Continuity plan in the case of an event or default affecting a counterparty

I. Summary

Background

Following the public consultation on ETFs, which ended in May 2017, the French financial regulator (AMF) asked French management companies who managed ETFs to produce a continuity plan in the event of default of a counterparty of the ETF.

The purpose of this note is to propose a continuity plan in relation to management of ETFs, when the fund uses OTC financial derivative instruments or securities lending, each management company being responsible for putting its own continuity plan in place.

Counterparty risk of ETFs can be considered in 2 forms:

- in the use of a financial derivative instrument – Swap – for ETFs known as “indirect replication” ETFs,
- in the use of securities lending for “direct replication” ETFs using securities lending (which is not systematically the case for direct replication ETFs).

Default of a counterparty may be associated with various market events (eg; systemic problem, shortage of liquidity on the market preventing the counterparty from meeting its commitments, fraud, etc.) and consequently different solutions will be required depending on the event in question. The management company must consider a range of solutions. Moreover, the solution considered in the event of default of a counterparty depends on each ETF and its underlying index. Consequently, there is no general solution which would be suited to all circumstances.

II. Action plan “upstream” of the counterparty default

An analysis of the scope of the fund giving rise to the decision to apply one of the resolution mechanisms may be combined with identification and listing of the counterparties with which the management company has signed master agreement(s).

A. Prevention of default of a swap counterparty

The management company has 3 possible resolution mechanisms:

- continuing with indirect replication management and switching the portion of the swap allocated to that counterparty to another of the fund’s existing counterparties, or changing the counterparty for a new one,
- moving to direct replication,
- or closing the fund.

These 3 options will be considered and selected in the best interests of investors and on the basis of various criteria including, inter alia, market risk, the credit risk situation, liquidity of the underlying instrument(s). Implementation of the options will also depend on the contractual framework in place at the time when the default event occurs.

B. Prevention of default of a securities lending counterparty

The management company has several resolution mechanisms:

- continuing its lending activity with one or more other counterparties for which a master agreement is in place, while implementing the plan for resolution of the counterparty’s default (recovering collateral, redeeming the loaned securities etc.),
- suspending stock lending temporarily, for long enough to put in place a master agreement with one or more other counterparties,
- discontinuing securities lending.

These 3 options will be considered and chosen in the best interest of investors and on the basis of market risk and the existing master agreements in place at the time when the default event occurs.

C. Legal formalism with the swap or securities lending counterparty

In many cases, the management company has already signed ISDA or FBF master agreements with several possible counterparties. The management company should therefore choose the best "back-up" counterparty for continuity of the activity (having regard to the market conditions prevailing at the time of default of the first counterparty and to the application of best execution), and in the best interests of investors.

In the absence of master agreements negotiated with other potential swap counterparties, the management company may enter into urgent trading with such counterparties, by signing a *Long Form* confirmation (document setting out all features of the transaction, in which the parties indicate what type of regime they fall under). The master agreement with such counterparties, implementation of which may take a very long time, will then be drawn up subsequently. Use of the *Long Form* will allow the manager of the ETF to retain its *best execution/best selection* capacity when it trades with a new counterparty.

III. Action plan "downstream" of the counterparty default

Upon the occurrence of default of a swap or securities lending counterparty, the management company shall set up a committee responsible for the implementation of the management of the event and overseeing the effectiveness of those arrangements. The management company may call on several departments, for example: Structuring, Investment Management, Trading, Legal Department, Risk Department, Commercial and Marketing Division, Middle Office, Compliance and Ongoing Control. Each management company is responsible for setting up its committee and its process for managing and exiting the crisis, having regard to its internal organisation, its expertise and the resources available to it.

The committee shall analyse the situation and decide whether a credit event should trigger an action plan in accordance with point II. If this is the case, it shall carry out operational management of the crisis throughout the various stages. The committee shall classify the event and determine the strategy for exiting the crisis. As an example, the components of this crisis exit management phase may include: a phase of notification of the default, a phase of informing the market (trading halt, discontinuing calculation of net asset value, transitional management measures intended to mitigate the impact on investors, etc.). In parallel, depending on the prior analysis which will have been carried out upstream of the default, the management company shall implement its action plan for exiting the crisis without undue delay.

IV. Revision and dissemination of the action plan

The continuity plan shall be updated when the management company decides that it is appropriate to do so, in particular to include solutions suited to the nature of the new funds. Additionally, the management company shall keep the plan available for the AMF.

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