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Central Bank Publishes Dear Chair Letter Outlining Findings from ETF Themed Review

Background

In 2023, the Central Bank of Ireland (the **Central Bank**) carried out a themed review of the primary and secondary market trading arrangements of Irish authorised exchange-traded funds (**ETFs**) (the **Review**). As part of the Review, the Central Bank issued two questionnaires (one qualitative and one quantitative) to Irish UCITS management companies which manage Irish-authorised ETFs (**Firms**). A key focus of the Review was on the procedures which Firms have in place in relation to due diligence, ongoing monitoring and board oversight of authorised participants (**APs**) and market makers (**MMs**).

Following on from the Review, the Central Bank has now issued a Dear Chair letter (the **Letter**) in which it highlights the key findings from the Review and sets out its expectations as well as the actions to be taken by the boards of Firms. We have outlined below the four key findings contained in the Letter.

Key Findings

1. **Inadequate Due Diligence of APs/MMs**
The Review assessed the level of due diligence performed by Firms on APs and MMs both at the initial and ongoing stages. While some good practices were found, most Firms did not evidence appropriate levels of due diligence being performed on APs/MMs, with a significant number of Firms not having formal policies and procedures in place to assess APs/MMs.
2. **Limited Ongoing Monitoring of APs/MMs**
The Review found that the majority of Firms did not demonstrate a sufficient level of ongoing monitoring of APs/MMs and very little evidence of risk monitoring and stress testing performed on APs/MMs.
3. **Lack of Board Oversight**
The Review found that Firm boards receive minimal specific AP/MM reporting, which increases the likelihood of the board being unaware of potential risks in relation to APs/MMs relied upon by ETFs.
4. **AP and MM Concentration**
The Review identified that creation and redemption activity is concentrated among a limited number of APs and that there is a similar level of concentration in the MMs used by ETFs. The Central Bank warned that such concentration may pose risks to the ETF with regards to liquidity, effective arbitrage mechanisms and access to the market if there is disruption in the marketplace or with individual APs/MMs.

Action required

The Letter requires that Firms review the actions outlined below and incorporate any necessary changes to their frameworks and practices by Q2 2025:

1. All Firms are required to, at a minimum, assess their current practices against Measure 4 of the IOSCO Good Practices (see our previous briefing here) and close any identified gaps, particularly in relation to due diligence and ongoing monitoring.
2. An assessment of reporting received by Firms regarding the activity of APs and MMs should be conducted in order to ensure that Firms remain fully aware of the extent to which APs interact with an ETF, and the extent to which MMs' trading is within the defined parameters of their contracts.
3. Firms should review their current arrangements to ensure that they have a sufficient number of AP and MM relationships in place. Firms should also ensure that there is effective contingency planning in place in order to address circumstances of impairment of the arbitrage mechanism.

Should you have any queries or require any assistance in complying with the actions following from Letter, please contact your regular contact in Dillon Eustace for assistance.

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