

## Collateral Explained

### Index tracking with limited third party exposure

In order to reduce the tracking error to the benchmark index, some ETF Securities' products use a swap structure. To minimise credit exposure to swap counterparties products are backed by cash collateral or Eligible Collateral posted by the counterparty. ETF Securities has agreed a set of criteria which apply to all its collateralised products and defines the assets that constitute Eligible Collateral, how those assets are valued and the process for ensuring swap counterparty exposure is collateralised on a daily basis. The Eligible Collateral requirements are consistent with the repo collateral requirements under UCITS guidelines. As a result ETF Securities' products seek to minimise tracking error with limited credit exposure.

### Which issuers use a swap structure?

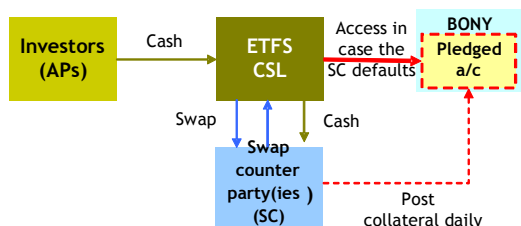
Issuer	Economic exposure	Swap based	Credit risk
<b>MSL, GBS, IML</b>	Precious & Industrial metals	No	No - all exposure physically backed (metal in vault or LME approved warehouse)
<b>CSL</b>	DJ-UBS <sup>SM</sup> commodity indices	Yes	Credit exposure against swap providers backed by collateral posted with and monitored by an independent custodian (The Bank of New York Mellon)
<b>FXL</b>	MSFX <sup>SM</sup> indices		
<b>ETFX</b>	Equity indices (UCITS Compliant)		

N.B: ETFS Oil Securities Limited is an uncollateralised swap based structure and so the holders have credit exposure to the swap counterparty, Shell Trading Switzerland A.G.

### Types of Collateralised Swap Structure

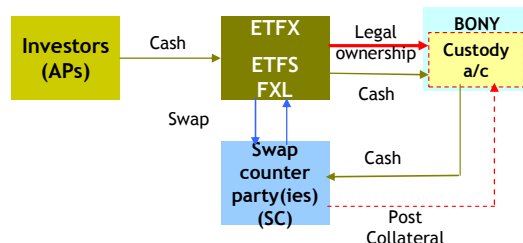
There are two different types of collateralised swap structure used for ETF Securities' products; however the key collateral characteristics are common across all such products. The two main structures are shown below:

#### ETFS Commodity Securities Limited (CSL)



Under the CSL structure each swap provider posts Eligible Collateral to a pledge account in its name, held with and monitored by an independent collateral manager, the Bank of New York Mellon (BONY). Each swap provider must contact BONY prior to removing any Eligible Collateral from the account. Exposure to each swap provider is reconciled, marked to market daily, and backed by Eligible Collateral targeting at least 100% of this mark to market value. If the swap provider defaults on its obligations, the issuer (CSL) will take ownership of the Eligible Collateral and realise it (see Credit Event).

#### ETFS Foreign Exchange Limited (FXL)



Under this structure the cash held by the issuer (FXL) is delivered to the swap provider and Eligible Collateral is transferred under a repurchase agreement (**Repo**) (to which FXL receives legal title). The collateral manager (BONY) will only release the cash to the swap provider upon Eligible Collateral being posted. For FXL the cash inflows are 100% collateralised and there is a daily mark to market of swap exposure.

#### ETFX Fund Company Plc (ETFX)

ETFX currently has four swap providers on the platform. Swap positions are collateralised differently according to the swap provider. Citigroup and Bank of America Merrill Lynch swaps are unfunded and similar to the FXL structure above. The cash is mainly invested in Eligible Collateral by way of a repo and any remaining cash is invested in money market funds with daily liquidity (in order to satisfy any margin calls from these swap providers). For market moves on the relevant index which affects the swap value, exposure is reduced (as often as daily) using cash transferred between the relevant sub-fund and the relevant swap provider. These swaps are reset monthly where the profit or loss is paid or received between the swap provider and the relevant sub-fund while the corresponding Eligible Collateral and/or money market funds are liquidated as necessary.

Barclays and Rabobank are the other swap providers, each of which provides fully-funded swaps that reset daily. With Barclays, the exposure for the swap is collateralised in a similar fashion to CSL above where Eligible Collateral is transferred to the relevant sub-fund through BONY according to the previous business day's closing positions (including anything receivable by the sub-fund for pending trades). Rabobank does not transfer Eligible Securities but instead transfers cash equating to 102% of the swap value from the previous business day's close (including anything receivable by the sub-fund for pending trades) in the base currency of the relevant sub-fund. This cash received as collateral is invested in AAA money market funds.

## Eligible Collateral

Type of Eligible Collateral	Concentration limits and margin
<b>Money market funds:</b> - AAA Government or Treasury money market funds only, with no ABSs nor CDOs	Country concentration limit U.S.: 100% UK, Japan, Germany, France: 50% Others: 25%  Margin < 5 years to maturity: 100% 5-10 years to maturity: 101% 10+ years to maturity: 102% US Agencies: 102%
<b>Sovereign fixed income</b> - USA	
- G10 and other European government bonds (with minimum rating of AA)	
- Supranational bonds with a L-T issuer rating not lower than AAA - US Agencies 100% backed by the US government	
<b>Equities</b> - Securities have to belong to specific indices. Currently, the Main index names include the major benchmarks such as S&P 500 and EURO STOXX 50, and the Other index names include developed market indices such as NASDAQ and STOXX 600 <small><sup>1</sup>5% for ETFX funds with no notional maximum.</small>	Per security issuer: 3.3% <sup>1</sup> or \$10 mio, whichever is greater  For each security Free-float market cap: 2.5% 30 day ADV: 100%  Country concentration limit U.S.: 75% UK, Japan, Germany, France: 25% Others: 10%  Margin Main index names: 105% Other eligible equities 110%

The following securities are not Eligible Collateral:

- Securities issued by the swap counterparty or an affiliate;
- Securities subject to corporate actions;
- ABS or MBS.
- ADRs and GDRs (applies to ETFX only)

Collateral lending or rehypothecation is **not** allowed either.

## Credit Event

It is important to note there are different parties involved in the overall issuance and trading process for each of the above structures (i.e. swap provider, issuer, collateral manager and market maker).

In the event of a counterparty default, the Issuer (or the Trustee) would take control of the Eligible Collateral and realise it to attempt to satisfy any amounts owed by the swap counterparty (see credit risk).

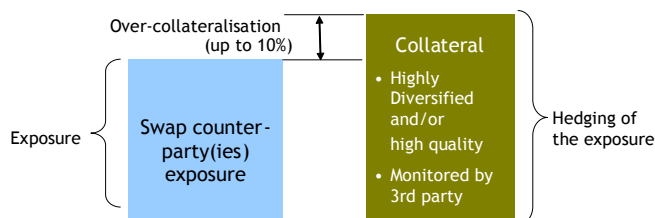
In the case of ETFX, the appointment of multiple swap providers allows the sub-funds to continue operating by moving swap balances. BONY, who acts as our collateral manager, is one of the world's largest custody banks.

## Valuation of the collateral

Collateral is valued by the collateral manager (BONY) on daily basis. BONY applies detailed collateral screening and valuation methodology which includes:

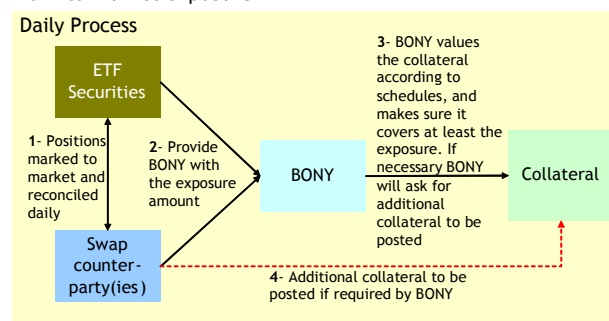
- Source the prices from at least 4 data vendors
- Test and validate the price quality
- Remove invalid prices after standard deviation tests and tolerance level tests
- Value at zero any security if the last available price is more than 5 days old

BONY then apply margin and concentration rules.



## Collateralisation process

On a daily basis, ETF Securities liaises with swap counterparties to aim for 100% collateralisation the reported mark to market exposure:



## Important facts relating to the collateral

It is important to understand several facts:

**Collateral schedule matters** - The holdings of Eligible Collateral posted by the swap providers will change daily. Investors should carefully consider the criteria of the quality of Eligible Collateral as well as the concentration and margin limits that apply.

**Credit risk** - Eligible Collateral is posted to reduce potential credit risk if the counterparty were to default. The posting collateral does not guarantee that no loss would occur on a credit event. The realised value of the Eligible Collateral following an event of default may differ from the amount owed by the swap counterparty, as prices fluctuate intraday (i.e. from the last point the exposure and collateral were valued). Our collateral schemes apply strict margins and concentration limits to reduce the risk of such a loss, but do not completely remove it.



## For More Information

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