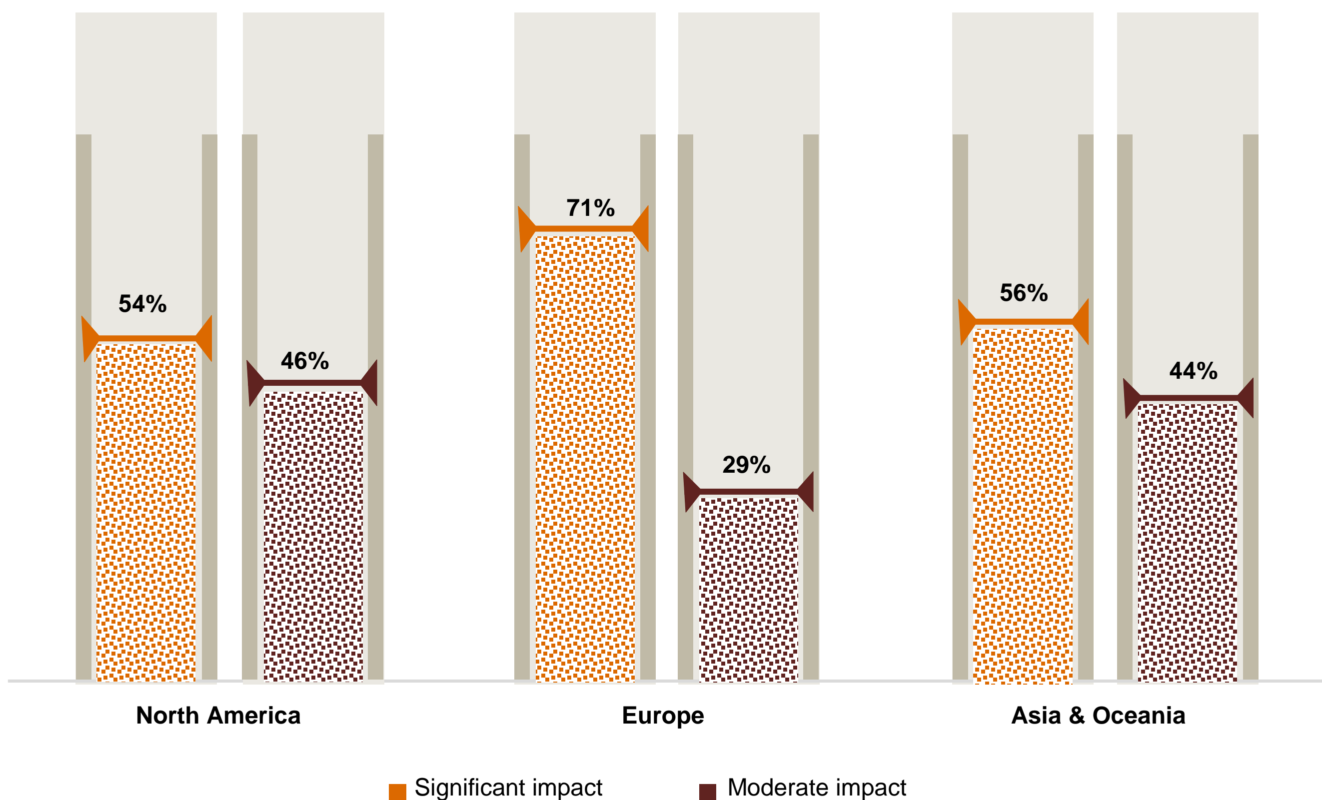
As the investor base becomes progressively more educated and sophisticated, the ability to demonstrate comparative levels of tax outcomes should be an area of focus for ETF sponsors seeking opportunities for competitive advantage in the increasingly crowded European ETF space.

Where tax matters most

Distribution dynamics

The process of managing tax impacts must be a holistic one – from taxes imposed at the portfolio level through to the fund level and to the end investor. As such, the importance of understanding local tax rules in key markets and complying with local tax reporting regimes, where applicable, should not be underestimated. 71% of European survey respondents stated that taxes have had a significant impact on the cost of structuring and operating ETFs (see Figure 3). This compares to the North American (54%) and Asia & Oceania (56%) survey participants. This finding is not surprising to us given complexity of the various tax rules and regulations across many of the European countries.

Figure 3: Taxing Burdens



Source: PwC 2016 Global ETF Survey

While the pursuit of growth and scale drives multiple listings and broad cross-border distribution of products, the fragmented nature of some ETF markets poses challenges for ETF sponsors looking to expand geographically. The non-standardized nature of tax rules across the globe poses challenges for sales teams attempting to understand the tax treatment of investors in local markets and the nuances of the treatment of income and capital elements of return from their specific products in the hands of various investor types. Some of these challenges are highlighted below.

Compliance with investor tax reporting regimes

For widely distributed ETFs, the lack of visibility into the investor base can result in the need to comply with local investor tax reporting regimes in certain markets, which can be costly and complex and pose reputational risks for ETF sponsors. Many of the ETF survey respondents were concerned about compliance with investor tax reporting requirements, especially among in Europe, who ranked it as the top area of focus. **Impact:** Given the reputational importance of investor tax reporting, ETF sponsors will need to work closely with their tax advisors to monitor compliance with the various investor tax reporting requirements in the countries in which their ETFs are distributed.

German tax reform

Significant reform to the tax system for investment funds will be implemented in Germany in January 2018, simplifying the compliance requirements for funds distributed into Germany. The applicable tax treatment for German investors will be driven by the fund's investment strategy and dividend policy. **Impact:** Sponsors of ETFs distributed to the German market will need to be prepared for additional inquiries, particularly the impact on after-tax returns.

Japan tax reform

Legislative changes in Japan have resulted in better tax outcomes for distributions to Japanese investors from equity ETFs than for other equity investment trusts, which is likely to drive increased traction for these products. **Impact:** Japan ETF sponsors will likely be focusing on the launch of more equity ETFs which will be more attractive to Japanese investors as a result of them having better tax outcomes than other equity investment trusts.

Taiwan tax reform

Taiwan has introduced an exemption from the application of Securities Transaction Tax to transfers of units in bond ETFs for a 10 year period with effect from 1 January 2017, thus increasing their attractiveness to investors. **Impact:** We expect that there will be an increase in demand for Taiwan bond ETFs launched over the next few years given their ten year exemption from the Securities Transaction Tax.

Navigating the regulatory and tax course

Overall, with the continued growth of the global ETF market and the increasing distribution opportunities to retail investors and other investor categories, the requirement for ETF sponsors to understand the tax requirements of key investor markets and categories will likely intensify. Prudent ETF sponsors should focus on providing their sales teams with the necessary information and training to articulate the comparative tax benefits of their products.

The rapid growth of ETFs, fueled by their broad appeal, has driven sponsors to explore expansion opportunities beyond their markets of origin. Structural complexity may be growing, but so too should product innovation and even, on a regional basis, customization. Before taking flight, however, ETF sponsors must plan a route that will enable them to fly high even in the face of fast-moving regulations and tax policies. By cultivating a heightened awareness of the risks—both current and in the future—associated with global growth, ETF sponsors can be better prepared to expand globally.

ETF sponsors should also monitor their regulators’ and tax authorities’ activities and engage in a dialogue with them to help shape the future regulations and tax rules which may impact ETFs. We encourage you to reach out to your local PwC representatives for further guidance.

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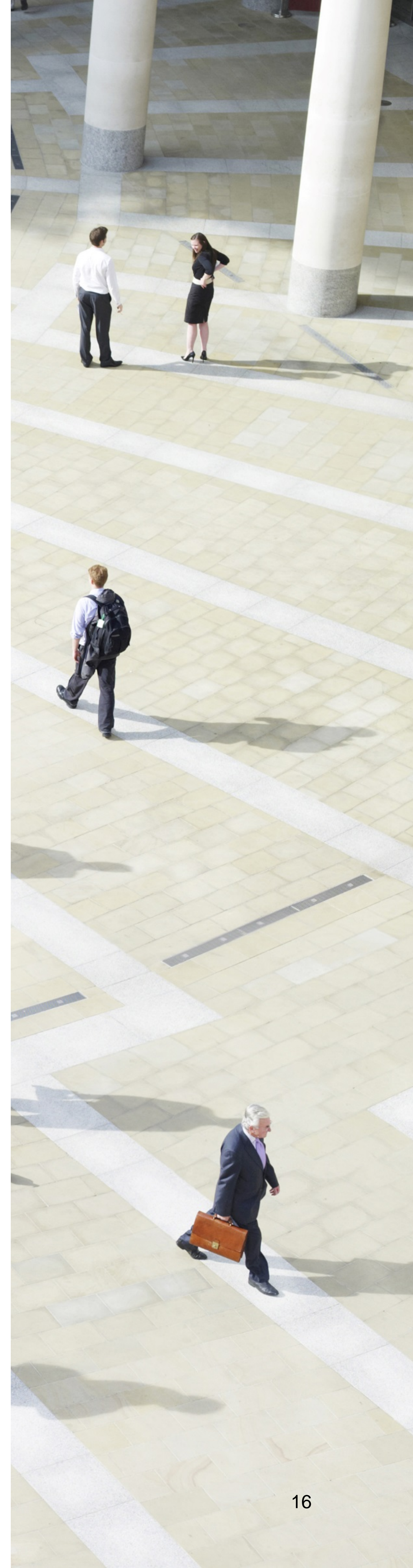

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