Irish Funds Industry Association response to ESMA's policy orientations on guidelines for UCITS in Exchange-Traded Funds and Structured UCITS

INTRODUCTION

The Irish Funds Industry Association (IFIA) is the industry association for the international investment fund community in Ireland, representing the custodians, administrators, managers, transfer agents and professional advisory firms involved in the international fund services industry in Ireland.

Ireland is the leading centre for Exchange Traded Funds (ETFs); with EUR 62 billion of assets in Ireland domiciled ETFs. In addition to the ETF industry, Ireland is also a leading center for UCITS funds with EUR 780 billion in Ireland domiciled UCITS, as of July 2011. Accordingly, all developments in both the Exchange Traded Funds and UCITS arena are of particular importance to the Irish industry.

The IFIA welcomes the publication of, and the opportunity to comment on, ESMA's policy discussion on ETFs and Structured UCITS. We have responded, in detail, to the questions in Discussion Paper. However, we want to lay out some of the core themes of our response.

Many of the issues highlighted in the paper are not unique to ETFs and/or Structured UCITS. For example, index tracking, the use of derivatives, securities lending and Secondary market of listed UCITS, are examples of issues that impact all UCITS. It does not make sense to view these issues through the prism of a sub-set of UCITS funds. Accordingly, as we reiterate through our response, we urge ESMA to consider these issues holistically as UCITS issues and not strictly as ETF and/or Structured UCITS issues.

In addition, as ESMA notes, there are ETFs which are sold into the EU, but are not organized as UCITS. Any regulation of these funds should be considered in the context of the AIFMD, which is the framework for non-UCITS funds in the EU.

Finally, discussion around the regulation of UCITS ETF should also take into account other open regulatory initiatives, such as MiFID II, MAD and PRIPS. As we note in our response, some of the issues highlighted by ESMA are better addressed by these regulatory frameworks.

II – General Policy Discussion

Q1	**Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.**
	Whilst we note, and fully respect, ESMA's right to explore these issues we believe that product marketing considerations should be dealt with within the existing MiFID review process the PRIPS initiative. In addition, we note that ETFs and structured UCITS are only two types of products sold to retail investors. Any review of the marketing of products to retail investors should not be limited to two subsets of UCITS products, nor should any review be limited to UCITS products. This will ensure a level playing field between all retail products in Europe. UCITS are well recognised for being transparent, diversified and well structured funds which insulate investors from many of the credit and other risks inherent in other financial product platforms. Given this, we are not supportive of the idea of creating categories of UCITS types, such as complex and non-complex. We believe that such a distinction will tarnish the overall brand reputation of UCITS and could jeopardize UCITS standing as the preeminent global fund product.
Q2	**Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria could be used to determine which UCITS should be considered as 'complex'?**
	No, we disagree with this approach. The issue of complexity and risk is more nuanced than simply the portfolio management techniques and financial instruments used in a fund. A UCITS using complex portfolio management techniques does not necessarily mean the product or return is inherently complex. In addition, a fund's complexity does not have a direct correlation to its riskiness. Furthermore, as we stated in question 1, UCITS funds are highly regulated and provide robust investor protection. Given this, we do not think that there is a need to split UCITS into "Complex" or "Non-Complex". Finally, we are concerned about the unintended consequence of creating categories of UCITS. The creation of more advanced UCITS funds is in response to investor demand for products that offer enhanced investment opportunity along with the safety of the UCITS framework. Any move to restrict access to these fund types will not impact demand for these products; rather it may push retail investors into more unregulated product types.
Q3	**Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?**
	We disagree with the assertion that there are UCITS funds that are inappropriate for retail investors. Any consideration on the distribution of funds, or other financial products, is a matter that should be addressed within the MIFID framework and/or the PRIPS initiative.

Q4	**Do you consider that some of the characteristics of the funds discussed in this paper render them unsuitable for the UCITS label?**
	No. Structural complexity does not automatically equate with greater product risk or complexity of return. UCITS fund have been designed and built to mitigate risk and this continues to hold.
Q5	**Are there any issues in terms of systemic risk not yet identified by other international bodies that ESMA should address?**
	No, systemic risk is not something which can be addressed looking at a single sub-set of the financial markets (e.g. UCITS) in isolation, nor do we believe the issues raised (bank financing requirements; capital flight) can be effectively dealt with by specifically regulating a very small segment of the investment products industry.
Q6	**Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union? If not, please give reasons**
	No, the UCITS regulations are for UCITS funds. Any purported extension would lead to confusion as to which products had the benefit of the comprehensive protections built into the UCITS framework. Any new regulation for non-UCITS funds must be handled in the context of the AIFMD, which is the regulatory framework for non-UCITS funds that are established or sold in the EU. Given the difference between UCITS and non-UCITS funds, it is not appropriate, in all cases, to harmonize the rules between the two product types.
Q7	**Do you agree that ESMA should also discuss the above mentioned issues with a view of avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.**
	We fully appreciate that it is within ESMA's remit to ensure that there are no gaps in regulation. We would welcome consideration of harmonizing regulation in the EU to avoid the possibility of regulatory arbitrage. However, as stated above, we believe that any further action should be taken within the context of the exiting framework(s).

III.I – Exchange Traded Funds (Title)

Policy orientations identified by ESMA

17. *In order to reduce the risk of confusion among investors when they buy UCITS ETFs, ESMA is considering the following policy orientation:*

- *ETFs should use an identifier, in their name and in their fund rules, prospectus and marketing material, which identifies them as an exchange-traded fund. This identifier could be either 'ETF' or 'Exchange-Traded Fund'.*

Q8 **Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.**

There is debate amongst our members as to whether creating a specific identifier for a UCITS ETF provides any meaningful protection to the investor. Some feel the disclosures in the prospectus and KIID should be enough to allow the investor to understand the product. However, some members believe that it important to preserve the ETF brand through the creation of an ETF identifier.

All members agreed that, if ESMA wishes to create specific criteria for an ETF identifier, it is crucial that the criteria for the use of the identifier be clearly defined, in order to avoid misuse and to avoid catching any UCITS and non-UCITS funds which are listed or admitted to trading on Regulated Markets but are not true ETFs. The approach should be similar to CESR's definition of "Money Market Funds". In addition, any concept of an ETF identifier must contemplate both UCITS and non-UCITS funds. For non-UCITS funds, this includes both EU ETFs not organized as UCITS and third country ETFs.

Given that this issue touches upon both UCITS and non-UCITS and is concerned with potential misselling of funds to retail investors, we believe that issue might be better handled in the existing MiFID review process and the PRIPS initiative.

Q9 **Do you think that the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs?**

We do not believe that creating further identifiers to distinguish synthetic and physical ETFs and actively-managed ETFs is warranted. While it can be argued these ETF identifiers would protect the brand identity of ETFs, we consider that the creation of further subcategories for ETF identifiers would provide little benefit to the end investor.

However, we do acknowledge there is a difference between the types of ETFs. Knowing how the ETF is constructed and managed is in the clear interest of the investor. We believe that there should be clear and

	comprehensive disclosure of portfolio management techniques in both the KIID and prospectus. Ultimately, investors should not be buying funds on the basis of an identifier alone.
Q10	**Do you think that the identifier should also be used in the Key Investor Information Document of UCITS ETFs?**
	No, the inclusion of an ETF identifier in the KIID does not provide the investor with any meaningful information. What is important is that the KIID contain clear and comprehensive disclosure in the KIID. This disclosure includes information such as the fund's strategy, replication methodology (or methodologies) and the index being tracked (whenever appropriate). This type of meaningful disclosure is far more important than the actual ETF identifier.

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III.II – Exchange Traded Funds (Index Tracking Issues)

Policy orientations identified by ESMA

25. ESMA believes that the prospectus for index-tracking UCITS ETFs should contain a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index. This information should include:

- *A clear description of the index including details of the underlying index components. In order to avoid frequent updates of the document, the prospectus can provide investors with a link to a web site where the exact composition of the index can be found;*
- *Information on whether the index will be tracked synthetically or physically (or a combination of both) and the implications for investors in terms of their exposure;*
- *The policy of the index-tracking UCITS ETF regarding the tracking error including its maximum level;*
- *A description of issues which will affect the index-tracking ETF's ability to fully replicate e.g. transaction costs, small illiquid components, dividend reinvestment etc;*
- *Details of whether the index-tracking UCITS ETF will follow a full replication model or use, for example, a sampling policy.*

Q11 Do you agree with ESMA's analysis of index-tracking issues? If not, please explain your view.

We generally agree with ESMA's analysis of index tracking issues. However, the issues raised are not unique to ETFs and must be considered in the broader UCITS context. In addition, we do have some comments on the analysis.

Firstly, we believe that a number of the matters raised are already required for Irish domiciled UCITS ETFs.

Furthermore, in the description of synthetic or swap-based index tracking UCITS, we believe the model being described is only one of the swap-based models that are available in the market. The model being described is that of an "unfunded swap". In this model, the fund does not hold a basket of securities as collateral but acquires, as assets of the Fund, a UCITS-compliant basket of securities, the return of which it swaps out for the return on the index being tracked. No "collateral" is held by the Fund. Alternative models exist, namely the "funded swap" (referenced elsewhere in your discussion document) and in some funded-swap models collateral may be obtained by the Fund for the purposes of reducing counter-party exposure.

Finally, we do not agree with the description of tracking error in paragraph 21. We believe what is described here is a measure of difference in performance between the return of the portfolio of the Fund and the return of the index (a "performance difference"). However, what is commonly understood as tracking error is a measure of the volatility of the performance difference.

Q12	**Do you agree with the policy orientations identified by ESMA for index-tracking issues? If not, please give reasons.**
	We generally agree with the policy orientations ESMA has identified. We believe that these are generally already disclosed and provide for transparency, a matter which is demanded by investors in ETFs. However, we have concerns about the proposal on the introduction of a tracking error policy and in particular, the requirement for a maximum level of tracking error. We believe that tracking error is something that can be calculated in a number of different ways and is done differently by different promoters. In addition, an exchange-traded fund by definition has a policy of tracking an index. It is a matter for the Board of that Fund to review whether the product is adhering to its policy and to review how well the objective is being met in accordance with the parameters it deems appropriate taking account of all relevant market and index circumstances. Performance can vary over different periods for different reasons and review needs to take into account factors impacting it. A set disclosure in prospectus would not allow for this and could be out of date relatively quickly. Our members are opposed to the introduction of a maximum level of tracking error as this would introduce the concept of some kind of guaranteed performance. Performance can be impacted by many factors outside of the control of the investment manager of the Fund. The risks in relation to performance are outlined in the prospectus document of the Fund and investors are advised in this way that performance can vary. In place of setting a maximum level of tracking error, we suggest that ESMA consider a standardised definition and methodology for calculating tracking error, this would allow investors to compare products more easily.
Q13	**Do you think that the information to be disclosed in the prospectus in relation to index- tracking issues should also be in the Key Investor Information Document of UCITS ETFs?**
	We do believe, subject to the comments above, that the policy orientations identified by ESMA should be in the KIID. We, however, believe that the existing requirements for the KIID drive disclosure of the items discussed in the policy orientations. In terms of the underlying index components, we support substitutive disclosure in both the prospectus and/or KIID. However, it is not feasible to fully disclose the components of an index. Firstly, the number of components may be too large or variable to fully list. Secondly, most indices are proprietary information, licensed from an external index provider, and cannot be fully disclosed.
Q14	**Are there any other index tracking issues that ESMA should consider?**
	We reiterate that ESMA should consider that ETFs are not the only index tracking UCITS and any proposals should be applied to all UCITS index tracking funds.
Q15	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**
	N/A

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III.II – Exchange Traded Funds (Synthetic ETFs – Counterparty Risk)

Policy orientations identified by ESMA

31. *ESMA believes that the information provided to investors in the prospectus of synthetic ETFs should include at least the following:*

- *Information on the underlying of the investment portfolio or index, the counterparty(ies) and, where relevant, the type of collateral which may be received from the counterparty(ies); and*
- *The risk of counterparty default and the affect on investor returns.*

32. *The annual report should also contain details of the following:*

- *The underlying exposure obtained through financial derivatives instruments;*
- *The identity of the counterparty(ies) to these financial derivative transactions; and:*
- *The collateral held by the UCITS to reduce counterparty exposure.*

Q16 **Do you support the disclosure proposals in relation to underlying exposure, counterparty(ies) and collateral? If not, please give reasons**

Yes we agree that the prospectus of synthetic ETFs should include information on the underlying investment portfolio or index, the counterparties (where relevant) and the type of collateral (where relevant). Again we note that this issue is not limited to ETFs and must be considered in the context of the UCITS framework.

It should be noted that the Discussion Paper seems to work on the assumption that all synthetic ETFs operate by way of fully funded swaps with a single counterparty in each case. This is often not the case. For example, some will operate by hedging the performance of certain assets (that the fund acquires and holds) against the performance of the index, thereby potentially significantly reducing the risk of counterparty exposure and the need for a significant amount of collateral from the counterparty to keep under the UCITS OTC counterparty exposure limits. As a result, it may not be appropriate to identify in the prospectus details of the counterparty or collateral, this could be dealt with in the annual report (as proposed in paragraph 32).

Q17 **For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets**

	constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.
	We do not believe that the provisions on quality and type of assets constituting collateral need to be further developed for synthetic index-tracking UCITS ETFs. Box 26 of CESR's Guidelines and Risk Management on calculation of Global Exposure and Counterparty Risk for UCITS already provides significant detail. In addition, the issue of collateral is potentially relevant for all UCITS funds that engage in OTC derivative trading and, therefore, any changes or further clarification should apply to all funds and not be specific to synthetic UCITS ETFs. Please also note our point above that, depending on the type of synthetic UCITS ETF, the issue of collateral may not be as important for all such funds. We do not believe that there should be a requirement for the quality and type of assets constituting collateral to match more closely the relevant index. The quality of collateral is important to any UCITS fund and the CESR Guidelines referred to above cater for that. The idea of matching the quality and type of collateral to what could potentially be a volatile index would not be appropriate. In addition managers should have the flexibility of determining what collateral is received while complying with the CESR Guidelines referred to above.
Q18	**In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.**
	No, we do not believe that collateral received by UCITS funds (whether they are synthetic ETFs or not) needs to comply with UCITS diversification rules. Collateral diversification is already dealt with in the CESR Guidelines referred to above as one of the factors that should be taken into account. The more important issues are liquidity, valuation and issuer credit quality. In particular, the use of haircuts for collateral which does not have a very high grade credit rating should be sufficient to address any concerns.

III.IV - Exchange Traded Funds (Securities Lending Activities)	
Policy orientations identified by ESMA ➢ *A UCITS ETF should clearly inform investors in the prospectus of the intention to engage in securities lending. This should include a detailed description of the risks involved in this activity including counterparty risk and the impact securities lending will have on tracking error for index tracking ETFs.* ➢ *The prospectus should also clearly inform investors of policy in relation to collateral. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks attached to the re-investment policy.* ➢ *The extent to which fees arising from securities lending are earned by the UCITS ETF should be disclosed. Where an UCITS ETF engages in fee sharing arrangements in relation to securities lending, this should be clearly disclosed together with the maximum percentage of fees payable to the securities lending agent or other third party.* ➢ *Where the securities lending agent is the investment manager or a connected party to the manager/investment manager this should also be disclosed.* ➢ *Collateral received in the context of securities lending activities should comply with the criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement.*	
Q19	**Do you agree with ESMA's analysis of the issues raised by securities lending activities? If not, please give reasons.**
	Broadly, yes we agree with ESMA's analysis. However, there a couple of points on which we disagree. First, the issues raised by ESMA, with regards to securities lending activities, are not unique to ETF fund structures. As such, we do not think that it is appropriate to address securities lending specifically in the context of ETFs. Any move to create regulation on securities lending should be handled at the level of the UCITS framework or, alternatively, the new AIFMD framework. Accordingly, all of our answers below should be read in terms of more guidance for securities lending rules applicable at the UCITS level, rather than for specific ETF rules. Secondly, on tracking error we note that securities lending returns generally contribute positively to performance, so any concerns about the tracking error should be outweighed by the long term performance contribution of securities lending to the funds. Overall, what is important is for a set of harmonized securities lending rules to be created for implementation across the EU.
Q20	**Do you support the policy orientations identified by ESMA? If not, please give reasons.**
	Broadly yes, though we have concerns around the collateral proposals as discussed in the response to Q22 below. As regards the prospectus we would agree that broad collateral policies should be reflected in the prospectus, but more detail on collateral parameters, such as collateral types, eligibility limits and levels of over-

	collateralisation, which may change depending on the market environment, should be available to clients and are better reflected on a provider's website or upon request.
Q21	**Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced? If yes, please specify.**
	No, we believe the current rules are sufficient.
Q22	**Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral? If not, please give reasons.**
	No - we agree that non-cash collateral should not be rehypothecated - as already reflected in the new UCITS rules (" non-cash collateral cannot be sold, pledged or re-invested ") and for cash collateral, UCITS defines reinvestment parameters. In our view it's key that collateral guidelines are consistent across ETFs and other UCITS funds. To this end we suggest that rather than making reference to collateral criteria for OTC derivatives, the reference should be to UCITS.
Q23	**Do you consider that ESMA should set a limit on the amount of a UCITS portfolio which can be lent as part of securities lending transactions?**
	No we do not believe there should be a limit on securities lending in a UCITS portfolio. This question overlooks the very tangible benefit that lending brings to investors. Provided the collateral rules are robust and the lending framework is disclosed, as suggested above, then we do not think it beneficial to investors to limit the potential upside to lending activity.
Q24	**Are there any other issues in relation of securities lending activities that ESMA should consider?**
	Currently, securities lending regulations are on the national level. We think that it is in the industry's best interest to have a set of harmonized UCITS securities lending rules across the EU. We would welcome the opportunity work with ESMA on such an initiative.
Q25	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**
	N/A

IIIl.V - Exchange Traded Funds (Actively Managed UCITS ETFs)	
Policy orientations identified by ESMA ➢ *The UCITS ETF should clearly inform investors of the fact that it is actively managed and indicate how it will meet with the stated investment policy including any intention to outperform an index.* ➢ *The UCITS ETF should inform the investors on the main sources of risks due to the investment strategy.* ➢ *Due to the fact that the majority of UCITS ETFs are passive index tracking funds an active UCITS ETF should clearly indicate that it is not an index tracker. It should also clearly describe the policy regarding portfolio transparency and where this information may be obtained.* ➢ *The UCITS ETF should clearly disclose how the indicative net asset value ('iNAV') is calculated.*	
Q26	**Do you agree with ESMA's proposed policy orientations for actively managed UCITS ETFs? If not, please give reasons.**
	Yes, we agree with the proposed policy orientation. However, we believe that all the requirements around risks, investment policy, iNAV and active nature of the funds are met in existing documentation.
Q27	**Are there any other issues in relation to actively managed UCITS ETFs that ESMA should consider?**
	No, however we believe ESMA should note that, by virtue of the publication of a PCF, active ETFs are transparent on a level over and above that typically seen with active funds which are not traded as an ETF.
Q28	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**
	Any action taken by ESMA to regulate use of the term ETF will protect against active funds which are not true ETFs using the ETF label.

III.VI - Exchange Traded Funds (Leveraged UCITS ETFs)	
Policy orientations identified by ESMA ➢ *The prospectus for leveraged UCITS ETFs should disclose the leverage policy, how this is achieved and the risks associated with this policy.* ➢ *In particular the impact of reverse leverage i.e. short exposure should be clearly disclosed.* ➢ *This should also include a description of how the daily calculation of leverage impacts on investors' returns over the medium to long term and should also include details of the costs involved.*	
Q29	**Do you agree with ESMA analysis of the issues raised by leveraged UCITS ETFs? If not, please give reasons.**
	In general, we agree with the analysis of the issues raised by leveraged UCITS ETFs.
Q30	**Do you support the policy orientations identified by ESMA? If not, please give reasons.**
	We agree with the policy orientations identified by ESMA for leveraged UCITS ETFs, in general. However it may be difficult to provide estimates of costs involved and this requirement should only apply in the annual report and where the costs are material.
Q31	**Are there any other issues in relation leveraged UCITS ETFs that ESMA should consider?**
	The key for leveraged UCITS ETFs is disclosure of the impact of leverage (long or short) and, in particular, the impact over longer periods of time where there are daily resets.
Q32	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**
	The information in the KIID should not be so detailed as to require constant updating. Instead it should focus on giving the investor information as regards to general use of leverage and the calculation of leveraged exposure (long or short).

III.VII - Exchange Traded Funds (Secondary Market Investors)

Policy orientations identified by ESMA

45. *The market participants who acquire creation units may be the only recognised investors in the UCITS ETF and the rules in the UCITS Directive designed to protect unit holders will not necessarily apply to investors who acquire shares on the secondary market when they are not registered unit holders. While UCITS are retail products and are suitable for all types of investors it is important that, at a minimum, the prospectus and marketing material inform the secondary market investors of their status and rights. The following type of warning could be used in this regard:*

> *'ETF units are not usually redeemable from the fund other than by authorised participants of creation units. Investors who acquire units on the secondary market must buy and sell shares with the assistance of a stock broker and investors may incur brokerage fees and pay more than the current net asset value when buying units and receive less than the net asset value when selling units.'*

46. *As an alternative UCITS ETFs could be required to give all investors, including those who acquire units on the secondary market, the right to redeem their units directly from the UCITS.*

47. *One could consider UCITS that redeem creation units on demand satisfying the UCITS Directive requirements in relation to redemption rights so that it might not be necessary to ensure that the stock exchange value of their shares does not differ significantly from the net asset value per share. However, given that most investors acquire units on the secondary market and in line with the requirements of the Directive, consideration could be given to imposing this requirement on all UCITS ETFs.*

Q33	**Do you support the policy orientations identified by ESMA? If not, please give reasons.**
	We disagree with ESMA's conclusion that, because shares in the ETF were purchased on the secondary market, investors cannot redeem from an ETF. The right to redeem is a fundamental tenant of UCITS, which is present in UCITS ETFs. ESMA is correct to note that an ETF is different from a traditional UCITS fund, in that the shares are traded in a secondary market. However, we think that ESMA is confusing the concept of shareholder and beneficial owner. Almost all funds in the EU are bought and sold through financial intermediaries. There is no material difference between a nominee account on the register of a traditional UCITS fund and the nominee account within the CSD for an ETF. In both cases, the underlying beneficial owner of the fund is not recognized as the legal owner of shares/units in the funds. When funds are bought through financial intermediates, the end investors' rights and protections are not compromised. We do not believe that, because ETFs are traded on a secondary market, the end investor is at a disadvantage when compared to the investor in a traditional UCITS fund. Most importantly, investors' right to redeem from the UCITS fund exists (acting through their nominee).
Q34	**Are there any other issues in relation to secondary market investors that ESMA should consider?**
	Any contemplation of the issues related to secondary market investors should recognize the benefits afforded

	to secondary market investors, in particular, the additional liquidity investors receive from ETFs over and above other non-ETF UCITS. In addition, we would like to point out that there are existing EU regulations, such as MiFID and MAD, which deal with secondary market issues; both of these regulations are in the process of being reviewed and modified.
Q35	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**
	Secondary Market inventors would benefit greatly from harmonization of EU exchanges. We would welcome the opportunity work with ESMA on such an initiative. In addition, we would welcome consideration of an extension of MiFID's rules regarding post trade reporting and transparency to cover ETF trading.
Q36	**In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?**
	Investors in ETFs have the right to redeem their units of an ETF. However, similar to investors in a traditional UCITS, investors must go through the financial intermediary which holds shares as their nominee to do so.
Q37	**If yes, should this right be limited to circumstances where market makers are no longer providing liquidity in the units of the ETF?**
	We agree that non APs should always be encouraged to use the secondary market where possible and would generally support steps to ensure shareholders use the best method available to redeem shares.
Q38	**How can ETFs which are UCITS ensure that the stock exchange value of their units do not differ significantly from the net asset value per share?**
	An ETF has no influence on the secondary market. Therefore, there is nothing that can be done to "ensure" the stock exchange value of their units do not differ significantly from the net asset value per share. However, practically speaking, the primary market process for an ETF automatically ensures that the secondary market will stay in line with the NAV of the fund. For example, at all times the AP/Market Makers for an ETF are monitoring the 'Fair Value' of an ETF against the current market price. This is calculated in real-time by valuing the components of the NAV and adjusting for the cost of creation/redemption. In the event that the on exchange price moves outside this fair value, the AP will have an arbitrage opportunity. For example, if the on exchange price is at a premium to the fair value due to high demand, the AP can sell at the 'premium' price on exchange and create at the lower NAV price. This will introduce additional inventory into the secondary market therefore removing the demand impact on the price. This will bring the price back in line with the NAV. Conversely, if the on exchange price is at a discount to the fair value, the AP can buy shares and reduce the inventory in the secondary market. This would have the effect of increasing the price of the ETF.

IV.I – Structured UCITS (Total Return Swaps)

Policy orientations identified by ESMA

- *Both the UCITS' investment portfolio, which is swapped, and the underlying to the swap, which the UCITS obtains exposure to, must comply with the relevant UCITS diversification rules.*
- *Where the swap counterparty assumes any discretion over the UCITS portfolio the extent to which the counterparty has control over the investment policy and the limitations imposed in the management of the UCITS should be disclosed to investors in the prospectus.*
- *Where the swap counterparty has discretion over the composition or management of the UCITS portfolio or can take any other discretionary decision related to the UCITS portfolio or the* ***u****nderlying swap portfolio then the agreement between the UCITS and the swap counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation. Thus, the counterparty should be treated and disclosed as an investment manager.*
- *Where the approval of the counterparty is required in relation to any portfolio transaction this must be disclosed in the prospectus.*
- *The prospectus should include information on the underlying strategy, the counterparty(ies) and, where relevant, the type of collateral which may be received from the counterparty(ies);*

60. *The structured UCITS' annual report should also contain details of the following:*

- *The underlying exposure obtained through financial derivatives instruments;*
- *The counterparties to these financial derivative transactions; and*
- *The collateral held by the UCITS to reduce counterparty exposure*

Q39	**Do you agree with ESMA analysis of the issues raised by the use of total return swaps by UCITS? If not, please give reasons.**

Broadly, we agree with the analysis. However, we do not agree with the following sentence in point 56:

> "While it may be considered that the composition of the physical assets held by a UCITS is not relevant to the asset diversification test, by virtue of the diversification provided through the swap, it is not clear that Article 52 of the Directive would allow for this interpretation."

We believe that a constant interpretation of most regulators, across Europe, has been that diversification has to be implemented after derivatives, and only after derivatives. We believe that this is reinforced by a simple economic analysis: the purpose of diversification is to diversify the exposure of investors. Exposure is real only after derivatives.

Q40	Do you support the policy orientations identified by ESMA? If not, please give reasons.
	As regards diversification, we do not believe that this is required. The purpose of diversification regulations is to diversify the risks taken by investors. Risks taken by investors are the real exposure of the fund, after the effect of derivatives. Whilst we are in broad agreement with the section we are concerned that ESMA feels there is a level of discretion exercised by swap counterparties with respect to assets of a fund. It is clear under UCITS that only the fund and its investment management delegates (as approved by the relevant competent authority and disclosed in the prospectus) have discretionary management of a UCITS. The board of directors of a fund have a fiduciary duty in such regard to ensure that the fund is appropriately managed by an approved person. Furthermore, MIFID and each implementing country of such directive, sets out in detail who can manage client assets, on what basis, and what approvals are necessary. The swap counterparty may exercise discretion in fulfilling contractual commitments but these calculation or other determinations in no way constitute investment management.
Q41	**Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?**
	No, we believe that derivatives are highly regulated by Europe, especially in relation to UCITS since the CESR Guidelines on Risk Measurement which issued in July 2010.
Q42	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**

IV.II - Structured UCITS (Strategy Indices)

Policy orientations identified by ESMA

<u>*Sufficiently diversified*</u>

65. *The prospectus for an index replicating UCITS must, where relevant, inform investors of the intention to avail of increased diversification limits together with a description of the exceptional market conditions which justify this investment.*

66. *UCITS which gain exposure to an index which contains a single component which represents between 20% and 35% of the overall index must disclose this fact in its prospectus and describe the exceptional market conditions which justify this investment.*

67. *A strategy index may contain a component which at the outset represents less than 20% of the overall index. However due to the methodology being followed the impact of a price movement on this component could have an impact on the index return which exceeds 20%. Accordingly it should not be sufficient that the components of the index respect the limits set out in the Directive - their impact on the return provided to investors through the swap should also respect these limits.*

- *A single component of an index must not have an impact on the overall index return which exceeds the relevant diversification requirements i.e. 20%/35%;*
- *Commodity indices must comprise of different commodities, e.g. oil, gold, silver which respect the 20%/35% limit in order to be considered an eligible index.*

<u>*Adequate benchmark*</u>

68. *A strategy index must be able to demonstrate that it meets with the index criteria including that of being a benchmark for the market to which it refers. Many of these indices are not designed to be benchmarks but are simply an investment strategy wrapped in an index. In some cases the objective of the strategy, the underlying components and their weightings are not fixed and can change depending on market developments.*

- *An index must have a clear single objective in order to represent an adequate benchmark for the market;*
- *the universe of the index components and the basis from which these components are selected for the strategy should be clear to investors and competent authorities;*
- *If cash management is included as part of the index strategy, the UCITS must demonstrate that this does not affect the objective nature of the index calculation methodology.*

<u>*Rebalancing*</u>

69. *The frequency at which an index can be rebalanced must also be considered. Strategy indices tend to be rebalanced far more frequently than traditional indices which typically rebalance quarterly or annually. Strategy indices usually rebalance daily or even on an intra-day basis, however ESMA considers that these type of indices are unlikely to be able to satisfy the UCITS requirements in terms of replication and transparency. This can result in increased costs for the UCITS and can also affect index transparency for investors.*

- *The rebalancing frequency should not prevent investors from being able to replicate the financial index. ESMA considers that indices which rebalance on an intra-day or daily basis cannot satisfy this criterion.*
- *The UCITS prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.*

<u>Published in an appropriate manner</u>

70. *Strategy indices often include proprietary calculation models and index sponsors do not typically publish the full calculation methodology. It is not considered sufficient for a UCITS to disclose a summary of the objective and calculation methodology.*
71. *Therefore, the index provider must disclose the full calculation methodology to inter alia enable investors to replicate the strategy.*
72. *In principle the requirement that an index be published in an appropriate manner means that an investor should be able to access relevant material information on the index with ease, for example, via the internet. Index performance must be freely and continually available. Information on matters such as index constituents, index calculation, re-balancing methodologies, index changes and information relating to any operational difficulties in providing timely or accurate information should also be available.*
73. *Therefore, strategy indices which involve proprietary information on the composition that the index provider is unwilling to disclose should not be considered as eligible financial indices.*
74. *A financial index must publish the constituents of the index together with their respective weightings. Weightings may be published after each rebalancing on a retrospective basis. This information should cover the previous period since the last rebalancing and include all levels of the index.*

<u>Hedge fund indices</u>

75. *In addition to guidelines for financial indices in general, CESR issued the following additional guidelines for the eligibility of hedge fund indices:*

1. *The methodology of the index provider for the selection and re-balancing of the components of the index must be based on a set of pre-determined rules and objective criteria;*
2. *The index provider may not accept payments from potential index components for inclusion in the index.*
3. *The index methodology must not permit retrospective changes to previously published index values ('backfilling').*
4. *The UCITS must carry out appropriate documented due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the hedge fund investment strategy and whether the index represents an adequate benchmark. The UCITS must also assess the availability of information on the index including whether there is a clear narrative description of the benchmark, whether there is an independent audit and the scope of such an audit, the frequency of index publication and whether this will affect the UCITS ability to calculate its NAV. The due diligence should also cover matters relating to the index components.*

76. *In order to ensure that all financial indices, including strategy indices:*

– *use pre-defined methodologies based on objective criteria and do not include any discretionary element; and*
– *provide adequate disclosure of the index objective and benchmark and appropriate transparency in relation to the index*

components and calculation methodology

ESMA's preliminary views are that it might be appropriate to require that all financial indices comply with points 1 to 4 in the paragraph 69 above which currently only apply to hedge fund indices.

Conflicts of interest

77. *In many cases the manager/investment manager of the UCITS, the counterparty to the swap and the index provider are part of the same group. It is important therefore to ensure that the UCITS has a clearly documented conflicts of interest policy to deal with these issues and a summary of this policy should be disclosed in the prospectus.*

- *UCITS must ensure that any valuation of the swap must include an independent assessment of the underlying index.*
- *The financial index should be subject to independent valuation.*

Q43 Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.

For the sake of clarification, we believe that the proposed ESMA orientations as regards indices should be applicable to all indices, not only strategy indices.
As regards the specific requirement:

a) Sufficiently diversified

We agree with the proposal, except that we do not understand what ESMA means by "impact". We need some clarification on this.
We agree with requirements proposed for commodity indices. We understand the ESMA proposal as being, for example, that a WTI contract and a Brent contract should be seen as only one asset for the sake of diversification.
ESMA should also be explicit about whether crude oil and gasoline, for example, should be seen as only one commodity or different commodities. We believe that they should be considered as separate commodities, because, simply, they are different, and their markets respond to different economic conditions.

b) Adequate benchmark

While we support the objective of providing investors with disclosure on benchmarks, we do not feel there is a need for additional regulation in this area as the existing rules are sufficient.

c) Rebalancing

	Traditional indices have a rebalancing policy which is, in general, quarterly. However, the world of indices knows a lot of innovation these days and we do not see why having a more frequent rebalancing, even intra-day, would be in itself a problem in terms of public policy. It depends also about what we define as "rebalancing". If rebalancing is defined by changing the weights, traditional indices are rebalanced every second, because the weight of each constituent depends on the market price of such constituent. If we define rebalancing by the number of units of the constituents, yes traditional indices tend to rebalance quarterly, but in this case, an index which is equally-weighted would be seen as rebalancing every day, in order to keep its weight constant. We do not see any convincing reason to limit indices to monthly rebalancing. ESMA mentions two problems: the costs and the transparency. Investors should clearly be informed that rebalancing can happen intra-day, but the costs are not necessarily significant, since the underlying concerned can be very liquid (futures etc.). Also, the rebalancing can affect only a small part of the portfolio so that would not be significant in terms of costs. Ultimately, the rebalancing has to be adequate with the market the index seeks to represent, and, if such market suggests an intra-day rebalancing, it could be harmful to the industry and to the investors to limit the rebalancing frequency. Transparency may be an issue, but the frequency of rebalancing is not the issue. An index can be rebalanced quarterly and be completely non transparent. An index can be rebalanced intra-day and be very transparent. We believe there is no absolute relation between the two. What is also important is the fact that the index is rebalanced according to a model. It does not matter very much that it is rebalanced intra-day, if such rebalancing is purely model-based. On the contrary, a rebalancing that would happen every month, for example, but on a purely discretionary basis, should be prohibited. We agree with the disclosure of the rebalancing frequency in the prospectus. <u>d) Published in an appropriate manner</u> Some index providers do not provide for free the components and weights of their indices. This is in fact very usual. Besides, the notion of the investors being able to “replicate” the performances of the underlying index is according to us not as relevant as it seems. Some well-known and recognized financial indices (e.g. the S&P GSCI) allow some discretion, though constrained through their index committee and some other indices do not disclose commercially sensible information (which would allow an investor aiming at replicating the index to arbitrage it). It seems to us that the right criteria as regards transparency should be that investors must be able to assess which market is exactly represented, what the objectives of the index are and how the rebalancing methodology works.
Q44	**How can an index of interest rates or FX rates comply with the diversification requirements?**
	We believe that interest rate derivatives and FX derivatives should be disregarded for the sake of diversification of indices, i.e. their notional should not be constrained by a diversification limit. Diversification is not a

meaningful measure with interest or foreign exchange rates as there is no issuer and interest/FX rates reflect supply/demand of a currency. There is no requirement that UCITS must diversify its currency risk, i.e. a fund can have 100% exposed to equities denominated in a single currency.

A UCITS can have 100% exposure to EUR cash deposits (provided banks are diversified) which deliver a return of overnight EUR interest rates. This is equivalent to investing in an index delivering EUR interest rates. In addition, a UCITS in USD base currency can have 100% exposed to short term money market instruments denominated in EUR i.e. investors are subject to EUR/USD foreign exchange risk. This is equivalent to the fund investing in an index with USD/EUR as its underlying. In both cases, anything a UCITS is permitted to do physically it should be allowed synthetically

Q45	**Are there any other issues in relation to the use of Strategy Indices by UCITS that ESMA should consider?**
	a) The situation of "indices of indices", indices that contain some other indices among their constituents, should be clarified We believe that an index should be able to use as a constituent another index, that we will name a "sub-index". If the sub-index is itself an index according to the UCITS Directive and ESMA guidelines, the sub-index is itself properly diversified. The weight of the sub-index should therefore be allowed to be higher than 35%. For example, we propose that it should be possible to have an index that would be made of 4 constituents, each of them for 15% of the index, plus a compliant sub-index for 40% of the index. As a constituent of the index, the sub-index can represent more than 35% of the index. b) the existing level 3 guidelines concerning non-diversified indices should be kept These guidelines allow non-diversified indices to be used by UCITS, provided that the exposure to such indices is considered as a non-exempted exposure as regards the diversification of the fund.
Q46	**If yes, can you suggest possible actions or safeguards ESMA should adopt?**
	ESMA guidelines should include a paragraph allowing indices that include other indices as constituents. It should simply mention that when an index includes as constituent another index (the "sub-index") and when the sub-index respect European regulations as an index, the exposure to such index can be higher than 35% of the index.