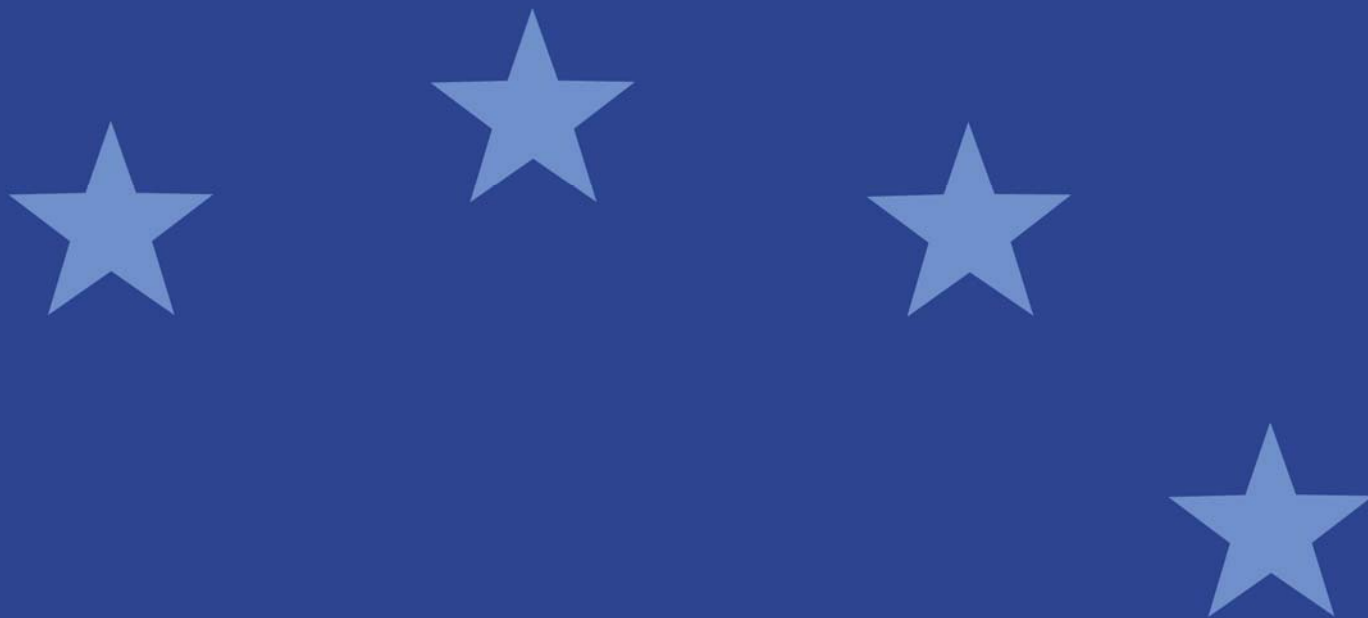
European Securities and Markets Authority

Consultation paper

ESMA's guidelines on ETFs and other UCITS issues



| ESMA/2012/44

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- indicate the specific question to which the comment relates and respond to the question stated;
- contain a clear rationale, clearly stating the costs and benefits; and
- describe any alternatives ESMA should consider.

Comments should reach us by **30 March 2012**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your Input - Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Legal Notice'.

Who should read this paper?

This document will be specifically of interest to asset management companies and trade associations of asset management companies managing UCITS, as well as to institutional and retail investors and their associations.

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Acronyms used

AIFMD	Alternative Investment Fund Managers Directive (2011/61/EU)
CESR	Committee of European Securities Regulators
EPM	Efficient portfolio management
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
FSB	Financial Stability Board
iNAV	Indicative Net Asset Value
KIID	Key Investor Information document
TRS	Total Return Swap
UCITS	Undertaking for Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC

I. Executive Summary

Reasons for publication

In the summer of 2010 ESMA started looking into the operation of UCITS making use of the new investment freedoms introduced by the UCITS III Directive and the Eligible Assets Directive (2007/16/EC) in order to identify the possible impact on investor protection and market integrity. As part of this work, ESMA published a discussion paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS on 22 July 2011 (ESMA/2011/220), responses to which were due by 22 September. This consultation paper represents the next stage in the development of ESMA guidelines in this area.

Contents

This consultation paper sets out ESMA's proposals for guidelines on UCITS ETFs, index-tracking UCITS, efficient portfolio management techniques, total return swaps and strategy indices for UCITS.

The formal proposals for guidelines are contained in the boxes in Sections II to VIII of the paper, while further commentary and explanation is provided in the explanatory text.

Index-tracking UCITS

This section includes draft guidelines on the disclosure required in the prospectus and annual and half-yearly reports of index-tracking UCITS.

Index-tracking leveraged UCITS

This section sets out draft guidelines on the disclosure required in the prospectus and Key Investor Information Document (KIID) of index-tracking leveraged UCITS.

UCITS Exchange-Traded Funds

This section covers draft guidelines for UCITS Exchange-Traded Funds, including the definition of UCITS ETFs and the use of an identifier by such funds, disclosure requirements for actively-managed UCITS ETFs and rules for protecting investors dealing on secondary markets.

Efficient portfolio management techniques

This section set outs draft guidelines on the employment of efficient portfolio management techniques by UCITS and on the related disclosure requirements.

Total Return Swaps

This section clarifies the rules applicable to UCITS entering into total return swaps and the related disclosure requirements.

Strategy indices

This section sets out draft guidelines for UCITS gaining an exposure to strategy indices.

Transitional provisions

This section clarifies the transitional provisions for the entry into force of the future guidelines.

Next steps

ESMA will take into account responses to this consultation paper in finalising the guidelines for adoption in Q2 2012.

II. Retailisation of complex products

1. In the discussion paper (DP) published in July 2011, ESMA highlighted a number of broader issues that arise in the context of exchange-traded funds and UCITS using more complex investment techniques or structures. One such issue related to the so-called retailisation of complex products. As explained in the DP, the current MiFID framework treats all UCITS as automatically non-complex instruments for the purposes of the appropriateness test. ESMA's predecessor, CESR, provided advice to the European Commission in July 2010 on the question of a possible distinction between types of UCITS in this context. The Commission's proposal for the review of MiFID suggests removing from the scope of instruments that are automatically non-complex structured UCITS as defined in the KII Regulation[1]. ESMA will await the outcome of the negotiations on the revised MiFID and stands ready to provide any further input on this point at the appropriate stage.

III. Index-tracking UCITS

2. Index-tracking UCITS track a broad range of indices including equity, bond, commodity, currency, sector specific and strategy indices. Many index-tracking UCITS take the form of ETFs but some of them are non-listed. As far as European index-tracking ETFs are concerned, most of them are passively managed. This can be done physically or synthetically or by a combination of both.

3. Physical replicating or cash based UCITS replicate the performance of an underlying index by investing in all the securities of that index or a representative sample of those securities. Full replication of an index can be difficult to achieve and involves significant rebalancing transaction costs. This is particularly the case for indices with a large number of constituents, some of which may need to be purchased or sold in small amounts. There are also issues relating to tracking error which are discussed in more detail below.

4. Synthetic or swap-based index-tracking UCITS hold a basket of securities as collateral and exchange the performance of these securities with a counterparty in return for the performance of the index. This strategy avoids the high rebalancing costs and tracking error associated with physical replication but introduces other risks including counterparty risk.

5. For index-tracking UCITS, the tracking error is usually defined as the volatility of the difference between the return of the index-tracking UCITS' portfolio and the return of the benchmark or index. The tracking error helps measure the quality of the replication.

6. Tracking error is higher for physical replicating UCITS due to transaction costs and difficulties in buying and selling small illiquid components of the index. Where it is not possible to own every stock on an index due to the size of the index or because some components are very illiquid, physical replicators may rely on sampling. The index-tracking UCITS implements the sampling strategy by acquiring a subset of the component securities of the underlying index, and possibly some securities that are not included in the corresponding index that are designed to help the UCITS track the performance of the index. An index-tracking UCITS that uses a robust sampling methodology is still considered to be pursuing a passive investment strategy.

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[1] Commission Regulation (EU) No 582/2010

7. Although synthetic replication reduces tracking error, it does not eliminate this problem entirely. Index return swaps are not always based on the same assumptions and calculations as the main version of an index. For example, dividend re-investment assumptions and dividend tax enhancements mean that the version of an index used by a swap may differ from what most investors are familiar with.

8. The prospectus for each UCITS must contain a description of its investment policy. In practice an index-tracking UCITS will include the name and a short description of the index. However, it may not include sufficient detail in relation to the components of the index or the benchmark to which the index refers. Moreover, an index-tracking UCITS may not always specify the replication mechanism, physical or synthetic, used to track the index or, in the case of physical replication, whether full replication or sampling is used. It is important that investors are provided with sufficient detail to understand the index tracking policy used and the types of underlying assets and strategies they are gaining exposure to. Investors must always be informed of the principle risks in relation to the investment policy of the UCITS.

9. The majority of respondents to the discussion paper agreed with the policy orientations identified by ESMA regarding index-tracking issues in the context of UCITS ETFs. However, it was pointed out that the same policy orientations should apply to all UCITS tracking an index and not be limited to index-tracking ETFs. ESMA saw merit in this suggestion and therefore decided to take it on board in the consultation paper.

Box 1

Index-tracking UCITS

1. The prospectus of an index-tracking UCITS should include:

   a) A clear description of the index including details of its underlying components. In order to avoid the need to update the document frequently, the prospectus can direct investors to a web site where the exact composition of the index is published.

   b) Information on how the index will be tracked and the implications of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk.

   c) The policy of the index-tracking UCITS regarding the ex-ante tracking error including its target level.

   d) A description of factors that are likely to affect the index-tracking UCITS' ability to track the performance of the index, such as transaction costs, small illiquid components, dividend reinvestment etc.

   e) Details of whether the index-tracking UCITS will follow a full replication model or use, for example, a sampling policy.

2. The annual and half-yearly reports of an index-tracking UCITS should state the size of the tracking error as at the end of the period under review. The annual report should provide an explanation of any divergence between the target and actual tracking error for the relevant period.

Explanatory Text

10. Box 1 sets out the disclosures that index-tracking UCITS should make in their prospectuses, annual and half-yearly reports regarding the way they track the relevant index.

Questions to stakeholders

Q1: Do you agree with the proposed guidelines?

Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs.

Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?

IV. Index-tracking leveraged UCITS

11. Index-tracking UCITS are permitted to engage in leverage subject to the limits and rules on global exposure set out in the UCITS Directive and Level 2 and 3 measures.

12. Most index-tracking leveraged UCITS provide investors with a leveraged exposure (both long and short) to the performance of the index or benchmark they track. They seek to achieve a daily return that is a multiple or an inverse multiple of the daily return of a securities index. The most common of these are the so-called 2x (double return) or -2x (double-inverse return) which offer investors twice the positive or negative return of the benchmark on a daily basis. In order to comply with ESMA's Guidelines on Risk Measurement, the maximum positive or negative leveraged return cannot exceed twice the return of the index.

13. To accomplish their objectives, index-tracking leveraged UCITS pursue a range of investment strategies through the use of swaps, futures contracts, and other derivative instruments. An important characteristic of these index-tracking leveraged UCITS is that they seek to achieve their stated objectives on a daily basis, and their performance over longer periods of time can differ significantly from the multiple or inverse multiple of the index performance over those longer periods of time. This effect can be magnified in volatile markets.

14. The majority of respondents to the discussion paper agreed with the policy orientations on leveraged ETFs. Based on the feedback received, ESMA has decided to keep the policy orientations identified in the discussion paper as proposed guidelines and decided to broaden the scope of the guidelines to include all index-tracking leveraged UCITS, not just leveraged ETFs.

Box 2

Index-tracking leveraged UCITS

1. The prospectus for index-tracking leveraged UCITS should include the following information:

a) A disclosure on the leverage policy, how this is achieved (e.g. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage and the risks associated with this policy;

b) A disclosure on the impact of any reverse leverage (i.e. short exposure);

c) A description of how the frequency of calculation of leverage impacts on investors' returns over the medium to long term.

2. Information to be provided according to paragraph 1 (b) above should also be included in the KIID.

Explanatory Text

15. The use of leverage by index-tracking UCITS should not be used as a means to circumvent the relevant limits on UCITS global exposure. This means that an index-tracking leveraged UCITS should comply with the requirements on global exposure established by Article 51(3) of the UCITS Directive and calculate its global exposure using either the Commitment Approach or the Value at Risk (VaR) Approach according to the rules set out in CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

Questions to stakeholders

Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?

Q5: Do you believe that additional guidelines should be introduced requiring index-tracking leveraged UCITS to disclose the way the fund achieves leverage?

V. UCITS Exchange Traded Funds

V.I. Introduction

16. Notwithstanding the fact that this section only relates to UCITS ETFs, ESMA is aware of the fact that products similar to those offered as UCITS (i.e. under a harmonised regulatory framework) could also be structured and issued as notes (exchange-traded notes or ETNs) by credit institutions or Special Purpose Vehicles (SPVs). As such they can be sold to retail investors (even if in such a case these products will not fall within the MiFID definition of non-complex products, entailing the application of additional rules in the sales process) or admitted to trading on regulated markets or other trading venues.

17. ETNs are structured products that are issued as non-interest paying debt instruments whose prices fluctuate with an underlying index or an underlying basket of assets. Because they are debt obligations, ETNs are backed by the issuer and subject to the solvency of the issuer. When investors hold an ETN until the maturity date, they receive a one-time payment based on the performance of the underlying asset, index or strategy. The note can also be sold on the secondary market as these products are transferable securities which offer real-time pricing and intraday liquidity. ETNs are debt obligations and are therefore not free of credit risk. Special purpose vehicles (SPVs) may be established through which ETNs are issued.

18. ETNs, SPVs and products issued by SPVs are not subject to a UCITS-equivalent framework (nor to the type of requirements to which credit institutions are subject2) and they are less likely to have the same level of controls and rules in place in terms of, for example, risk spreading, eligibility, risk management and risk measurement. They are not subject to supervision with respect to the performance of their activity, nor are they subject to on-going disclosure requirements with respect to the product. In addition, there is no obligation on SPVs to have an external depositary. Credit risk of SPVs is borne entirely by the investor.

19. This paper does not deal specifically with non-UCITS funds although they can be established as ETFs and pursue the types of strategy discussed in this paper. The AIFMD will to some extent consider issues relating to non-UCITS but it will not address retail investor protection concerns. Moreover, there could be concerns in terms of broader market stability which are relevant even for funds exclusively marketed to professional/institutional investors (typically issues related to quality of collateral, liquidity risk, etc.).

20. ESMA will reflect further on the extent to which any of the guidelines agreed for UCITS can be applied to regulated non-UCITS funds established or sold within the European Union. Also, ESMA is of the view that further consideration should be given to the development of harmonised definitions at European level of all exchange-traded products. More generally, ESMA believes that products with broadly similar characteristics should be subject to the same level of regulatory requirements and that investors in such products should be able to rely on an equivalent level of regulatory protection.

V.II. Definition of UCITS ETFs and identifier

21. Although the majority of European ETFs are authorised as UCITS they have some unique features which are not present in traditional open-ended funds. For example, investors (other than creation unit-holders) usually do not subscribe or redeem directly from the ETF but rather acquire and dispose of their shares on the secondary market. Contrary to other UCITS investors, they may not always receive the fund documentation (such as the KIID) where they acquire UCITS ETF units directly on-exchange, for example, or through dedicated websites.

22. ETFs are also often confused with other types of exchange-traded products such as exchange-traded notes and exchange-traded commodities. They may also be confused with listed closed-ended funds. UCITS ETFs can be established under different forms. UCITS ETFs that intend to replicate the performance of an index may do this either physically or synthetically or a combination of both. Some UCITS ETFs may also aim at outperforming an index and therefore are actively managed. The UCITS Directive provides that a UCITS which replicates a stock or debt securities index must include a prominent statement to this effect in the prospectus and any other promotional literature.

23. Respondents to the discussion paper generally agreed with the policy orientation identified by ESMA on the identifier. However, several stakeholders did not deem appropriate to further specify the type of structure of the ETF in the name. Therefore, ESMA is proposing that ETFs should at least use in their name the identifier "ETF".

[2] Where the products are issued by credit institutions, the credit institutions are obliged to implement general requirements on risk management and measurement. However, such requirements apply to the whole activity of the credit institution and not, as is the case for UCITS, with respect to the specific product offered.

Box 3

Definition of UCITS ETFs and identifier

1. A UCITS exchange-traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradeable on at least one regulated market or multilateral trading facility (MTF) with at least one market maker which takes action to ensure that the stock exchange value of its units or shares does not significantly vary from their net asset value.

2. A UCITS ETF should use an identifier, in its name and in its fund rules or instrument of incorporation, prospectus, KIID and marketing communications, which identifies it as an exchange-traded fund. The identifier should be 'ETF'.

3. A UCITS which does not fall under the definition of UCITS ETF in paragraph 1 of this Box should not use the 'ETF' identifier in its name or in its fund rules or instrument of incorporation, prospectus, KIID or any marketing communications.

Explanatory Text

24. ESMA is aware of the fact that under one element of the Commission's proposal for the review of MiFID[3] , which extends the transparency rules to equity like instruments such as depository receipts, exchange-traded funds, certificates and other similar financial instruments issued by companies, ETFs are defined as 'units in those open-ended collective investment schemes which are freely negotiable on the capital markets and in most cases track the performance of an index'. The definition of ETFs provided in this paper is broadly consistent with the one in the MiFIR proposal while taking into account the specificities of UCITS products. Depending on the outcome of the negotiations on the MiFIR proposal, in the future ESMA may consider the appropriateness of any further alignment between the definition of ETFs provided in this paper and the one in the MiFIR final text.

25. For the purposes of paragraph 1 of Box 1, a regulated market or MTF shall mean a European regulated market or MTF or an equivalent third country market within the meaning of MiFID. Not all UCITS which are listed should be considered as falling within the definition of UCITS ETF unless they have all the features described in the definition (in particular, the existence of at least one market maker in the regulated market or MTF where the UCITS is listed).

26. The reference to the continuous tradability of the UCITS ETF shares or units in paragraph 1 of this box should be understood as limited to the opening hours of the relevant stock exchange.

27. ESMA is aware of the fact that throughout the day an iNAV is calculated for ETFs, usually by an agent of the ETF but in some cases by the stock exchange. This iNAV is updated continuously, based on the most up to-date information and provides a guide for investors trading on the secondary market. iNAV is not the price at which investors purchase or sell units and the final closing NAV is calculated on a daily basis. The reference in paragraph 1 of the box to the action taken by the market maker to ensure that the stock exchange value of its units or shares does not significantly vary from their net asset val-

[3] Proposal for a Regulation of the European Parliament and of the Council on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories published on 20 October 2011 (the MiFIR proposal)

ue is without prejudice to any equivalent action taken directly by the UCITS ETF in compliance with Article 1(2)(b) of the UCITS Directive or any action taken by the market maker or the UCITS ETF to also ensure that the stock exchange value of its units or shares does not significantly vary from their iNAV calculated at any time.

Questions to stakeholders

Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?

Q7: Do you agree with the proposed guidelines in relation to the identifier?

Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?

Q9: Do you think that the use of the words 'Exchange-Traded Fund' should be allowed as an alternative identifier for UCITS ETFs?

Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?

V.III. Actively-managed UCITS ETFs

28. Most UCITS ETFs aim to replicate the performance of an index (index-tracking UCITS ETFs) and are passively managed. However, some UCITS ETFs are actively managed usually with an objective to outperform an index or other benchmark. Actively managed UCITS ETFs have the traditional structure of an ETF but the manager has discretion in relation to the composition of the portfolio, subject to the stated investment objectives and policies. Index constituents are published on a daily basis, depending on the requirements of the relevant stock exchange.

29. Respondents to the discussion paper welcomed the policy orientations on actively-managed UCITS ETFs. Therefore, ESMA decided to keep these policy orientations as proposed guidelines.

Proposed guidelines

Box 4

Actively-managed UCITS ETFs

1. A UCITS ETF that is actively managed should clearly inform investors in its prospectus, KIID and marketing communications of that fact and that it is not an index tracker.

2. An actively-managed UCITS ETF should clearly disclose the following in its prospectus, KIID and marketing communications:

    a) How it will meet the stated investment policy including any intention to outperform

an index;

b) Without prejudice to the rules of the relevant regulated market or MTF, the policy regarding portfolio transparency and where this information may be obtained, including where the iNAV, if applicable, is published.

3. An actively-managed UCITS ETF should clearly disclose in its prospectus how the iNAV is calculated, if applicable, and the frequency of its calculation.

Explanatory Text

30. Box 4 sets out the specific disclosure requirements for actively-managed UCITS ETFs.

31. In particular, the second bullet point in paragraph 2 of Box 4 requires that an actively-managed UCITS ETF clearly describe the policy regarding portfolio transparency to the regulated market or MTF where its units or shares are tradeable, and where this information may be obtained.

Questions to stakeholders

Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in the prospectus, the KIID or any marketing communications of the UCITS ETF?

V.IV. Secondary market investors

32. Before launching a UCITS ETF the promoter will test the product with market participants to assess investor demand. Market participants are members of the exchange where the UCITS ETF is admitted to trading and may also act as market makers for the fund, creating a liquid market in the shares. Market participants buy and sell shares directly from the UCITS ETF in large blocks known as creation units, and are usually the only unit holders of record. In the case of physical UCITS ETFs these subscriptions and redemptions may be carried out on an in-specie basis using assets which make up the index and the fund portfolio. In the case of synthetic UCITS ETFs creation units are usually issued on a cash basis.

33. After purchasing a creation unit, the market participant splits it up and sells the individual units on a secondary market. This is the usual method by which investors purchase and sell individual units in the fund.

34. According to the rules of the stock exchange where units are traded, the UCITS ETF must publish the securities and other assets in its portfolio every day. Throughout the day an iNAV is calculated, usually by an agent of the ETF but in some cases by the stock exchange. This iNAV is updated continuously, based on the most up to-date information and provides a guide for investors trading on the secondary market. iNAV is not the price at which investors purchase or sell units. In many cases, the UCITS ETF will actually trade at a premium or discount to the NAV due to various factors, including supply and demand, and expectations. Final closing NAV is calculated on a daily basis.

35. Some respondents to the discussion paper did not consider the warning proposed for secondary market investors suitable; however, these respondents were of the opinion that the ETF's prospectus

should provide disclosures on redemptions on the primary market. In contrast, one asset manager agreed on clearly outlining in the ETF's documentation the difference between the primary market and the secondary market.

36. Several respondents agreed in principle on giving investors the right to request direct redemptions, while providing reasons for encouraging investors to use the secondary market[4]. These respondents argued that the right to request direct redemption should be limited to exceptional circumstances (e.g. where an ETF is delisted or the secondary market is disrupted), with one asset manager noting that in this case the ETF should simply be liquidated.

Proposed guidelines

Box 5

Secondary market investors

Option 1

1. A UCITS ETF or its management company should ensure that the market maker(s) of the listed units or shares of the UCITS ETF continue(s) to offer redemption to secondary market investors whenever the market is open for trading.

2. A UCITS ETF or its management company should take appropriate action to replace the market maker(s) if it is no longer able or willing to act in that capacity, and should ensure the protection of unitholders in the event of such a process of replacement or if the redemption in the secondary market is disrupted. This may include making arrangements for investors who have acquired their units or shares on a secondary market to sell them directly back to the UCITS ETF or its management company.

3. The prospectus of a UCITS ETF should explain that ETF units are generally not redeemable from the fund other than by authorised participants holding creation units.

4. The prospectus and marketing communications of a UCITS ETF should include the following warning:

   '*UCITS ETF units / shares cannot usually be sold directly back to the fund. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. Investors may pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them.*'

Option 2

1. Investors who acquire units or shares of a UCITS ETF on the secondary market shall be able to redeem

[4] Individual investors may find it challenging in practical terms to redeem directly with the ETF, mainly due to the operational challenges imposed by the Central Securities Depositaries (CSDs) which clear the shares of an ETF, which are listed on exchange (and not due to restrictions imposed by the ETF itself).

their shares directly from the UCITS ETF at any time.

2. The prospectus and KIID of the UCITS ETF should indicate, where applicable, the redemption fee that will apply to the investor in such circumstances.

Explanatory Text

37. Box 5 provides rules for the protection of investors dealing on the secondary markets.

38. Option 1 in Box 5 sets out rules dealing with the fact that the market participants who acquire creation units may be the only recognised investors in the UCITS ETF; as such, 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 investor it is important that, at a minimum, the prospectus and marketing material inform the secondary market investors of their status and rights. For this reason a specific warning has been elaborated. UCITS ETFs listing only some of their units or shares on a regulated market or MTF should make clear to investors that the warning only applies to their listed shares and that those shares which are not listed may always be redeemed directly from the fund.

39. In addition, in order to ensure that investors on the secondary market are continuously able to redeem their units or shares, a specific provision has been introduced to require the UCITS ETF or its management company to make adequate contractual arrangements with each market maker, so that the market maker may not withdraw from its activities in the secondary market until a replacement market maker has been appointed.

40. Option 2 in Box 5 provides for the right of investors acquiring their units or shares on the secondary market to ask for the redemption of their holding directly from the UCITS ETF. In such circumstances, the UCITS ETF should be able to set and disclose higher redemption fees to be paid by such investors in order to recover the additional costs it has incurred to satisfy such direct redemption requests.

Questions to stakeholders

Q12: Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?

Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.

Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.

Q15: Can you provide further details on the relationship between the ETF's register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?

VI. Efficient portfolio management techniques

41. Pursuant to Article 51(2) of the UCITS Directive, Member States may authorise UCITS to employ techniques and instruments relating to transferable securities and money market instruments under the conditions and within the limits which they lay down provided that such techniques and instruments are used for the purpose of efficient portfolio management (EPM). Article 11 of the Eligible Assets Directive sets out further criteria on the use of these techniques and instruments. CESR's guidelines concerning eligible assets for investment by UCITS (Ref. CESR/07-044b), meanwhile, clarified that EPM techniques should not 'result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its applicable sales documents'.

42. These EPM techniques include sale and repurchase agreements (repo), purchase and resale agreements (reverse repo) and securities lending. ESMA considers it important to impose additional requirements on UCITS that make use of these techniques, particularly with respect to the collateral that the UCITS receives from the relevant third party.

Securities lending

43. The use of securities lending by UCITS is growing in popularity as the profits earned can increase returns and offset other costs. Securities lending can be a significant activity for physical UCITS ETFs given the size of their available portfolio of securities and the ability to generate significant returns. Synthetic UCITS ETFs may also engage in this activity, depending on the composition of the portfolio and the nature of the swap instrument. While the activity is likely to boost UCITS ETFs' returns, this can also increase the tracking error for index-tracking UCITS ETFs. However, in certain circumstances the returns from securities lending activity can offset other costs within the index-tracking UCITS ETF and actually reduce tracking error.

44. It is not always evident to investors how the proceeds from securities lending are allocated. The role of securities lending agents is not always clear or disclosed adequately to investors. The type of income generated from securities lending will depend on the type of collateral received by the UCITS. For example, if securities are received as collateral the UCITS will receive a fee from the lender. In the case of cash collateral, income is generated by the reinvestment of this collateral and no fee is paid by the lender who provides the cash. In both cases the income received i.e. fee or interest may be split between the securities lending agent if one is appointed and the UCITS. The securities lending agent may be a related party to the UCITS and in some jurisdictions the investment manager.

45. Securities lending introduces risks arising from borrower default notwithstanding the provision of collateral, and, where cash collateral is received, from the re-investment of cash collateral, all of which must be managed by the UCITS. The criteria for collateral received by UCITS in the case of OTC derivative transactions set out in CESR's Guidelines on Risk Measurement do not apply to collateral received as part of a securities lending transaction. For example, non-cash collateral received as part of a securities lending transaction could be sold, re-used or pledged and there are no restrictions on the re-investment of cash collateral. While Member States may impose their own national rules in this regard, it would seem appropriate to impose the rules which currently apply to collateral received in the context of OTC transactions to collateral received by UCITS as part of a securities lending transaction or repurchase agreement.

46. According to CESR's Guidelines on Risk Measurement the net exposure to a counterparty generated through a securities lending or repurchase agreement has to be included in the 20% limit of Article 52(2) of the UCITS Directive. There is no limit in the guidelines or the UCITS Directive on the amount of a UCITS portfolio which can be on loan.

47. As noted by the FSB report[5], securities lending activities can also potentially give rise to broader systemic concerns. For example, if securities lending is particularly prevalent, there could be a greater risk of a market squeeze in the underlying securities if ETF providers were to recall on-loan securities on a large scale in order to meet redemptions.

Repo and reverse repo

48. ESMA is of the view that many of the issues arising from securities lending activity are also present when UCITS engage in repo and reverse repo transactions. Therefore, ESMA proposes to apply the same guidelines to these transactions.

49. There was broad support among respondents to the discussion paper on the policy orientations identified by ESMA, and in particular on the application of the CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. However, respondents believed that any proposals should apply to all UCITS, not only to UCITS ETFs.

Proposed guidelines

Box 6

Efficient portfolio management techniques

1. A UCITS should clearly inform investors in the prospectus of its intention to employ the techniques and instruments referred to in Article 51(2) of the UCITS Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS.

2. The prospectus should also clearly inform investors of the UCITS' collateral policy. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks arising from the re-investment policy.

3. Fees arising from EPM techniques should be disclosed in the prospectus and, as a general rule, returned to the UCITS. Where a UCITS engages in fee-sharing arrangements in relation to EPM techniques, this should also be clearly disclosed, together with the maximum percentage of fees payable to the third party. Other fees that may be deducted to the return delivered to investors should also be disclosed in the prospectus

4. Where the third party is the investment manager or a connected party to the UCITS management company / directors / investment manager / depositary, this should also be disclosed in the prospectus.

[5] Report on Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs) from 12 April 2011

5. A UCITS should ensure that it is able at any time to recall any security that has been lent or terminate any securities lending or repo agreement into which it has entered.

6. Collateral received in the context of EPM techniques should comply with the criteria for collateral received in the case of OTC derivatives set out in Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

7. The collateral posted by the relevant third party to mitigate the counterparty risk arising through EPM techniques should be sufficiently diversified in order that at any time, the portfolio composed of the collateral and the assets not subject to the EPM technique complies with the UCITS diversification rules. The UCITS should comply with the UCITS diversification rules in relation to entities at which cash is deposited, taking into account both the cash received as collateral and any other cash held within the fund.

8. Entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

9. A UCITS should have in place a clear haircut policy for each class of assets received as collateral. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.

10. The UCITS' annual report should also contain details of the following:

    a) The underlying exposure obtained through EPM techniques;

    b) The identity of the counterparty(ies) to these EPM techniques; and

    c) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

Explanatory text

50. In line with paragraph 6 of Box 6, collateral received in the context of EPM techniques should comply with the criteria for collateral received in the case of OTC derivatives as set out in Box 26 of CESR's guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. These criteria cover such elements as the reinvestment of collateral, liquidity, valuation and credit quality of the issuer. However, the draft guidelines go further than the existing CESR guidelines by clarifying the criteria against which the asset diversification and haircut policies should be assessed.

51. It should be noted that the proposed guidelines amend Box 9 of the aforementioned CESR guidelines as far as EPM techniques are concerned. Indeed, reinvestment of cash collateral received in the context of EPM techniques in non-risk-free assets as is permitted by the CESR guidelines would no longer be possible.

52. ESMA has considered whether these qualitative criteria should be supplemented by an indicative list of assets that would be eligible for collateral purposes. The following list has been developed:

    a. Cash;

b. Shares or units of money market funds that comply with the CESR guidelines[6] ;

c. Shares or units of UCITS that offer daily dealing;

d. Sovereign debt issued by an EU or OECD member states;

e. Shares admitted to trading in a regulated market that are component of an index compliant with the UCITS Directive; and

f. Bonds admitted by the European Central Bank; and

g. Money market instruments that would be eligible to be held in a money-market fund or short term money market fund complying with the CESR guidelines.

53. ESMA is of the view that collateral received by the UCITS when using EPM techniques should be sufficiently diversified in order that at any time, the portfolio composed of the collateral and the assets not subject to the EPM technique complies with the UCITS diversification rules.[7] Such diversification will help ensure that the collateral serves its purpose as a risk mitigation tool in the event of a default by the counterparty. Different approaches can be envisaged regarding the extent of consistency that should be ensured between the composition of the collateral and the investment policy of the UCITS. On the one hand, greater consistency would give investors a higher chance of recovering assets that are in line with the UCITS' investment policy. On the other hand, it could be argued that in the event of counterparty default, the emphasis should be on having collateral which is very liquid and of a high quality, regardless of whether the assets are correlated to the composition of the portfolio. ESMA is seeking stakeholders' views on the most appropriate approach.

54. Paragraph 9 addresses the haircut policy to be followed by the UCITS. When determining the amount of collateral that must be provided by the third party, the UCITS should apply a haircut to the market value of the instruments. A 1% haircut would mean that the relevant instruments are valued at 99% of their market value. The haircut policy should be prudent; in particular, any decision to apply a 0% haircut should be exceptional and fully justified. When defining a haircut policy for each class of assets, the UCITS should take into account haircuts applied to margin requirements for exchange-traded derivatives.

55. ESMA is of the view that any cash collateral received by the UCITS should be deposited at entities in such a way that the diversification requirements laid down in Article 52(1)(b) of the UCITS Directive are respected, taking into account both cash collateral and any other cash held by the UCITS. Moreover, entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

56. Under the current UCITS framework, there is no limit on the proportion of the UCITS' portfolio that can be used for EPM purposes. Some Member States have imposed limitations at national level, particularly with respect to securities lending activities. ESMA believes there is a case for imposing quantitative limits on this activity taking into account the additional counterparty risk that is generated. These quantitative limits could be set at the level of the entity that borrows securities (i.e. by capping

[6] CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788)
[7] It should be noted that for UCITS ETFs, collateral received (excluding cash collateral) has to be held by the depositary.

the proportion of the portfolio that can be lent to any single entity) or at the level of the UCITS' portfolio as a whole. Stakeholders' views are sought on such a limitation and at what level it should be set.

57. As a matter of best practice, UCITS should consider disclosing the information set out in paragraph 9 on their websites on a more regular basis e.g. quarterly or monthly.

Questions to stakeholders

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If not, please explain.

Q18: Do you see merit in the development of further guidelines in respect of the re-investment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?

Q19: Would you be in favour of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio? Please explain your view.

Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transactions when calculating the maximum exposure under Article 52(1) of the UCITS Directive?

Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?

Q26: What is the current market practice regarding the proportion of assets that are typically lent?

Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interest? If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps.

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

VII. Total Return Swaps

58. Some UCITS use financial derivatives, usually a total return swap (TRS), to provide investors with a predefined payout at the end of a specific period based on the return on underlying assets. The underlying assets to the TRS can consist of a variety of asset classes, strategies and indices. These UCITS are usually passively managed and can incorporate features such as capital protection or a payoff guarantee. This investment can represent up to 100% of the assets, in which case the UCITS can be qualified as a structured UCITS.

59. An increasing number of UCITS are gaining exposure to complicated investment strategies using TRS. Generally the UCITS portfolio is comprised of a TRS with a single counterparty. Collateral is provided by the counterparty to the UCITS to ensure that the UCITS does not breach the counterparty exposure limits set out in the UCITS Directive. The UCITS may invest in a portfolio of assets, usually debt securities or money market instruments but in some cases other types of assets e.g. an equity portfolio. The UCITS either passes the entire portfolio or the subscription proceeds to the swap counterparty (funded swap). Alternatively the UCITS undertakes to pay the return on the UCITS portfolio (unfunded swap) to the swap counterparty. In return the counterparty provides the UCITS with a return based on the underlying assets.

60. While many of these structured UCITS provide exposure to a simple basket of assets or traditional index, they can also involve more complex investment strategies which incorporate long/short equity, absolute return, complex macro, arbitrage and commodity strategies through commodity indices only. In most cases the TRS is passively managed by the counterparty. Indeed, the payoff is defined by the

management company, which establishes at the outset all of the management guidelines. These guidelines predefine all the investment rules (swap payoff, portfolio composition and risk) which are set out in the swap contract. The role of the counterparty is limited to a replication of the portfolio specified in the swap contract.

61. Questions have arisen on the extent to which the investments of UCITS might not be required to comply with the diversification requirements of the UCITS Directive where the UCITS has invested in a TRS giving exposure to an underlying UCITS compliant index or diversified basket of UCITS compliant instruments.

62. Some UCITS enter into swaps which are not passively managed by the counterparty and the contract incorporates some discretionary elements. For example, the UCITS sets the investment policy but, rather than selecting the individual assets and their weighting in the strategy, the UCITS defines a pool of eligible assets and sets minimum and maximum exposure limits which the counterparty can work within. In some cases the underlying strategy to the swap is managed completely within the discretion of the swap counterparty without a clear objective methodology.

63. Where the UCITS gains exposure to an investment strategy through an OTC derivative, which is not wrapped in an index, the UCITS must ensure that the underlying assets comprising the strategy are eligible assets. The derivative must also comply with the requirements in relation to the eligibility of counterparties, counterparty exposure limits, valuation of the OTC derivative, risk management and calculation of global exposure. The exposure to the underlying assets taken together with the UCITS direct investments (if any) must not exceed the limits set out in Article 53 of the UCITS Directive. The terms of the derivative contract must ensure that the UCITS can obtain sufficient liquidity to meet any redemption requests from investors.

64. UCITS which enter into an actively managed swap must also consider other issues in relation to the management of the UCITS and the role of the counterparty, including conflict of interest or management delegation issues. While there are certain practices which are banned by the UCITS Directive, for example physical short selling and borrowing, it is not entirely clear whether these types of transaction are part of the investment strategy.

65. It is worth recalling that s UCITS which use financial derivative instruments, including TRS, must comply with all applicable UCITS Directive requirements including CESR's Guidelines on Risk Measurement (Ref. CESR/10-788).

66. Arguably, notwithstanding that the underlying of the TRS is UCITS-compliant, it is not possible for a UCITS which has entered into a TRS to acquire a non-compliant portfolio of securities (or one security). Such (an) acquisition(s) would appear to be an advertent breach of the UCITS requirements. 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.

67. Certain TRS entered into by some UCITS can include provisions which give the counterparty an element of control of the UCITS portfolio which can affect investment decisions. UCITS can also have difficulty rectifying breaches of the UCITS investment restrictions. While some structured UCITS comply in full with the UCITS Directive requirements at the launch date there can be problems rectifying breaches during the life of the UCITS. The following issues can arise in managing the UCITS:

- Changing the composition of the UCITS portfolio and restructuring the swap may affect the pre-defined payoff; alternatively maintaining the pre-determined payoff may result in significant expense for the UCITS;

- In some cases the swap contract specifies the assets which make up the UCITS portfolio to be swapped and the counterparty must approve any change; and

- The agreement with the counterparty may also specify that the UCITS must purchase the securities included in the portfolio from the counterparty.

68. It must also be considered whether these types of provisions in swap agreements are acceptable, and even whether the counterparty ought to be treated (and disclosed) in the same way as an investment manager.

69. Most structured UCITS use a TRS with a single counterparty to obtain the underlying exposure. Collateral is received to reduce counterparty exposure which must comply with CESR's Guidelines on Risk Measurement. It is important that the investor is properly informed of the increased risk of being exposed to a single counterparty and the type of collateral obtained to reduce this risk. Investors should also be made aware of the impact of a counterparty default and the related effects on the return.

70. It should be noted that CESR's Guidelines on Risk Measurement apply to all transactions involving OTC derivatives, including total return swaps. The proposed guidelines set out below should be seen as tailoring those existing requirements with respect to total return swaps only.

71. Several respondents to the discussion paper supported the policy orientations identified by ESMA. A public authority explained that these policy orientations would be beneficial not only to investors but also to the asset management industry in general by strengthening the role of asset managers and their fiduciary duties. On the diversification issues, some respondents did not consider that UCITS diversification rules should apply to the swap underlying. In particular, one respondent considered that the policy orientations should apply to all UCITS, not just to 'structured UCITS'. Furthermore, several stakeholders disagreed with the treatment of the swap as an investment management delegation when the counterparty has discretion over the composition or the management of the UCITS portfolio.

72. ESMA agreed with the suggestion made by some respondents to apply the guidelines on total return swaps to all UCITS making use of this type of financial instrument. Also, ESMA decided to take a horizontal approach to the treatment of collateral received by UCITS to mitigate counterparty risk. Therefore, ESMA is proposing that collateral posted in the context of total return swaps should comply with the same rules as collateral received when a UCITS engages in EPM techniques.

Proposed guidelines

Box 7

Total return swaps

1. In the case of an unfunded swap, both the UCITS' investment portfolio, the return of which is swapped, and the underlying to the swap, to which the UCITS obtains exposure, must comply with the relevant UCITS diversification rules. If collateral is posted by the swap counterparty to mitigate

the counterparty risk, this collateral should be sufficiently diversified over the course of the swap in order that at any time, the portfolio composed of collateral and the other investments made by the UCITS comply with the UCITS diversification rules.

2. In the case of a funded swap, the collateral posted by the swap counterparty to mitigate the counterparty risk should be sufficiently diversified to comply with the UCITS diversification rules, taking into account both the investments made by the UCITS and the collateral. The UCITS should comply with the UCITS diversification rules in relation to entities at which cash is deposited, taking into account both the cash received as collateral and any other cash held within the fund.

3. Entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

4. A UCITS should have in place a clear haircut policy for each class of assets received as collateral of a funded swap. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.

5. Information provided to investors in the prospectus of UCITS using total return swaps should include at least the following:

    a) Information on the underlying strategy and composition of the investment portfolio or index, the counterparty(ies) and, where relevant, the type and level of collateral required and, in the case of cash collateral, reinvestment policy, including the risks arising from the re-investment policy; and

    b) The risk of counterparty default and the effect on investor returns.

    c) 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.

    d) 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 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.

    e) Where the approval of the counterparty is required in relation to any portfolio transaction this must be disclosed in the prospectus.

6. The UCITS' annual report should also contain details of the following:

    a) The underlying exposure obtained through financial derivatives instruments;

    b) The identity of the counterparty(ies) to these financial derivative transactions; and

    c) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

Explanatory text

73. In line with paragraph 2 of Box 7 and the approach proposed for EPM techniques, collateral received in the case of funded swaps should be sufficiently diversified to comply with the UCITS diversification rules taking into account both the investments made by the UCITS and the collateral. ESMA has considered whether this qualitative criterion should be supplemented by an indicative list of assets that would be eligible for collateral purposes. The following list has been developed:

    a) Cash;
    b) Shares or units of money market funds that comply with the CESR guidelines (Ref. CESR/10-049);
    c) Shares or units of UCITS that offer daily dealing;
    d) Sovereign debt issued by an EU or OECD member states;
    e) Shares admitted to trading in a regulated market that are component of an index compliant with the UCITS Directive;
    f) Bonds admitted by the European Central Bank; and
    g) Money market instruments that would be eligible to be held in a money market fund or short-term money market fund complying with the CESR guidelines (Ref. CESR/10-049)

74. In the case of unfunded swaps, the swap counterparty and the UCITS management company can agree that the counterparty risk will not be mitigated by resetting the swaps on a regular basis but rather via the posting of collateral. Therefore, in line with the requirements on EPM techniques in Box 6, collateral posted by the swap counterparty should be sufficiently diversified in order that at any time, the portfolio composed of the collateral and the other investments made by the UCITS comply with the UCITS diversification rules.

75. Paragraphs 1 to 4 of Box 7 above modify Box 26 of the existing CESR guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS with respect to total return swaps by providing more guidance on how the diversification of the collateral should be assessed or haircut policies should apply.

76. As a matter of best practice, UCITS should consider disclosing the information set out in paragraph 6 on their websites on a more regular basis e.g. quarterly or monthly.

77. Paragraph 4 of Box 7 addresses the haircut policy to be followed by the UCITS. When determining the amount of collateral that must be provided as part of the total return swap, the UCITS should apply a haircut to the market value of the instruments. A 1% haircut would mean that the relevant instruments are valued at 99% of their market value. The haircut policy should be prudent; in particular, any decision to apply a specific haircut should be exceptional and fully justified.

Questions to stakeholders

Q32: Do you agree with the proposed guidelines?

Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return swaps is of good quality? If not, please explain your view.

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?

Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.

Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?

VIII. Strategy indices

78. A strategy index is an index which aims at replicating a quantitative strategy or a trading strategy. In most cases the strategy is structured and operated by the index provider and not by the UCITS. For instance, if the strategy index aims at replicating a quantitative strategy then the index construction process is based on proprietary applications and models developed by the index manager. The model includes an optimisation process which sets up the dynamic portfolio construction process.

79. Where a UCITS gains exposure to a financial index using a financial derivative, it must comply with the UCITS rules in relation to the construction and publication of the index. Regardless of whether underlying components of the index themselves would be eligible for direct investment by UCITS, the financial index may be eligible provided it complies with the following criteria:

- It is sufficiently diversified and the price movement of one component does not unduly influence the performance of the index. Where the index is composed of eligible assets the components of the index must comply with the limits in Article 53 of the UCITS Directive i.e. 20/35% of assets in a single issuer. If the index does not respect the risk diversification rules in Article 53 the component assets of the index must be combined with the UCITS direct investments to ensure compliance with the UCITS 5/10/40% rule. Where the index is comprised of ineligible assets it must be diversified in an equivalent way to Article 53.

- It represents an adequate benchmark for the market to which it refers and measures the performance of the group of components in a relevant and appropriate way. The index must be rebalanced periodically using publicly available criteria to reflect the market and the underlying components must be sufficiently liquid.

- It must be published in an appropriate manner using sound procedures to collect prices, calculate and publish the index. Information on the index calculation and rebalancing methodologies, index changes and operational difficulties must be publicly available in a timely manner.

80. It is also important to note that, in accordance with CESR's Guidelines on Risk Measurement, leverage which is embedded in an index must be included in the calculation of global exposure.

81. Given the ever expanding universe of indices being created it would appear necessary to provide more guidance on the three criteria to ensure that these strategy indices can properly be defined and treated as financial indices for the purposes of the UCITS Directive. It may also be beneficial to consider how indices comprising interest rates or FX rates can comply with the diversification requirement.

82. Many respondents to the discussion paper agreed with the policy orientations on the diversification requirements for strategy indices. However, many respondents asked ESMA to clarify the meaning of the word 'impact' of one component on the overall return of the index. Also, several respondents expressed some concern on the policy orientations regarding the adequate benchmark on the basis that they restricted the scope of eligible financial indices to long-only and beta financial indices not embedding any kind of strategy. Several respondents were of the opinion that in the case of proprietary indices, it was not appropriate to require public disclosure of proprietary information. They feared that very few index providers would be willing to comply with the extensive disclosure standards proposed by ESMA, resulting in an effective ban on the use of such indices. These respondents also noted that the level of transparency required by ESMA would pose a major problem for nearly all index providers, not only for strategy indices.

Proposed guidelines

Box 8

Strategy indices

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

2. 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%. In the case of a leveraged index, the impact of one component on the overall return of the index, after having taken into account the leverage, should respect the same limits.

3. Commodity indices must consist of different commodities which respect the 20%/35% limit in order to be considered an eligible index.

4. A strategy index must be able to demonstrate that it satisfies the index criteria, including that of being a benchmark for the market to which it refers. For that purpose:

   a) An index must have a clear, single objective in order to represent an adequate benchmark for the market;

   b) The universe of the index components and the basis on which these components are selected for the strategy should be clear to investors and competent authorities;

   c) 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.

5. The UCITS' prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.

6. The rebalancing frequency should not prevent investors from being able to replicate the financial index. Indices which rebalance on an intra-day or daily basis do not satisfy this criterion.

7. The index provider should disclose the full calculation methodology to, inter alia, enable investors to replicate the strategy. This includes information on index constituents, index calculation (including effect of leverage within the index), re-balancing methodologies, index changes and information on any operational difficulties in providing timely or accurate information. This information should be easily accessible by investors, for example, via the internet. Information on the performance of the index should be freely available to investors

8. 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.

9. The methodology of the index for the selection and the re-balancing of the components of the index must be based on a set of pre-determined rules and objective criteria;

10. The index provider may not accept payments from potential index components for inclusion in the index.

11. The index methodology must not permit retrospective changes to previously published index values ('backfilling').

12. 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 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 ability of the UCITS to calculate its NAV. The due diligence should also cover matters relating to the index components.

13. UCITS must ensure that any valuation of the swap includes an independent assessment of the underlying index.

14. The financial index should be subject to independent valuation.

Explanatory text

83. 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. Therefore, strategy indices which involve proprie-

tary information that the index provider is unwilling to disclose would not be considered as eligible financial indices.

84. 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.

85. 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 to ensure that the UCITS has a clearly documented conflicts of interest policy to deal with issues arising from such a structure and a summary of this policy should be disclosed in the prospectus.

86. 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 of 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 of the index provided to investors through the swap should also respect these limits. For example, some strategy indices include a leverage factor that amplifies the impact of the variation of the components on the return of the index. This impact of the components on the return of the strategy index, taking into account the leverage factor, should respect the 20%/35% limit. This means that it should not be possible that a variation of one component results in the index increasing by more than 35%.

87. Commodity indices should be composed of different commodities which respect the 20%/35% limit. For avoidance of doubt, sub-categories of a commodity should be considered as being the same commodity for the calculation of the diversification limits. For example, Brent and WTI contracts should be considered as being the same commodity i.e. oil.

88. Many strategy 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. The provisions in paragraph 4 are designed to address this.

Questions to stakeholders

Q39: Do you consider the proposed guidelines on strategy indices appropriate? Please explain your view.

Q40: Do you think that further consideration should be given to potential risks of conflict of interest when the index provider is an affiliate of the management company?

IX. Transitional provisions

Box 9

Transitional provisions

1. The guidelines will come into effect on XX 2012.

2. Any new investment made by a UCITS or any new collateral received after XX 2012, and the content of any new document or marketing communication issued by or in respect of the UCITS after XX 2012 will have to comply with these guidelines immediately.

3. Investments made by UCITS and collateral received before XX 2012 are not subject to the guidelines, except:

   a) Uninvested cash collateral should comply with Box 6 paragraph 7 and Box 7 paragraph 2 no later than X months after these guidelines come into effect; and

   b) Fees arising from EPM techniques should be returned to the UCITS in accordance with Box 6 paragraph 3 with immediate effect unless the UCITS has engaged in fee-sharing agreements prior to XX 2012.

4. Requirements relating to the use of an identifier in the name of an existing UCITS ETF do not come into effect until the earlier of:

   a) The first occasion after XX 2012 on which the name of the fund is changed for another reason; or

   b) XX 2013 (twelve months after these guidelines come into effect).

5. Requirements relating to the contents of the fund rules or instrument of incorporation of an existing UCITS, its prospectus, its KIID, or any marketing communication that it has issued prior to these guidelines coming into effect, do not come into effect until the earlier of:

   a) The first occasion after XX 2012 on which the document or communication, having been revised or replaced for another purpose, is published; or

   b) XX 2013 (twelve months after these guidelines come into effect).

6. Requirements to publish information in the report and accounts of an existing UCITS do not apply in respect of any accounting period that has ended before XX 2012.

89. ESMA recognises that it may not be in the interests of unit-holders of UCITS that have already made investments that would be covered by the proposed guidelines to unwind those investments. ESMA is therefore proposing that the guidelines only apply to new investments made after guidelines come into effect on XX 2012.

Questions to stakeholders

Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.

Annex I - Summary of questions

I. Index-tracking UCITS

Q1: Do you agree with the proposed guidelines?

Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs.

Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?

II. Index-tracking leveraged UCITS

Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?

Q5: Do you believe that additional guidelines should be introduced requiring index-tracking leveraged UCITS to disclose the way the fund achieves leverage?

III. UCITS Exchange Traded Funds

Definition of UCITS ETFs and Title

Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?

Q7: Do you agree with the proposed guidelines in relation to the identifier?

Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?

Q9: Do you think that the use of the words 'Exchange-Traded Fund' should be allowed as an alternative identifier for UCITS ETFs?

Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?

Actively-managed UCITS ETFs

Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in the prospectus, the KIID or any marketing communications of the UCITS ETF?

Secondary market investors

Q12: Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?

Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.

Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.

Q15: Can you provide further details on the relationship between the ETF's register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?

IV. Efficient portfolio management techniques

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If no, please justify.

Q18: Do you see merit in the development of further guidelines in respect of the reinvestment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?

Q19: Would you be in favour of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio? Please explain your view.

Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Q22: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?

Q23: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.

Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?

Q26: What is the current market practice regarding the proportion of assets that are typically lent?

Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interests? If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

V. Total return swaps

Q32: Do you agree with the proposed guidelines?

Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return is of good quality? If not, please justify.

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?

Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.

Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?

VI. Strategy indices

Q39: Do you consider the proposed guidelines on strategy indices appropriate? Please explain your view.

Q40: Do you think that further consideration should be given to potential risks of conflict of interests when the index provider is an affiliated firm of the management company?

VII. Transitional provisions

Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.

Annex II – Cost benefit analysis

1. Index-tracking UCITS

Risk addressed / Policy objective
- Investor protection

Scope issues
- All UCITS tracking an index

Options	Benefits	Costs	Evidence
Option 1 As proposed in Box 1 of the consultation paper.	The guidelines apply to all UCITS tracking an index and not only to index-tracking UCITS. Transparency in terms of index composition would be improved. Investors would be better informed about the exposition of UCITS. UCITS management companies would not need to keep the prospectus updated with the exact composition of the index tracked by the ETFs as long as investors have access to this information via a link to a web site where the exact composition of the index should be disclosed	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation.
Option 2 As proposed in the discussion paper on policy orientations	Similar to the Option 1 above but limited to UCITS ETFs.	Low level of harmonisation across UCITS.	N/A

2. Index-tracking leveraged UCITS

Risk addressed / Policy objective
- Investor protection

Scope issues
- All index-tracking leverage UCITS

Options	Benefits	Costs	Evidence
Option 1 As proposed in Box 2 of the consultation paper.	The guidelines apply to all index-tracking leveraged UCITS, not just leveraged ETFs. Investors are informed about the leverage policy,	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation.

	whether the leverage is at the level of the fund or at the level of index tracked.		

3. UCITS ETFs

3.1. Definition of UCITS ETFs

Risk addressed / Policy objective
- Investor protection

Scope issues
- All UCITS ETFs

Options	Benefits	Costs	Evidence
Option1 As proposed in Box 3 of the consultation paper.	Clear definition of UCITS ETFs. Not all listed UCITS ETFs are categorised as ETFs.	UCITS which do not comply with the definition cannot be marketed as UCITS ETFs. Modification of the prospectus, marketing materials and KIID necessary.	Feedback from the consultation.
Option 2 No definition of UCITS ETFs	No need to modify the prospectus, marketing materials and KIID.	Low level of harmonisation. Definition of UCITS ETFs left to national legislation or market practices.	Feedback from the consultation.

3.2. Identifier for UCITS ETFs

Risk addressed / Policy objective
- Investor protection

Scope issues
- All UCITS ETFs

Options	Benefits	Costs	Evidence
Option 1 As proposed in Box 1 of the consultation paper.	Investors would be immediately informed by reading the name of the UCITS that the fund is an ETF.	Management companies, promoters and entities in charge of the commercialisation would have to adapt their documentation to reflect these new guidelines when applicable.	Feedback from the consultation on the costs for modifying prospectus, KIID and marketing materials of existing UCITS ETFs.
Option 2 Identical to Option 1 with further distinction between the	Investors would be immediately informed about the type of ETFs and the level of leverage by reading the name of the UCITS.	Management companies, promoters and entities in charge of the commercialisation would have to	Feedback from the consultation on the costs for modifying prospectus and marketing materials of existing materials.

structure of the UCITS ETFs and the level of leverage.		adapt their documentation to reflect these new guidelines when applicable. The name of the ETFs may be long in order to reflect the different features of the fund.	

3.3. Actively-managed UCITS ETFs

Risk addressed / Policy objective
- Investor protection

Scope issues
- All Actively-managed UCITS ETFs

Options	Benefits	Costs	Evidence
Option 1 As proposed in Box 4 of the consultation paper.	Improvement of the quality of the information delivered to investors. Option 1 would avoid investors investing in an actively-managed UCITS ETFS to think that they invest in an ETF that tracks an index.	Prospectus of existing ETFS may have to be modified in order to reflect the guidelines.	Feedback from the consultation on the costs for modifying prospectus and marketing materials of existing materials.

3.4. Secondary market investors

Risk addressed / Policy objective
- Investor protection

Scope issues
- All UCITS ETFs

Options	Benefits	Costs	Evidence
Option 1 As proposed under option 1 in Box 5 of the consultation paper	Investors could redeem their shares at any time either on the secondary market or directly from the ETF if needed.	The management company should take the necessary measures to ensure that investors can redeem their shares at any time either on the secondary market or directly from the ETF if needed.	Feedback from the consultation.
Option 2	Secondary market investors would be able to redeem	UCITS ETFs would be obliged to accept	Feedback from the consultation.

As proposed under option 2 in Box 5 of the consultation paper.	their shares or unit directly from the ETF at any time.	direct redemptions at the level of the fund. Practical problems may arise for the execution of direct redemptions	

4. Efficient portfolio management techniques

Efficient portfolio management techniques	Benefits	Costs	Evidence
Option 1 As proposed under Box 6 of the consultation paper.	Option 1 applies to all UCITS using efficient portfolio management techniques and is not limited to securities lending activities performed by UCITS ETFs. Full consistency between rules applicable to collateral received in the context of securities lending activities and total return swaps (funded swaps). Requirements on the diversification of collateral, haircuts are further specified compared to the CESR guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS.	UCITS management may have to adapt the composition of the collateral in order to comply with the guidelines with regards the diversification and the haircuts.	Feedback from the consultation.
Option 2 As proposed in the discussion paper on policy orientations.	More flexibility for UCITS management companies in terms of diversification and haircut policies with regards collateral.	No horizontal approach: guidelines limited to securities lending activities in the context of UCITS ETFs. Less convergence with more room for interpretation and national or market practices.	N/A

5. Total return swaps

Risk addressed / Policy objective

- Investor protection

Scope issues
- All UCITS investing in total return swaps

Total return swaps	Benefits	Costs	Evidence
Option 1 As proposed under Box 7 of the consultation paper.	Option 1 applies to all UCITS investing in total return swaps and not only Structured UCITS. Full consistency between rules applicable to collateral received in the context of securities lending activities and total return swaps.	UCITS management companies may have to adapt the composition of the collateral in order to comply with the guidelines with regards the diversification and the haircuts.	Feedback from the consultation.
Option 2 As proposed in the discussion paper on policy orientations	More flexibility for UCITS management companies in terms of diversification and haircut policies with regards collateral.	No horizontal approach: guidelines limited to structured UCITS investing in total return swaps Less convergence with more room for interpretation and national or market practices.	N/A

6. Strategy indices

Risk addressed / Policy objective
- Investor protection

Scope issues
- UCITS investing in strategies indices and strategy indices.

Strategy indices	Benefits	Costs	Evidence
Option 1 As proposed under Box 8 of the consultation paper.	These guidelines would ensure that the performance delivered to investors in case of strategy indices is not driven by a too limited number of components and comply with UCITS diversification rules. Investors would be able to better understand the exact strategy of the underlying index and how this index is	UCITS investing in strategy indices that do not comply with the UCITS diversification rules would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to	Feedback from the consultation.

	constituted. Investors would be able to better replicate the performance of the underlying index what would enhance the understanding of the fund by investors. A minimum level of due diligence by UCITS management companies when selecting hedge funds indices as underlying of the strategies would be ensured. Potential conflicts of interest between the index provider and index components which otherwise could undermine the adequate benchmark requirement of the index would be prevented.	comply with ESMA guidelines.	

7. Transitional provisions

Risk addressed / Policy objective

- Entry into force of the guidelines

Scope issues

- All UCITS covered by the guidelines.

Transitional provisions	**Benefits**	**Costs**	**Evidence**
Option 1 As proposed in Box 9 of the consultation paper	UCITS would be granted with sufficient time to ensure a smooth entry into force of the guidelines.	No immediate entry into force of the guidelines.	Feedback from the consultation.
Option 2 No transitional provisions	Immediate entry into force of the guidelines	UCITS management companies may have some difficulties to make the necessary adjustments to comply immediately with the guidelines once they enter into force.	Feedback from the consultation.

Annex 3 – Feedback statement on the discussion paper

1. ESMA consulted on its policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS by means of a discussion paper published on 22 July 2011 (ESMA/2011/220). ESMA received 65 responses to the discussion paper. Feedback was provided by the Securities and Markets Stakeholder Group (SMSG), asset managers (and their associations), consumer associations, public authorities, trading platforms, index providers and institutional investors.

<u>Response of the SMSG</u>

2. The SMSG generally agreed with the concerns raised in ESMA's discussion paper, which relate mainly to the fact that ETFs have become increasingly complex and may raise significant issues both in respect to investor protection and to systemic risk. However, the SMSG recommended that ESMA investigate how to facilitate investment in index-tracking ETFs by retail investors.

3. The SMSG pointed out that issues relating to UCITS ETFs should not be treated differently from other UCITS, and from other exchange-traded products such as notes and certificates that are distributed to retail investors, in order to avoid the creation of regulatory loopholes, and to establish a level playing field between similar products.

4. In respect to the prevention and mitigation of the risks that may arise from ETFs, while the SMSG agreed that greater disclosures are required, the majority of the SMSG members were of the opinion that, in addition to these disclosure requirements, regulators should adopt a more interventionist approach.

5. In particular, the SMSG agreed that:

    - UCITS ETFs should use an identifier in their names, fund rules, KIID, prospectus and marketing material. In addition, with respect to ETFs there should be clearer labelling in the prospectus that in the event of default, consumers do not have recourse to a guarantee scheme.

    - investors should be provided with sufficient details to understand the index tracking policy used[8];

    - there is a need for greater disclosures in respect to synthetic ETFs, notably in relation to underlying exposure, counterparty(ies) and the portfolio fund, as well as for stricter requirements in respect to the quality of the collateral, in the form of quantitative requirements on the quality (notably the liquidity) of the collateral, over-collateralisation requirements in specific circumstances;

    - risks of conflicts of interests should be limited by prohibiting entities from the same group from acting at the same time as the ETF provider and the derivative counterparty;

    - securities lending should be made more transparent to investors, should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, and the lending agent must be required to indemnify the UCITS when a counterparty defaults for all types of ETF (synthetic and physical);

    - actively-managed UCITS ETFs should be subject to greater disclosure requirements;

[8] Some members of the SMSG felt that the definition of tracking error in paragraph 21 of the discussion paper should be refined on the basis that the tracking error is, in fact, the volatility of the difference of the returns of the fund and of the returns of the index.

- it is necessary to specify, in the name of leveraged UCITS ETFs, that they constitute leveraged ETFs, as well as the level of leverage; the word "daily" or "monthly" should also be included, as appropriate, in the identifier;

- greater protection of secondary investors would be achieved by informing investors of their redemption rights, the ETF manager being made responsible for paying the difference between the collateral and the index underlying the swap if a counterparty defaults; investors should be better informed of the possibility to redeem any amounts against the fund, although fees would apply;

- total return swaps and strategy indices need to be better regulated; in particular, the total return swap should be over-collateralised and the collateral should be posted daily

Responses of other stakeholders

General comments

1. Many respondents stressed that EU ETFs are UCITS listed on a regulated market. The fact that they are listed does not, by itself, increase their risks or creates a specific requirement for additional protection of investors, except as regards the secondary market itself.

2. An asset manager association said that the UCITS framework already provides for a very high level of investor protection; therefore, there is not a need for ETF-specific regulation, except with regard to listing rules. Also an asset manager did not agree on singling out ETFs inside the UCITS framework. It noted that the swap is only a tool used in order to track the index with a minimal tracking error and that other UCITS funds use options and derivatives instruments (according to UCITS regulation) and their pay-off as well as the nominal amount exposed are in most cases not disclosed to the investors. Similarly, an alternative asset manager association did not understand the justification for singling out certain types of UCITS and not covering other retail investment products with similar underlying investment strategies, such as non-UCITS exchange-traded products.

3. An asset manager fully supported added protection of investors as regards the secondary market while another asset manager highlighted that synthetic ETFs are already subject to two set of rules, UCITS regulation and listing rules (which include the obligation to calculate and publish an indicative NAV, spread limits and minimal bid/ask spreads and the need to have several market makers).

4. Slightly differently, another asset manager noted that the current UCITS framework may not be sufficient to preserve financial stability, mitigate the risks associated with these types of funds and achieve an adequate level of investor protection. Therefore, this respondent shared ESMA view on the need of full transparency and sufficient disclosure in relation to UCITS ETFs and structured UCITS. Moreover, it shared ESMA observations on the discrepancy between UCITS regulations governing OTC derivatives and those governing stock lending, despite similar levels of counterparty risk, and encouraged ESMA to adopt UCITS guidelines for securities lending and repo activities similar to those currently in place for OTC derivatives.

5. When considering investor protection and disclosure, almost all respondents strongly encouraged ESMA to take a horizontal approach to funds and non-fund products alike, in the spirit of MiFID and of the PRIPs initiative. Respondents were of the opinion that any consideration regarding the marketing of ETFs could not be dissociated from a review of other products which are also subject to MiFID

and that, therefore, any action should be taken within the context of the MiFID review, maintaining a level playing field vis-à-vis other financial instruments.

6. In particular, an alternative asset manager association was strongly supportive of the Commission's PRIPs initiative and very concerned both by the fact that the initiative was being fragmented and by the fact that it appeared to be given a lower priority than it so clearly warranted.

7. A distributors' and depositaries' association explicitly asked for not having ESMA guidelines for ETFs and structured UCITS but waiting for the MIFID review. This respondent argued that issuing ESMA guidelines would create regulatory uncertainty and legal problems regarding the KIID regulation.

8. Some respondents proposed the following specific suggestions for a horizontal approach:

   - Guidelines on "complex" and "simple" products should not be applicable to UCITS only, but to all financial products;

   - Guidelines on securities lending, the use of derivatives and the tracking error should be applicable to all UCITS;

   - Guidelines on the secondary market for listed UCITS should be applicable to all listed UCITS.

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.

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?

9. Several consumer associations agreed that ESMA should explore common approaches to the issue of marketing synthetic ETFs and structured UCITS to retail investors. One of these associations believed that ESMA's initiatives should go further since, notwithstanding the importance of disclosure, the latter does not provide an appropriate substitute for action to eliminate conflicts of interest and set clear product standards. In particular, consumer associations suggested the introduction of the following measures:

   - To distinguish between 'synthetic' and 'physical' ETFs and to require for the introduction of this distinction in the fund name; some respondents also mentioned the Hong Kong market example where, since January 2011, an asterisk has been put in place as indicator for synthetic ETFs;

   - To include the word 'daily' in the name of leveraged and inverse ETFs which rebalance daily since these funds are not suitable for long-term holding;

   - To state a minimum investment threshold (EUR 50,000) for UCITS that are inappropriate for retail investors;

- To impose clear language disclosure of the main risks associated with the product;

- To prohibit a single bank to act as the ETF provider and derivative counterparty as these structures entail a clear risk of conflicts of interest;

- To introduce some further restrictions on collateral management policies;

- To issue some guidance for intermediaries on how they should provide advice to retail investors to invest in ETFs.

10. A public authority believed that it was inappropriate to implement limitations on distribution that referred only to certain types of UCITS, since the provision of investment services in connection with shares and UCITS units falls under the scope of MiFID. Therefore, this respondent was of the opinion that any guidelines should refer to all products covered by MiFID, not just to UCITS.

11. For some asset manager associations any approach to the marketing of UCITS to retail investors (including potential limitations) should be in line with MiFID and should apply also to similar products such as certificates and notes. These respondents argued that ESMA should clarify whether potential restrictions are meant to apply only in case of "execution-only" transactions or also in case of transactions with advice. One of these asset managers associations was of the view that the adviser has direct knowledge of the investor's characteristics and needs and that, therefore, any sweeping restrictions applicable to distribution would harm investor choice, not necessarily helping investors.

12. Several respondents strongly disagreed on introducing marketing limitations for synthetic ETFs and structured UCITS because of the existence of the MiFID selling rules. Before considering limitations on the distribution of certain UCITS, these respondents asked regulators to intervene on less regulated products like exchange traded notes (ETNs) and structured notes.

13. A respondent underlined that, among others, synthetic replication is unavoidable because there are obstacles to full replication or sampling.

14. An alternative asset manager association mentioned that UCITS are uniquely subject to detailed product regulation and strongly believed that regulatory intervention should be made only where there is a clear market failure and supporting cost/benefit analysis. This respondent pointed out that "structured" UCITS are now subject to specific additional disclosures in the KIID and recognised that there may be some merit in extending this approach to other types of UCITS: this might include "synthetic ETFs", but "synthetic" strategies would need to be clearly defined. This respondent further mentioned that it wished to understand why exchange-traded synthetic UCITS would be differentiated from non-exchange-traded synthetic UCITS.

15. An asset manager was of the opinion that neither distribution limitations (via MiFID) nor risk disclosure warnings (via MiFID or UCITS) are sufficient to tackle complexity risk.

16. Another asset manager that strongly disagreed on creating sub-categories within the UCITS framework believed that isolating certain funds would weaken the whole UCITS brand. Moreover, this stakeholder was of the opinion that it is incorrect classifying synthetic ETFs and structured UCITS as intrinsically unsuitable for retail investors and rejected blanket criticisms. In particular, it argued that the most important thing in relation to retail investors is to differentiate between "good complex" and "bad complex" funds, where "bad complex" is the addition of complexity to justify higher fees or which

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increases the risk of the product and "good complex" is the use of derivative to reduce the risk of volatility of the product.

17. The same respondent disagreed on limiting the distribution of certain UCITS to retail investors simply because they use derivatives, but it recommended increasing the levels of transparency and disclosure and the use of prominent risk warnings for more risky speculative or complex funds. In particular, this respondent recommended more disclosure on the counterparty risk (i.e. the identity of the counterparty, the extent of the counterparty exposure, the quantity and quality of the collateral) and strongly believed that the UCITS rules on securities lending should be tightened up considerably both in terms of disclosure and collateral rules, and that the allocation of securities lending revenues between the promoter and the fund should be made clear.

18. A trading platform mentioned that it would welcome a strengthening of the requirements via a corresponding amendment of the UCITS Directive rather than limiting or even prohibiting the distribution of certain UCITS to retail investors.

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'?

19. Most respondents argued that complexity is not equal to risk: techniques such as derivatives used in structured funds might be complex to explain, but they result in investor protection, not in an increase of risk.

20. Several respondents opposed to the idea to consider UCITS which employ complex portfolio management techniques as 'complex'. Some of them considered that all UCITS should remain non-complex under MiFID as they are very strictly regulated and provide a high degree of investor protection. Nevertheless, these respondents were of the opinion that if ESMA deemed it necessary to modify the existing status of UCITS as automatically non-complex, it should avoid introducing rules pertaining solely to UCITS as a product category: ETF or UCITS specific regulation would contradict the PRIPs initiative, and any MiFID rules (as amended, if necessary) should be applicable across all MiFID financial instruments, including UCITS.

21. Moreover, an asset manager association mentioned that a distinction would have to be made between the financial product structure (i.e. portfolio management technique) and its pay-off. This respondent argued that from a retail investor's point of view, product complexity should be linked neither to the portfolio management techniques, nor to the financial instruments used in the portfolio, but to the products' pay-off especially because the fund's structure is well regulated under UCITS. The same respondent added that ETFs tracking plain-vanilla indices should certainly be considered as non-complex. A similar reasoning was developed by a public authority, which focused on the investors' difficulty in understanding the characteristics, returns and risks.

22. An asset manager mentioned that structured UCITS are sometimes incorrectly classified as complex, the terms complex is very subjective and not easy to define and there is recurrent confusion between the complexity of a fund and its risk profile (i.e. complexity does not mean more risky). Therefore, this stakeholder suggested giving much more consideration to the purpose of any complexity in a fund's structure and the resulting risk profile of the fund for investors.

23. Another asset manager strongly opposed to the "complex" designation for UCITS because it would not improve investment outcomes for European end-investors such as long-term savers and pensioners.

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In any case, this respondent suggested making the following distinction between (i) complexity designed to mitigate risk and deliver a straightforward outcome to investors (even where complex investment techniques are used), and (ii) complexity that might deliver unforeseen and unpalatable outcomes. The same respondent supported the idea of improving the transparency of the documentation for investors and was of the opinion that complexity inherent in the construction of a product does not imply more risks.

24. Furthermore, several asset managers were of the opinion that, whereas some products should be considered as complex, complexity should be treated through adequate disclosure's requirements.

25. A respondent took the view that UCITS which employ complex portfolio management techniques should be deemed complex for the purposes of the appropriateness test only; however, this should not imply any restrictions on marketing these products to retail investors. This respondent was of the view that a combination of an appropriateness test and a high level of transparency is the best way to avoid retail clients investing in products that are unsuitable for their needs.

26. Several respondents favoured the idea to consider UCITS which employ complex portfolio management techniques as 'complex'.

27. A consumer association was concerned by the evolution of the UCITS brand since the entry into force of the UCITS III Directive and the increased complexity and risks allowed under this new framework. This respondent and another consumer association were of the opinion that synthetic ETFs and structured UCITS should be considered as complex and undergo the MiFID appropriateness test when made available to retail investors; one of these two associations added that a specific warning should be inserted within the appropriateness test procedure for retail investors who are not supposed to understand the complexity or assess the risk of a financial instrument.

28. A third consumer association was in favour of a re-classification of structured UCITS and other UCITS which employ complex portfolio management techniques as 'complex' only if it was possible to set up operational criteria.

29. An asset manager mentioned that neither distribution limitations (via MiFID) nor risk disclosure warnings (via MiFID or UCITS) are sufficient to tackle complexity risk and recommended a more radical change to the UCITS Directive advocating to revert the UCITS investment restrictions to their UCITS 1 levels in conjunction with the Eligible Assets Directive. In this respondent's views, any movement back towards UCITS 1 would need to be delivered in two tranches:

    - for funds seeking authorisation after a return to UCITS 1, complex UCITS would instead fall under the scope of the AIFMD; and

    - for funds already authorised as UCITS, a complex/non-complex flagging regime should be introduced within the UCITS framework.

30. Another asset manager was of the opinion that the distinction between complex/simple UCITS could make sense, but it was not in favour of a unique set of criteria: the driver should be the capacity of investors to understand the product payoff and the risks involved.

Q4: Do you consider that some of the characteristics of the funds discussed in this paper render them unsuitable for the UCITS label?

31. A consumer association agreed that some of the characteristics of these funds render them unsuitable for the UCITS label.

32. A public authority mentioned that the possibility for the withdrawal of the UCITS label for complex and opaque structures could be explored to ensure that UCITS products remain simple.

33. A large number of respondents noted that ESMA discussion paper does not really discuss fund characteristics, but it focuses on the use of some financial instruments.

34. An asset manager mentioned that, as long as UCITS remain simple, investors can - indeed should - be encouraged to understand how they work.

Q5: Are there any issues in terms of systemic risk not yet identified by other international bodies that ESMA should address?

35. An asset manager believed that funds pursuing investment objectives that use derivatives which must be rebalanced daily to maintain a targeted exposure should be permitted under UCITS. However, this respondent recommended keeping in mind that the daily rebalancing process used by these funds may increase market volatility (as well as providing a risk profile that may be difficult for investors to understand).

36. Some asset managers mentioned that sampling replication creates a risk for investors that a UCITS, which is supposed to be indexed, is in fact only benchmarked to the index. Therefore, they were of the view that in market stressed events it is not impossible that such replication technique will not work and produce significant tracking errors.

37. Another asset manager mentioned that UCITS' securities lending and repo activities should have the same level of regulation as in the case of UCITS' OTC derivatives transactions.

38. A public authority mentioned the following potential risks to the stability of the financial system arising from the developments in the ETF market:

    - The growth in swap-based ETFs increases inter-connectedness of the financial system as a whole – which might amplify shocks in times of stress.

    - The ETFs' practices consisting in generating additional returns through securities lending exposes funds (and ultimately investors) to counterparty risk. In case of reinvestment of cash collateral in illiquid assets, the liquidity position of the ETF itself might be at risk. From a wider financial stability perspective, cash collateral that is re-invested in illiquid securities might increase concerns over the build-up of maturity mismatches across the financial system.

    - ETFs may entail a risk that, particularly during market stress, their liquidity proves illusory, with end-investors and/or market markers unable to redeem their ETF holdings without materially affecting market prices.

    - Risk assessment for investors and regulators is complicated by the ever-increasing complex strategies (e.g. leveraged ETFs, inverse ETFs and inverse-leveraged ETFs).

39. The same public authority suggested some additional measures, from a macro-prudential perspective, to those proposed by ESMA:

- A formal cooperation between securities markets and banking sector regulators to collect appropriate data, understand and monitor risks facing banks engaged in the ETF market should be sought. Specifically, this respondent pointed out the need of increasing further cooperation focused on funding liquidity risk and securities lending practices among EBA and ESMA.

- Disclosure should be further strengthened based on qualitative as well as quantitative criteria. For securities lending activities, examples of additional disclosures could be: the average/maximum percentage of securities on loans over a specified time period; the type of collateral held against securities lending; and the largest borrowers of securities.

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.

Q7: Do you agree that ESMA should also discuss the above-mentioned issues with a view to avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.

40. A public authority stressed the need to avoid any regulatory arbitrage between financial products: similar disclosure requirements to investors should be required for financial products such as “Exchange Traded Products” that show similar features as ETFs but are not structured as funds; UCITS products should remain simple. If further systemic risk analysis should conclude that additional measures are necessary and adequate, this public authority encouraged for additional standards to be developed, which might ultimately suggest that ETFs (and financial instruments with similar features) may only be sold as complex vehicles.

41. A consumer association agreed that ESMA should discuss issues relating to products which could be structured and issued as notes by credit institutions or special purpose vehicles and expressed a particular concern for products including the terms ‘guaranteed’, ‘protected’ or ‘secure’ in their names since buyers of some of these structured products think they are taking market risk, where they are actually taking highly concentrated credit or counterparty risk.

42. Similarly, two other consumer associations were of the opinion that the guidelines to be adopted should be applicable to all substitutable investment products, such as unit linked insurance product, structured notes or non-UCITS funds established or sold within the EU. One of these two consumer associations added that some products, like poorly regulated and non-transparent SPVs are not suitable for retail investors, whether the exposure to such products is direct or indirect (when wrapped in other funds).

43. A couple of asset manager associations disagreed on applying UCITS guidelines to non-UCITS funds, but welcomed regulatory harmonization in the EU to avoid regulatory arbitrage.

44. A public authority was of the view that non-UCITS funds established or sold in the European Union should be subject to the rules of MiFID or, if the latter is not applicable to them, to the legislation of their home states; accordingly the requirements applicable to UCITS should not be extended. Additionally, this public authority mentioned that when UCITS are distributed to retail investors, they should be subject to the provisions of MiFID.

45. An asset manager association considered that any distribution guidelines should apply to all financial products under MiFID, particularly if ESMA was of the view that there are systemic risk issues. Many

members of this association considered that non-EU ETFs listed on European regulated markets should also be covered by the rules.

46. An asset manager mentioned that special attention should be given to US-based ETFs (that are marketed through private placement or to retails via Euronext Amsterdam) since they are not UCITS and therefore less protective.

47. A respondent did not see any need for retail investor protection rules to be applied to non-UCITS funds which are specifically designed for, and may only be sold to, institutional investors.

48. An asset manager was supportive of a coordinated approach to adopt UCITS guidelines for other funds or products if they are sold to retail investors and regarding measures for ensuring financial stability (i.e. short selling restrictions). This stakeholder considered that a line should be clearly drawn between UCITS (ETF or not) and other products which are not UCITS and, in some cases, even not funds, like ETNs and exchange traded commodities (ETCs).

Exchange Traded Funds

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.

49. Almost all respondents agreed with a focus on the need of clear protection of the brand European UCITS ETFs, possibly legally binding.

50. Several consumer associations explicitly mentioned that UCITS ETFs should use an identifier in their names, fund rules, prospectus, marketing material and KIID.

51. An asset manager disagreed and argued that the replication technique used may change over time (some ETFs prospectuses allow for switching from one technique to the other, depending on market conditions or other factors). However, this respondent was in favour of the idea of introducing more disclosure.

52. Several respondents requested ESMA to find a definition of ETFs and structured UCITS and envisaged a clarification for the latter. These respondents also stressed the risk of misuse of the label ETF and highlighted that the acronym "ETF" is used to cover all types of exchange traded products (ETPs), including structured banking products and funds that are not UCITS.

53. An asset manager asked ESMA to ensure an on-going cooperation with EBA with regard to ETPs in particular, and with EBA and EIOPA with regard to complex PRIPs more generally.

54. An asset manager association stressed the importance of the fact that the criteria for the use of the identifier should be clearly defined, in order to avoid any 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. This respondent suggested to follow an approach which is similar to the one adopted for the CESR definition of "Money Market Funds".

55. Some members of an asset manager association mentioned that the ETF identifier should be introduced only for: a) UCITS actively traded on at least one European regulated market, with at least one market maker and b) European or non-European exchange-traded funds with equivalent regulation.

The notion of "actively traded" should be further defined to include only funds with real continuous trading, with small bid-offer spreads and significant offered size.

56. Other members of the same asset manager association considered that the ETF identifier should be reserved to any exchange-traded fund (UCITS or non-UCITS), while excluding other ETPs.

57. Some asset managers were of the opinion that a fund should have the following characteristics to carry the ETF name: UCITS, passive listed, with transparent index systematic not discretionary management rules, actively traded on an EU stock exchange.

58. While agreeing with the proposals, a respondent mentioned that a line should be clearly drawn between UCITS ETFs on one side and non-UCITS ETFs, non-ETF UCITS and non-fund ETPs on the other side.

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

59. The majority of the members of an asset manager association disagreed on this proposal since the borderline between synthetic/physical is fluid and a hard and fast distinction would confuse. Other members of the same association, however, believed that an identifier can be ascribed to a synthetic or physical form of replication by reference to the primary investment policy of the fund as opposed to efficient portfolio management or secondary investment techniques to replicate the index.

60. An asset manager felt not appropriate to set out the replication methodology in the prospectus.

61. A public authority considered that the inclusion of certain concepts or descriptors—such as synthetic, physical or actively-managed—may prove excessive and beyond the comprehension of the average investor.

62. Some respondents deemed appropriate to clearly identify whether the ETF is synthetic or physical. They mentioned that labelling could appear in the product name itself and should certainly be specified in the prospectus, marketing material and KIID.

63. Several consumer associations also supported the distinction between synthetic and physical ETFs in the fund name. One of these associations suggested that ESMA should look at the full spectrum of ETPs, such as ETNs and ETCs.

64. A respondent was in favour of clearly identifying passive and actively managed ETFs.

Q10: Do you think that the identifier should also be used in the Key Investor Information Document of UCITS ETFs?

Almost all respondents agreed that the identifier should also be used in the KIIDt of UCITS ETFs.

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

Q12: Do you agree with the policy orientations identified by ESMA for index-tracking issues? If not, please give reasons.

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?

Q14: Are there any other index tracking issues that ESMA should consider?

Q15: If yes, can you suggest possible actions or safeguards ESMA should adopt?

65. Several consumer associations agreed with ESMA's analysis on index tracking issues and believed that information should be disclosed in the prospectus and the KIID. In addition, some of these associations suggested including the word 'daily' in the name of leveraged and inverse ETFs which rebalance daily and do not provide effective tracking over longer periods. These respondents also suggested avoiding the use of the word 'tracker' in the name of these funds since this term may give the impression that these funds are designed to track the index over longer periods.

66. One respondent suggested adding the following to the policy orientations: "The index-tracking UCITS ETF should inform the investors on the main sources of risks due to the investment strategy".

67. Two consumer associations were of the opinion that the description of issues which affect the index-tracking ETF's ability to fully replicate the index to be included in the prospectus and the KIID (e.g. transaction costs, small illiquid components, dividend reinvestment, etc.) was too technical to be correctly assessed by a retail investor and suggested to insert in the KIID the mention that the index could be not perfectly replicated and that the tracking error could reach a certain maximum percentage of the index evolution. One of these consumer associations added that all risks, counterparty risk included, should be reflected in the synthetic risk indicator.

68. A public authority similarly recommended that the information that is included serves to enhance comprehension of the product and does not include concepts that are too technical for a document addressed to investors.

69. Several respondents pointed out that the definition of tracking error in paragraph 21 of the discussion paper was not accurate: tracking error is not the distance between the performance of the fund and the performance of the index, but it is the volatility of the difference of such returns. In particular, an asset manager mentioned that tracking error is technically measured as the standard deviation of the tracking difference (the under/over performance of the fund vs. the index), generally on a daily basis expressed as an annualized number, and is a measure of the volatility of the tracking or "performance difference".

70. Some respondents were of the opinion that ESMA should define and publish a clear tracking error definition and a standardized calculation method to allow for comparability, while several other respondents did not consider that such standardization is either necessary or useful for retail investors, and pointed out the fact that institutional investors have their own preferences in terms of calculation.

71. For an asset manager, ESMA would just have to define the applicable period to calculate the tracking error and the data that must be used (for example weekly data and closing values etc.).

72. Other respondents were of the opinion that it would be extremely difficult to impose a single tracking error limit across all index tracking funds without introducing complex definitional issues and that any rules introduced in this area should be applied on a level playing field across all index tracking funds.

73. Several respondents disagreed on paragraph 23 of the discussion paper since they were of the opinion that the tracking error issue is not specific to synthetic replication: dividend reinvestment and dividend tax issues apply both to synthetic and physical ETFs, and might lead to tracking error.

74. A respondent noted that ESMA's discussion paper described only one model of swap-based ETFs, the unfunded swap, but an alternative model exists, namely the funded swap.

75. The majority of respondents expressed a general consensus on the disclosure proposals with the following distinctions.

76. Some respondents disagreed on the disclosure of the maximum permissible tracking error. One stakeholder agreed on disclosing whether the replication policy provides for a full or partial replication, but not on disclosing the methodology since sampling replication is based on a proprietary model. The same stakeholder in principle agreed that key information should be reflected in the KIID, but it did not feel that index tracking issues should be a standard part of the KIID.

77. On the contrary, an asset manager was in favour of the disclosure of the maximum permissible tracking error in the prospectus and in the KIID. This respondent believed that fixing the replication methodology in the prospectus would not advantage investors, but, for transparency reasons, it agreed that this information should be disclosed in the KIID.

78. Some respondents believed that the key elements should be disclosed in the KIID and more explanations could be provided in the prospectus (also the sampling methodology).

79. Other respondents would support additional disclosures in the KIID and suggested to build in the current KIID provisions for "structured" UCITS. These respondents were of the opinion that the disclosure of the tracking error implies the standardization of the calculation method and that stating a maximum tracking error in the fund documentation may imply a guarantee where this is not the case.

80. An asset manager was of the view that, in the case of synthetic ETFs, it would be appropriate to disclose the spread of the swap in the prospectus.

81. Another asset manager noted that certain providers are reluctant to provide the full composition of indices without a full non-disclosure agreement in place. Moreover, this respondent suggested that also costs, illiquidity of certain small components or dividend reinvestment should be disclosed as well as sampling methodologies and the impact on the composition of the portfolio.

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

82. Almost all the members of an asset manager association agreed on the disclosure proposals; some of them did not agree with the proposals because they were of the opinion that, as a consequence of the disclosure required, the prospectus should change often.

83. A consumer association highlighted the risk of conflict of interest if the swap counterparty, custodian or collateral manager is connected to the ETF provider. Similarly, other consumer associations were concerned by the counterparty risk and the conflict of interest when the ETF manager and the counterparty are members of the same financial group.

84. Another consumer association was of the opinion that it is important, that the disclosure is informing the investors on the main risks in clear language.

85. A public authority agreed with the ESMA's proposal regarding the definition and harmonisation of the operation of ETFs, since this would enable all ETFs to compete on an equal footing regardless of their home Member State, provided that the specific measures arising out of these proposals enable these UCITS to continue to operate with sufficient flexibility.

86. An asset manager suggested that "Collateral" should only refer to the guarantee provided by the swap counterparty to the fund in the case of a funded swap as opposed to the "Substitute basket" in which the fund may invest in the case of an un-funded swap. Moreover, this respondent mentioned that the rule on eligibility of the assets for UCITS ETF avoids that they may raise funding against illiquid portfolios, whereas this may be a risk with non-UCITS ETF and with physical UCITS funds which engage in securities lending: indeed, the current UCITS rules on collateral are not particularly stringent for securities lending.

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.

87. Several consumer associations agreed that provisions on the quality and type of assets constituting the collateral should be further developed and that there should be a requirement for the quality and type of assets to match more closely the relevant index. These respondents were also concerned by the fact that the collateral provided for some synthetic ETFs consist of a significant proportion of corporate bonds issued by other banks, which are likely to be negatively affected in the event of a default by the swap counterparty.

88. A public authority pointed out that one of the key risks that banks, in their role as swap counterparties, are exposed to is funding liquidity risk. Because the collateral does not need to match the assets of the index being tracked, banks might have incentives to use the synthetic ETF structure as a source of collateralised borrowing to fund illiquid portfolios. This respondent argued that, in times of stress, a withdrawal of investors from the ETF market might spill-over to a funding liquidity shock for swap counterparties.

89. Several respondents did not consider that provisions on the quality and the type of assets constituting the collateral should be further developed as proposed by ESMA. These respondents were of the opinion that if fund assets comply with the liquidity, valuation, issuer credit quality, and diversification constraints, no further requirements for collateral to match closely the relevant index should be necessary. They argued that collateral is provided to secure a claim and should not be confused with portfolio assets.

90. Other respondents believed that CESR guidelines on collateral express general principles that need to be specified and asked for further rules of the following type: the collateral should be composed of assets from the same asset class as constituents of the index (when applicable), investors in ETFs investing in funded swaps should know what the eligible collateral is and what the expected delay before its enforcement in case of default of the counterparty is.

91. In particular, a respondent mentioned that establishing transparency about the type of collateral posted is a more effective approach than imposing rules on what kind of collateral qualifies as eligible.

92. An asset manager agreed with ESMA proposal regarding the disclosure of collateral and recommended a clear pan-European policy on haircuts to be applied on collateral. Similarly, a public authority considered that the type and quality of assets that are eligible as collateral need to be elaborated further to ensure that managers' operating possibilities are equivalent in all Member States. However, both respondents did not believe that the collateral should be required to match closely the relevant index.

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.

93. Several consumer associations were of the opinion that the collateral received by the ETF should comply with the UCITS diversification rules.

94. Several other respondents considered that collateral received by synthetic ETFs should comply with CESR's Guidelines on Risk Measurement, but need not to comply with UCITS fund diversification rules.

95. A public authority was of the opinion that collateral received by synthetic ETFs must fulfil certain diversification requirements for the event that it has to be executed, but they should not be as strict as those applying to an ETF's investments.

96. An asset manager supported the introduction of greater transparency for investors in relation to the underlying exposure, counterparties and the collateral taken by providers of synthetic ETFs. However, this respondent did not believe that there should be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index.

97. Another asset manager agreed on reviewing the collateral rules in relation to certain types of instrument and fund structure with a view to requiring that collateral more closely reflects the index being tracked (in terms of quality and type).

98. A respondent proposed to apply a conservative limit of 20% per issuer (i.e. at least 5 different issuers, as it is the case for cash deposits).

Securities lending activities

Q19: Do you agree with ESMA's analysis of the issues raised by securities lending activities? If not, please give reasons.

99. Almost all respondents agreed on ESMA analysis.

100. In particular, some asset managers agreed on the application of CESR Guidelines on Risk Measurement to securities lending activities because there is a need of harmonization.

101. On the other hand, a respondent mentioned that securities lending should not be addressed specifically in the ETFs contest and that it contributes positively to performance.

102. Some respondents disagreed on the potential systemic concerns mentioned in paragraph 37 of the discussion paper which securities lending activities can give rise.

103. A couple of asset managers asked for common standards of transparency applicable to all UCITS not only UCITS ETFs.

104. Another asset manager noted that in the synthetic model the investment banking affiliate may engage in the lending of its hedging basket and derive income from such activity. This respondent considered that it is appropriate for the fund to benefit from any securities lending activity carried out directly or indirectly in connection with its assets.

105. An asset manager association said that details of securities lending activities and the risks involved should already be disclosed in the prospectus as well as the levels of fees earned.

106. A respondent was of the opinion that it is essential that ETFs are not subject to unnecessary constraints which are not also imposed on competing funds and products. This respondent mentioned that there is a risk that additional regulation of securities lending within ETFs (such as limiting the amount of lending that can take place) could result in physical ETFs being disadvantaged.

Q20: Do you support the policy orientations identified by ESMA? If not, please give reasons.

107. There was a broad support among respondents on the policy orientations identified by ESMA, but respondents believed that any proposals should apply to all UCITS not only to ETFs.

108. Some consumer associations considered that that disclosure of securities lending activities and the existence of a related risk is of little help for retail investors who cannot asses that risk and suggested that the risk must be quantified to be understood by retail investors. A public authority supported the policy orientations, while it similarly pointed out that the information supplied to investors should be confined to fundamental, simple and specific aspects, avoiding aspects that are excessively technical and complex and which would not be readily understood by an average investor. A respondent also stressed that it is important that the information to investors is not confined in technical terms explaining the risks related to securities lending, but explains in clear language the risks to the investor.

109. A banking association supported ESMA to the extent the policy orientations simply aim at confirming or clarifying the current regime without implying the existence of diverging rules applying to ETFs.

110. An asset manager mentioned that the details on the collateral parameters, such as collateral types, eligibility limits and levels of over-collateralisation may change depending on the market environment. As such, while this respondent agreed that this information should be available to clients, it suggested being more sensible and practical to display this on the provider's website and/or upon request.

111. A respondent did not support the proposed disclosure of securities lending fees earned by UCITS ETFs because it is not part of the current UCITS regime and would thus place UCITS ETFs at a disadvantage compared to other UCITS and other index-tracking vehicles not covered by the UCITS regime.

112. Another stakeholder agreed on developing a generic description of securities lending activities in the prospectus and suggested having similar requirements for the annual reports, as it is already required in Ireland and Luxembourg. This respondent agreed on the disclosure of any connected companies in the securities lending chain, but it opposed to any proposal to restrict such arrangements. It agreed with the majority of the proposals for permissible collateral, except with those for the reinvestment of cash collateral which it considered far too restrictive. The same respondent also considered that the collateral requirements should be controlled within the remit of the general UCITS risk management rules.

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.

113. Several respondents disagreed with the idea of introducing further safeguards on the collateral received in the context of securities lending activities.

114. Several consumer associations agreed with the abovementioned idea and replicated the comments they made in their answers to questions 16 to 18 above.

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.

115. There was a broad support among respondents on the proposal made by ESMA, while few respondents disagreed on that proposal.

116. In particular, a public authority welcomed the proposal and added that, in order to reduce the risk of using ETFs as conduits for liquidity risk transfer by their counterparty, the guidelines should further mention that the liquidity of the collateral should match the liquidity that can reasonably be expected from the assets of the index being tracked.

117. An asset manager association recommended ensuring consistency through European ETFs and 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?

118. Almost all respondents disagreed on the proposal, except a couple of respondents that were of the opinion that a limit should be discussed.

119. For a public authority, in principle, there did not appear to be a need to set a limit; however, if one was established, it should be high enough (e.g. 75%).

120. A respondent mentioned that an appropriate risk management is sufficient to address potential risks arising from securities lending.

Q24: Are there any other issues in relation of securities lending activities that ESMA should consider?

Q25: If yes, can you suggest possible actions or safeguards ESMA should adopt?

121. Several respondents considered that there are no other issues that ESMA should analyse.

122. While supporting additional rules on the collateral received by UCITS as part of securities lending transactions, a consumer association expressed a concern with regard to the effectiveness of disclosure of securities lending activities leading to pressure from retail investors for improvements in practices.

123. Some other consumer associations believed that if the securities lent exceed a threshold (to be discussed), the physical character of the UCITS is vanishing and it must be considered as a complex UCITS.

124. An asset manager suggested that the securities lending revenue share (net of costs) to the fund and the absolute revenues the fund has received should be disclosed by the ETF providers.

125. Another asset manager mentioned the need of additional disclosure on the quality of the counterparty and of risk language on conflict of interests (in relation to any split of fees/interest between the securities lending agent, the investment manager and the fund).

Actively managed UCITS ETFs

Q26: Do you agree with ESMA's proposed policy orientations for actively managed UCITS ETFs? If not, please give reasons.

Q27: Are there any other issues in relation to actively managed UCITS ETFs that ESMA should consider?

Q28: If yes, can you suggest possible actions or safeguards ESMA should adopt?

126. There was a broad support among respondents on the proposals made by ESMA.

127. Some respondents mentioned that the calculation of the indicative net asset value (iNAV) is not part of a fund manager's duties. Other respondents did not believe that it would be practical or feasible to disclose how the iNAV is calculated. These respondents argued that this calculation is not relevant for investors as they will buy at the offer price on exchange and there is no guarantee that this will be close to the iNAV.

128. A respondent mentioned that there is no clear definition of actively managed and without a clear definition it will be very difficult to implement rules in this area.

129. Another respondent noted that the fact that a UCITS is actively managed and the related risks should be clearly stated in all fund documentation.

130. An asset manager stressed that the impact of the daily reset of leverage on investors' returns can only be estimated ex post and this creates a path-dependency.

Leveraged UCITS ETFs

Q29: Do you agree with ESMA's analysis of the issues raised by leveraged UCITS ETFs? If not, please give reasons.

Q30: Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q31: Are there any other issues in relation leveraged UCITS ETFs that ESMA should consider?

Q32: If yes, can you suggest possible actions or safeguards ESMA should adopt?

131. There was a broad support among respondents on the proposals made by ESMA.

132. Several respondents reminded that under UCITS regulations only a leverage of 2 is allowed differently from US mutual fund regulation.

133. An asset manager added that there are far more highly leveraged instruments than ETFs available to investors both institutional (futures) and retail (call/put warrants and turbos) and that ETFs are used primarily for hedging purposes. Moreover, this respondent noted that leveraged short ETFs may mitigate the risk by applying a stop-loss mechanism to reduce the losses in the fund if the benchmark index climbs in value.

134. Some asset managers recommended that leveraged ETFs use the word “Daily” or “Monthly”, as appropriate, in their identifier, as well as the level of leverage (e.g. 2X) in order to make it clear to investors which return is being tracked. Similarly, a respondent mentioned that the key issue for leveraged UCITS ETFs is disclosure of the impact of leverage and, in particular, the impact over longer periods of time where there are daily reset.

135. Several consumer associations asked for the introduction of a clear identifier in the ETF name for inverse and leveraged ETFs. In addition, they suggested including the word ‘daily’ in the name of leveraged and inverse ETFs which rebalance daily and do not provide effective tracking over longer periods. They also suggested avoiding the use of the word ‘tracker’ in the name of these funds since this term may give the impression that these funds are designed to track the index over longer periods.

136. Some of the abovementioned consumer associations mentioned that the disclosure of the impact of reverse leverage as proposed by ESMA could be too technical to be understood by retail investors and suggested instead the introduction of a special warning in the KIID and a careful appropriateness test with specific warning. One of these associations also suggested introducing a high minimum threshold for this kind of funds.

Secondary market investors

Q33: Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q34: Are there any other issues in relation to secondary market investors that ESMA should consider?

Q35: If yes, can you suggest possible actions or safeguards ESMA should adopt?

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?

Q37: If yes, should this right be limited to circumstances where market makers are no longer providing liquidity in the units of the UCITS ETF?

Q38: How can ETFs which are UCITS ensure that the secondary market value of their units does not differ significantly from the net asset value per unit?

137. Several consumer associations were concerned that secondary market investors could suffer detriment if liquidity in the ETF market is absent when they need to trade their shares since at times of market stress there could be a significant divergence between the price of the ETF and the ‘true value’ of the index it tracks. Therefore, these respondents asked ESMA to examine whether its proposal has the potential to increase liquidity in ETF markets at these times.

138. Some of the abovementioned consumer associations added that the KIID should be easily available for all ETFs available on a secondary market. Furthermore, an asset manager would like precise guidelines in relation to the obligation to provide the KIID for ETFs.

139. A public authority suggested considering that the liquidity provision and price formation processes of ETFs on secondary markets rely particularly on the implementation (most often by algorithmic and high-frequency traders) of liquidity provision and arbitrage strategies. This authority expressed some concerns on the capacity of investors to assess truly available liquidity and related liquidity costs. This respondent was of the view that such concerns might affect in particular ETFs that track illiquid asset markets (such as emerging markets and commodities), but they may also occur due to specific ETF features such as the rebalancing of leveraged and inverse ETF positions. Thus, ETFs may be particularly vulnerable to liquidity shocks, and, due to their hybrid nature of stock and fund, particularly likely to transmit such shocks across markets, market segments and asset markets.

140. A shareholders association supported the policy orientations and was of the opinion that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF independently of the activity of market makers. This association was of the opinion that it is not possible to ensure that the stock market value of the units is the same as the net asset value per share, but by giving correct and full information to the market it is possible to reduce the risk of a difference.

141. Some respondents did not consider that the warning proposed for the secondary market investors is suitable; however, these respondents were of the opinion that the ETF's prospectus should provide disclosures on redemptions on the primary market. In contrast, an asset manager agreed on clearly outlining in the ETF documentation the difference between the primary market and the secondary market.

142. Several respondents agreed in principle on providing for the right of the investors to request direct redemptions, but they gave reasons for encouraging investors to use the secondary market[9]. These respondents argued that the right to request the direct redemption should be limited to exceptional circumstances (if an ETF is delisted or the secondary market is disrupted or simply it does not work properly), but an asset manager noted that in this case the ETF should simply be liquidated.

143. A respondent highlighted that in case of direct redemptions ETFs should have the right to charge subscription and redemption fees to cover operational costs and that the current operational setup would need major adjustments.

144. An asset manager association did 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. This respondent argued that investors' right to redeem from the UCITS fund exists (acting through their nominee) and was of the opinion that the secondary market investors would benefit greatly from a harmonization of EU exchanges.

145. An asset manager suggested that ETFs put subscription and redemption fees on the primary market, in order to limit the number of such subscriptions and redemptions. The result of such fees is that only market makers have an incentive to access the primary market, most other investors having an advantage in purchasing or selling their shares or units through the secondary market.

[9] Individual investors may find it challenging in practical terms to redeem directly with the ETF, mainly due to the operational challenges imposed by the Central Securities Depositaries (CSDs) which clear the shares of an ETF, which are listed on exchange (and not due to restrictions imposed by the ETF itself).

146. A respondent mentioned that secondary market investors should not have a right to direct requests of redemption of ETF units to the issuer since the term "exchange-traded" makes it clear that units can only be bought and sold on an exchange.

147. Some respondents mentioned that ETFs cannot "ensure" that no significant variations from the calculated NAV occur. This is because ETFs have no influence on the market price of units on the secondary market, which is determined based on order matching rules in open order books that include a variety of different order types and quotes from official market makers, other market professionals and investors. These respondents highlighted that the NAV of a share is correct only at the moment when it is calculated and that the primary market process for an ETF automatically ensures that the secondary market will always stay in line with the NAV of the fund. However, a respondent was of the opinion that ensuring no significant variations is possible by arbitraging between the primary market and the secondary market or by having a hard trading limit between the price at which an ETF is traded on the secondary market and the iNAV.

148. Respondents also made the following general comments:

- market-making regulations should be harmonized;

- it would be appropriate for the upcoming MiFID Review to include an extension to ETFs (not to all other UCITS) of equity transparency requirements, to show the full extent of trading;

- MIFID rules, including post-transparency rules, should be extended to the trading of ETFs;

- a variety of exchange traded products are sold under the "ETF" brand. These can be Exchange Traded Commodities, non UCITS ETFs or UCITS ETFs. Secondary market investors are not necessarily aware of the investment strategies or the level of risk and supervision that are pursued by the product that they have acquired;

- regulators in some EU Member States have introduced a new general obligation for intermediaries selling or advising clients regarding UCITS (and ETFs) to provide a KIID to investors in good time before subscription of units on their own initiative and free of charge. This differs from current market opinion and practice where the distribution of ETFs is subjected only to the MiFID-rules.

<u>Structured UCITS</u>

Total return Swaps

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

149. An asset manager agreed on most of the issues raised regarding Total Return Swaps (TRS). However, it was of the opinion that an unfunded TRS providing the swap counterparty with a delta one exposure to the underlying assets can be analysed as a pure delivery mechanism and should not be seen as an investment comprised in the UCITS's portfolio.

150. Another asset manager disagreed on paragraph 50 of the discussion paper because it seems to imply that the complex strategy and the TRS are inextricably linked which it is not entirely accurate. This respondent was of the opinion that there is, in fact, a distinction between the actual investment

strategy of a fund and the instruments by which the investment manager gains access to these strategies: one of this is a TRS.

151. Some respondents disagreed on paragraph 54 of the discussion paper: the UCITS Directive regulates the fund, not the counterparty that can hedge itself or not how it wishes, without any restriction. The same respondents also disagreed on paragraph 56 of the discussion paper: they mentioned that a constant interpretation of most European regulators has been that diversification has to be implemented after derivatives, and only after derivatives. This is because the purpose of diversification is to diversify the exposure of investors (and exposure is real only after derivatives).

152. A consumer association was generally concerned by the lack of transparency of structured products and by the fact that such products with principal protection are too often proposed as an alternative to deposits.

153. Another consumer association mentioned that most of its comments relating to ETFs are applicable to structured UCITS and added that in Spain there are mainly two kinds of structured products available to investors: structured deposits and guaranteed funds. This consumer association asked for establishing a clear distinction between structured deposits and deposits, on one side, and for clearly informing and warning investors about the redemption fees and risks of guaranteed funds and lowering their risks, on the other.

Q40: Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q41: Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

Q42: If yes, can you suggest possible actions or safeguards ESMA should adopt?

154. An asset manager disagreed because it considered ESMA policy orientations (expressed under paragraphs 52, 54, 57 and 58 of the discussion paper) as problematic. In particular, this respondent was of the opinion that ESMA proposals attempt to re-qualify two entirely different legal and regulatory relations (investment manager and TRS counterparty) and this would cause uncertainty for the framework within which the two players operate.

155. Some respondents disagreed with the proposal to treat discretionary decisions relating to the underlying swap portfolio as a delegation of investment management. One of them also disagreed because it believed that the swap counterparty may exercise discretion in fulfilling contractual commitments, but these calculations or other determinations in no way constitute investment management. Another respondent disagreed because it mentioned that it would be quite onerous to request the underlying of the swap being compliant with UCITS diversification rules, especially as TRS are financial instruments which are subject to MiFID.

156. Several respondents supported the policy orientations identified by ESMA. A public authority explained that these will be beneficial not only to investors but also to the asset management industry in general by strengthening the role of asset managers and their fiduciary duties.

157. An asset manager suggested that:

- the policy should be extended to any third party manager who manages the underlying strategy of the swap as it may differ from the swap counterparty;
- the swap counterparty or the third party underlying strategy manager should be treated in the same way as the investment manager of the UCITS and be required to comply with UCITS investment restrictions;
- at all times the strategy should comply with UCITS investment restrictions and the level of discretion should be clearly disclosed;
- it would be imperative to put in place an investment management delegation or a trading agreement which sets the investment restrictions and the responsibilities of the underlying strategy manager.

158. Another asset manager agreed with the proposal to consider the swap counterparty as an investment manager, if the counterparty has discretion and flexibility on investments that have an impact on the performance/NAV of the UCITS. However, if the counterparty has discretion only on the collateral of the TRS (i.e. the investment portfolio that is swapped), it would be illogical to treat it as an investment manager. This respondent mentioned that as for any swap, the investment manager of the UCITS sets guidelines for acceptable collateral and the counterparty has discretion within these guidelines to choose the securities it gives as collateral.

159. On the diversification issues, some respondents did not consider that UCITS diversification rules should apply to the swap underlying. In particular, one respondent considered that the policy orientations should apply to all UCITS, not just to "structured UCITS".

160. A public authority, although agreeing that structured UCITS should be subject to the portfolio diversification requirements set out in the UCITS Directive, considered that, since there is no restriction on packaging structured UCITS under other labels (e.g. structured notes), the application of diversification rules may be harmful for investors, who would only have access to these structures through vehicles that are not as tightly regulated as UCITS.

161. An asset manager suggested that, in case of TRS, the UCITS portfolio complies with a minimum diversification requirement of 20% per issuer.

162. An asset manager association mentioned that the purpose of the diversification regulations is to diversify the risks taken by investors which represent the real exposure of the fund, after the effect of derivatives.

Strategies indices

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

Q44: How can an index of interest rates or FX rates comply with the diversification requirements?

Q45: Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

Q46: If yes, can you suggest possible actions or safeguards ESMA should adopt?

General Comments

163. There was a broad support among respondents on the proposals made by ESMA. Most of respondents were of the opinion that the proposed ESMA orientations should be applicable to all indices, not only to strategy indices and that ESMA should provide some grandfathering clauses for existing UCITS.

164. An asset manager disagreed on some of ESMA's policy orientations and noted that ESMA does not seem to give evidence to justify the necessity of extra rules or guidelines to increase investor protection for these products.

165. Other asset managers found it difficult to understand how a "strategy index" (as described in the discussion paper) fits easily within the requirements set out in the various pieces of UCITS legislation on eligible assets. However, they agreed on ESMA's policy orientation on strategies indices and suggested that a minimum number of components is to be used to determine whether an index of interest rates or FX rates complies with the diversification requirements.

166. An asset manager association suggested that there should be proper consideration as to whether strategy indices are appropriate for UCITS sold to the mass-retail market. If this is the case, then the Eligible Assets Directive wording would need to be amended. This respondent agreed that 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.

167. Some respondents considered that given that most of interest rates or FX rates indices are achieved through bonds portfolios it should be possible to comply with the diversification requirements mentioned by ESMA.

168. Other respondents were of the opinion 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. Some of these respondents argued that there is no proper way to take into account interest rate derivatives and FX derivatives which are already disregarded for the computation of diversification of assets held directly by UCITS according to article 52 of the UCITS Directive, the reason being that such derivatives do not have an "underlying" according to article 51(3), subparagraph 3, of the UCITS Directive.

169. An asset manager was of the opinion that, in relation to an index which comprises an interest rate hedge or a currency hedge component, the risk diversification rules should be applied only to the main underlying investments and not to the notional of the interest rate hedge or currency hedge. The notional amount of such hedge would be represented by underlying investments which provide the main exposure that the index is seeking to provide.

170. Some respondents added that from an economic perspective assessing whether an interest rate is "diversified" or not does not make sense. Diversification is not a pertinent measure of risk in respect of interest rates.

171. A public authority considered that an interest rate or currency index cannot fulfil the diversification requirements as currently defined since those requirements are established in terms of issuers, whereas interest rate and currency indices do not refer to any specific issuer.

Sufficiently diversified

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172. A large number of respondents agreed on the proposal made by ESMA, while asking for clarifications on the meaning of the word "impact", as it was used in the relevant policy orientations identified by ESMA.

173. An asset manager mentioned that commodity indices should not be required to comprise different commodities to be considered eligible indices. This respondent argued that the UCITS Directive sets out clear rules about the use of non-diversified indices (whether based on commodities or otherwise) to ensure that diversification criteria are met at the UCITS level.

174. A respondent was of the opinion that the overlap of index components should be taken into account and the overall weighting of an asset across indices monitored.

Adequate benchmark

175. Several respondents agreed on the proposal made by ESMA, but considered that, by suggesting that an index must be a benchmark for the market to which it refers, ESMA seems to restrict the scope of eligible financial indices to long only and beta financial indices not embedding any kind of strategy. Moreover, these respondents argued that in its advice (CESR/06-005) CESR stated that the index "must measure the performance of a representative group of underlying in a way that is meaningful and useful" and that strategy indices can be designed with a view to satisfying this condition. Furthermore, they mentioned that there are numerous strategy indices meeting that requirement that have been approved by the supervisory authorities across the EU over the last decade in connection with UCITS products: that some of those strategy indices have become benchmark indices themselves. Therefore, these respondents asked for clarifying the reasons for the perceived ESMA belief that strategy indices are not appropriate for UCITS funds.

176. An asset manager did not agree on the first bullet point of the proposed policy orientation. This respondent mentioned that components and their weightings can change if the rules for inclusion or changing are appropriately disclosed. Rules for inclusion of components are not always completely transparent with major well known indices (see for example FTSE100 or S&P500). In the case of strategy indices, they cannot be by definition adequate benchmarks for a market, because they do not track one market, but one strategy on one or several markets. The same respondent fully agreed on the principle that 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.

Rebalancing

177. Several respondents did not see any problem in having a rebalancing more frequently than quarterly and noted that the key element is the definition of rebalancing: rebalancing by changing the weights or by the number of units of the constituents. Moreover, they did not see convincing arguments for limiting indices to monthly rebalancing.

178. Some respondents mentioned that there is no relation between transparency and costs impacted, on one hand, and the average turnover of the allocation, on the other hand.

179. An asset manager noted that a daily or intraday rebalancing would be problematic from a replication perspective and might be seen as contrary to the rules-based nature of the index when it comes to strategy indices. This respondent was of the view that a more frequent rebalancing implies an active management or discretion in the index which is not incompatible.

180. Several respondents agreed on the fact that the rebalancing frequency should be more clearly disclosed in the prospectus, but for one of them a statement indicating that costs increase when rebalancing frequency increases would be more adequate, while for another one the disclosure of the rebalancing frequency is not a guarantee of transparency and it is not linked to the cost issue. Two respondents disagreed that there is a requirement under UCITS that investors should be able to replicate the index.

181. An asset manager was in favour of an intraday or daily rebalancing. Similarly, other respondents argued that the rebalancing frequency of an index should be reflective of the market which it is seeking to track and, since markets have different frequencies, they do not agree that indices which rebalance intra-day or daily are not eligible.

Published in an appropriate manner

182. Several respondents were of the opinion that in case of proprietary indices it is not appropriate to require public disclosure of proprietary information and feared that hardly any index provider would be willing to comply with the extensive disclosure standards proposed by ESMA which would result in an effective ban for ETFs and other UCITS in terms of utilization of such indices. These respondents also noted that the level of transparency required by ESMA would constitute a major problem for nearly all index providers, not only for strategy indices. Moreover, timely publication of comprehensive index data could result in enhanced front-running or prompt speculative trades against the index.

183. An asset manager mentioned, in particular, that it is not clear what is meant by “continually available” in paragraph 72 of the discussion paper and would disagree that a UCITS should be required to provide "live" index data such as composition and weighting. This respondent argued that this would create an unlevel playing field between index based UCITS and non-index based UCITS, which only need to disclose their physical portfolios in semi-annual and annual reports. In addition, as implementing this disclosure requirement would be very costly, the benefit of such a requirement would be disproportionate to its cost.

184. An asset manager association agreed that strategy indices which involve proprietary information on their composition that the index provider is unwilling to disclose should not be considered as eligible financial indices and suggested a minimum number of components to be used to determine whether an index of interest rates or FX rates complies with the diversification requirements.

Hedge Funds indices

185. Some respondents disagreed with the extension of the eligibility criteria for hedge fund indices to all financial indices as they have been developed for a specific market sector. These respondents mentioned that, if at all, application of the guidelines in points 1- 3 of paragraph 75 of the discussion paper could be envisaged.

186. A respondent was of the opinion that the requirement to carry out the due diligence on both the index and its components (as set out in the fourth additional guideline in paragraph 75 of the discussion paper) could suggest that there is some degree of discretion to be applied by the UCITS as to the components of the index.

Conflicts of interest

187. Some respondents argued that the conflicts of interest issue is sufficiently dealt with by the general conduct of business rules for UCITS managers. They mentioned that the suggested "independent" assessment should also allow for valuation by internal business units, provided the existence of Chinese walls or other segregation arrangements in relation to fund management.

188. An asset manager strongly disagreed on the proposal in paragraph 77 of the discussion paper.

Other issues

189. For several respondents the situation of "indices of indices", that is indices that contain some other indices among their constituents, should be clarified. Indices of indices should be analysed using the framework of the UCITS Directive for the diversification purposes.

190. Moreover, an asset manager association asked for including in the ESMA guidelines a paragraph mentioning indices that include other indices as constituents. This paragraph should mention that when an index includes as constituent another index (the "sub-index") and when the sub-index is an eligible index according to the UCITS rules, the exposure to such sub-index can be higher than 35% of the index.

191. A couple of respondents mentioned that the existing level 3 guidelines concerning non-diversified indices should be retained because they 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.

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Annex IV - Opinion from the ESMA's Securities and Markets Stakeholder Group on the discussion paper

I Executive Summary

The Group generally agrees with the concerns raised by ESMA in its Consultation Paper, which relate mainly to the fact that ETFs have become increasingly complex, and may raise significant issues both in respect to investor protection and to systemic risk. However, ETFs are a low cost and straightforward investment proposition for investors, and as such, ESMA should investigate how to make indexed ETFs more offered to retail investors, In respect to the prevention and mitigation of the risks that may arise from ETFs, while the whole Group agrees that greater disclosures are required, the majority of the Group members believes that, in addition to these disclosure requirements, regulators should adopt a more interventionist approach. The Group also believes it necessary to avoid any type of regulatory arbitrage, by subjecting all UCITS products and exchange-traded products to similar rules.

The Group generally supports the recommendations made by ESMA, and agrees that:

- UCITS ETFs should use an identifier in their titles, fund rules, Key Investor Document, prospectus and marketing material;
- investors should be provided with sufficient details to understand the index tracking policy used;
- there is a need for greater disclosures in respect to synthetic ETFs, notably in relation to underlying exposure, counterparty(ies) and the portfolio fund, as well as for stricter requirements in respect to the quality of the collateral, in the form of quantitative requirements on the quality (notably the liquidity) of the collateral, over-collateralisation requirements in specific circumstances, the regulators (and potentially ESMA) being responsible for regularly controlling the quality of the collateral. In addition, risks of conflicts of interests should be limited by prohibiting entities from the same group from acting at the same time as the ETF provider and the derivative counterparty;
- securities lending should be made more transparent to investors, should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, and the lending agent must be required to indemnify the UCITS when a counterparty defaults for all types of ETFs (synthetic and physical);
- actively-managed UCITS ETFs should be subject to greater disclosure requirements;
- it is necessary to specify, in the product title of leveraged UCITS ETFs, that they constitute leveraged ETFs, as well as the level of leverage;
- greater protection of secondary investors would be achieved by informing investors of their redemption rights, the ETF manager being made responsible for paying the difference between the collateral and the index underlying the swap if a counterparty defaults;
- total return swaps and strategy indices need to be better regulated.

II Explanatory remarks

1. The members of the Group welcome the opportunity to comment on the public consultation on UCITS Exchange-traded funds in the European Union (hereafter the “Discussion Paper”). However, before commenting ESMA’s Discussion Paper, the Group believes it necessary to place the key issues around UCITS Exchange-traded funds (hereafter “ETFs”) in the wider context. ETFs are one of the fastest growing investment products in the world, combining the trading characteristics of stocks with the diversified risk of investment funds. However, ETFs are still very small in comparison to the overall size of the fund market and their impact on secondary markets and their stability should be put into perspective: only 2.6% of all European funds are ETFs (3.5% of UCITS funds), and high growth rates are due to a low starting base. A large majority of ETFs in the European Union are already subject to one of the most respected and widely recognized fund regulatory frameworks: the UCITS Directive. Nonetheless, the Group believes that adapted regulation and its efficient enforcement can address some of the characteristics of ETFs, in order to ensure better protection of investors and a level playing field across Europe. The Group would therefore like to subscribe to the efforts of ESMA to provide guidelines on safeguards and controls in a proactive manner.

2. It is important to point out some key points for retail investors when discussing index-tracking ETF regulation: ETFs are a very low cost alternative to other UCITS funds for private investors but unfortunately most of them are very rarely, if at all, marketed for European individual investors. The main cause is due to differences in remuneration of the distribution channels and seems unrelated to the relative performance of index-tracking ETFs vis-à-vis other UCITS funds. This points to potential problems regarding ETF distribution.

3. In addition, the Group believes it important to distinguish between “index-tracking” ETFs (the bigger share of the ETFs market, simple and easy to understand investment objective, providing the performance of the market) and other ETFs (much less important in market share: leveraged ETFs and “active” ETFs, with less clear and more complex investment objectives).

4. The Group believes that issues around UCITS ETF should not be treated differently from other UCITS, and more importantly, from other exchange-traded products (“ETPs”) such as notes and certificates that are distributed to retail investors, in order to avoid the creation of regulatory loopholes, and to establish a level playing field between similar products.

5. Two options are possible in order to address the issues raised by ESMA in its Consultation paper. First, some argue that only transparency needs to be addressed by regulation creating more disclosure and information given to investors. Second, others argue that this regulation needs to go further by addressing not only transparency measures but also control and/or intervention on the products design, sale and governance.

6. This report will therefore present general observations of the Group and more specific comments relating to the different sections of the Consultation paper. In the General observations section, we will analyse the risks and benefits related to UCITS ETFs. In section two, we will broadly address the questions presented in the Consultation paper and analyse the different options for regulating UCITS ETFs in light of these different elements and ESMA’s propositions.

III GENERAL COMMENTS OF THE GROUP ON UCITS EXCHANGE-TRADED FUNDS IN THE EUROPEAN UNION

III.I Complexity

7. Some financial instruments are currently defined as automatically non-complex in Art. 19 of the MiFID Directive. For other instruments, criteria to identify non-complex financial instruments (set out in Article 38 of the MiFID implementing Directive10) focus on the ease with which the product can be understood by an investor, and not to the potential risk(s) it gives rise to[11]. All UCITS are currently classified as automatically non-complex.

8. ESMA's consultation raises the question as to how ETFs have evolved and whether some forms of ETFs should be considered "complex". If an ETF is created under the UCITS regime, there are already certain restrictions on the investment policy of the fund[12]. A number of regulators and policy-makers, along ESMA's line, are concerned by the potential complexity of ETFs, and the fact that, given the high level of innovation that has been observed lately, retail investors may not understand the products at stake, as illustrated by the FSA's 2011 Retail Conduct Risk Outlook.

9. In its proposal regarding the review of MiFID, released in October 2011, the European Commission suggests introducing some important changes in respect to UCITS products. It suggests excluding from the scope of "execution only" services (that is to say the services that an investment firm can provide without the need to obtain information regarding the knowledge and experience of the clients) the financial instruments including collective investment in transferable securities (UCITS), which embed a derivative or incorporate a structure for which it may make it difficult for the client to understand the risk involved. The proposal excludes explicitly structured UCITs (as defined in Commission Regulation 583/1020 at Level 2 of the UCITS Directive[13]) from the scope of the instruments that can be provided on an "execution only" basis. However, some the Group members believe there is still a scope for interpretation over whether swap-based ETFs (which embed a derivative) would also be excluded from the scope of the instruments that can be provided on an "execution-only" basis.[14]

III.II Main risks and benefits

10. UCITS ETFs' intrinsic advantage relates to the fact that these products combine the benefits of exchange-traded products (namely trading flexibility and cost-efficiency) with those of mutual funds (namely diversification). In addition, ETFs offer tax advantages in certain member states and cover different types of asset classes such as equities, commodities and fixed income.

11. Despite these benefits, UCITS ETFs also present significant risks:

    A. Increased complexity and opacity

        - Complexity as a result of synthetic ETFs and a wide range of asset classes covered

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[11] The central aim of the MiFID appropriateness test is to prevent complex products from being sold on an "execution-only" basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products. The MiFID Level 2 Directive allows a firm to assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those investment services or types of transactions or products for which the client is classified as a professional client.

[12] Risk diversification is the strength of UCITS, with a ceiling of 10 percent of the overall assets for any individual investment, with any holdings representing more than 5 percent of the overall assets capped collectively at 40% of the fund. The UCITS directive does, however, contain a special allowance for trackers, whereby the ceiling for an individual holding can reach 20 percent, and in exceptional circumstances 35 percent, provided the index is sufficiently diversified, is an adequate benchmark for the market it replicates, and is published in an "appropriate" manner (Art 53).

[13] See article 19 (6) of MiFID1 and new proposed art 25(3)a)iv) of October 2011 MiFID proposal.

[14] See article 19 (6) of MiFID1 and new proposed art 25(3)a)iv) of October 2011 MiFID proposal.

- Transparency issues related to the composition of the underlying assets, replication mechanism used (physical, synthetic, sampling), composition of the collateral and on the lending and borrowing arrangements

B. Counterparty risk and collateral

- Composition of the collateral is not yet sufficiently regulated
- The level of haircut on collateral is not yet regulated
- Limit on swap counterparty risk (10% swap counterparty risk maximum)
- Low liquidity of the assets held as collateral (risk to investors, bank and systemic risk)
- Risk of default of the swap counterparty (borne by investors and/or bank)
- Weaknesses of the enforcement procedure on swap counterparty risk

C. Securities lending and liquidity risks

- Counterparty risk borne by fund investors
- Many fund managers keep part of the benefits of security lending; there is no clear rule about passing on these benefits to the investors of the UCITS ETF
- Collateral rules
- Risk of market squeeze in the underlying securities
- But securities lending is not specific to ETF UCITS funds

D. Risk implications for authorities and ETF investors

- Regulatory arbitrage and unlevel playing field

IV SPECIFIC COMMENTS RELATED TO THE CONSULTATION

IV.I Scope

12. Regulation should be harmonised at European level. In this respect, ESMA should have a particular role, through, notably, the adoption of legally binding standards, and, potentially, a greater direct supervision role. The majority of the Group members therefore support the introduction of guidelines on UCITS ETFs. Some members insist on the need to extend the scope of these guidelines to all ETFs and - depending on the concern to be addressed - also other ETPs. The MiFID review and the Package Retail Investment Products legislation ("PRIPs") appear to them as more appropriate as policy instruments than guidelines only for UCITS ETFs and/or modifications to the UCITS Directive, in order to reduce regulatory arbitrage, and to provide comprehensive investor protection.

13. Regulators should be adopting an evidence-based approach to regulation and should seek to apply equal treatment for similar financial instruments. They must be wary of the unintended consequences of developing regulation that would have the effect of creating potential incentives for investors and issuers to move similar products off-exchange, where they are not subject to the same transparency and regulatory requirements as exchange-traded products.

IV.II Potential requirements

14. Greater transparency relating to UCITS ETFs is beneficial to foster investor protection and confidence.

15. However, the Group believes that transparency is not enough to truly protect retail investors. Considering the difficulty that the average investor may have in respect to understanding disclosed in-

formation related to characteristics and the significant systemic risks that may derive from some UCITS ETFs, the Group believes that disclosure requirements are not sufficient. Whilst disclosure about ETFs is important, it does not provide an appropriate substitute for action to eliminate conflicts of interest and set clear product-standards. Therefore, on top of greater transparency rules, according to the majority of the Group members, UCITS ETFs should also be subject to stricter regulation related to product control. Such more "interventionists" regulatory policies are currently contemplated in some of the European Union member state, as illustrated by the FSA's new product intervention policy reflecting its willingness to intervene during the product development cycle.

16. A minority of the Group members considers that the existing UCITS Directive already provides a very robust framework to mitigate the potential risks and manage conflicts of interest raised by some ETFs. They consider that existing rules are sufficient, notably in respect to the prevention and management of conflicts of interests that may arise when entities from the same group are at the same time the provider of a synthetic ETF and acts as the derivative counterparty. In addition, they believe that the potential risks related to collateral and securities lending are already well regulated – although some improvements may be appropriate – and ESMA's focus should be on establishing a level playing field with ETPs.

IV.III Retailisation of complex products (Questions 1 to 7)

17. The Group believes that the issue of marketing and sale of UCITS ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors could be solved by a common approach to these issues.

18. In general, the Group members believe that the UCITS disclosure rules and exchange listing requirements promote transparency in UCITS ETFs, but that additional disclosure is positive. However, the majority of the Group members is in favour of restrictions on the distribution even if investors understand the inherent risks by reading standardized disclosure and annual reporting of the fund.

19. Given the increasing familiarity and use of a range of investment products from structured UCITS, ETFs, CFDs, Warrants and Certificates – all of which have investment profiles which can be similar on certain dimensions, the Group suggests that any approach to marketing and solicitation rules must consider the unintended consequences of creating an unlevel playing field among all ETPs and similar financial instruments. This can be avoided if similar approaches including transparency requirements are proposed in the guidelines agreed for UCITS and those applied to regulated non-UCITS funds established or sold within the EU. However, the Group considers that such requirements should be extended to all ETPs in order to provide an appropriate level of investor protection.

20. In addition to these requirements in terms of transparency, some Group members believe it necessary to give regulators, and potentially to ESMA, increased powers in respect to the authorisation, banning[15] and regular controls of ETFs. Throughout the life of a product, regulators should continue monitoring the information that had been announced in the product's prospectus. Regulators could

[15] In the regulation setting up ESMA (regulation n°1095/2010), ESMA is entitled to ban financial activities, under certain conditions, and for a 3-month period, but with an unlimited renewal possibility (article 9). ESMA is generally required to consult the recipients of its intended decisions, but only in the case where ESMA's decisions explicitly mention a recipient (article 39), which would not apply to any generic ban or restriction of financial activities.

also, based on the assessment of the risks presented by certain ETFs, decide to ban their distribution to retail clients.

21. In order to guarantee consistency throughout the European Union, the actions taken by national regulators should be coordinated, notably through the powers of ESMA in respect to the harmonised application of the European regulations[16], and, ESMA, in addition to its own powers of intervention for banning or restricting certain financial activities[17], should also ensure a greater consistency of the bans / restrictions adopted by national regulators through the adoption of standards.

22. Other Group members support stronger powers for ESMA in relation to bans or restrictions on the distribution of products, in order to harmonise intervention in the European Union and preserve benefits of the Single Market for financial products. Consistency with other regulation (UCITS, Prospectus Directive) should also be closely considered. Above all, however, any restrictions or bans to distribution should not apply only to narrow categories of financial instruments (ETFs or subcategories of ETFs, UCITS), but be principle-based and apply to all instruments under MiFID.

23. In addition, the Group also discussed the appropriateness for regulators to forbid the distribution of synthetic ETFs to retail investors, but no definitive recommendation was reached.

IV.IV Title (Questions 8 to 10)

24. The Group agrees that UCITS ETFs should use an identifier in their names, fund rules, prospectus and marketing material as it will help investors' investment decisions. The Group also agrees that the identifier be used in the Key Investor Document as it will be a core support in the investment decision process. Some Group members support the suggestion according to which the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs.

25. In addition, the Group believes that with respect to ETFs there should be clearer labelling in the prospectus that in the event of default, consumers do not have recourse to a guarantee scheme. Similar warnings are considered important by other Group members for other ETPs and UCITS products.

IV.V Index tracking issues (Questions 11 to 15)

26. The Group agrees with ESMA's analysis of index-tracking issues, as it contributes to better transparency. A summary of the « index tracking issues » being present in the Key Investor Document (KID); or in the prospectus together with a clear reference in the KID that information on index tracking issues can be found in the prospectus can also be a beneficial disclosure transparency measure.

27. Full replication of an index can be difficult to achieve and issues relating to tracking error can be present. Synthetic or swap-based index-tracking ETFs can avoid the rebalancing costs and tracking error associated with physical replication but introduce other risks including counterparty risk. Tracking error is higher for physical replicating ETFs due to transaction costs and difficulties in buying and selling small illiquid components of the index. But although synthetic replication reduc-

[16] Articles 8.1.b and 9.5of Regulation 1095/2010
[17] Article 9 Regulation 1095/2010

es tracking error, it does not eliminate this problem entirely. Index return swaps may not always be based on the same assumptions and calculations as the main version of an index.

28. The Group believes that it is important that investors be provided with sufficient detail to understand the index tracking policy used and the types of underlying assets and strategies they are gaining exposure to. The Group fully supports ESMA's policy recommendation as to ensure that the prospectus for index-tracking UCITS ETFs contain a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index, as well as the mechanism and frequency for posting over-collateralisation.

29. Some Group members, however, would like to draw ESMA's attention on the necessity to adopt similar rules for all UCITS products, so as to avoid any kind of regulatory arbitrage.

30. Furthermore, the definition of tracking error in the 21st paragraph (page 10) of ESMA's discussion paper needs to be refined, since, according to some Group members, the tracking error is, in fact, the volatility of the difference of the returns of the fund and of the returns of the index.

31. In addition, while some Group members believe that greater disclosure requirements are sufficient to ensure a high level of investor protection, others believe the contrary. These members believe that a clear distinction should be made between the "theoretical" tracking error (determined at the moment of the creation of the product) and the "real" tracking error (related to the management of the product). The difference between these two types of tracking errors should be regularly compiled, so as to enable investors to have an accurate picture of the actual tracking error risk, throughout the life of the product.

32. In addition, regulators (and potentially ESMA) could be empowered to regularly control that the ETF adequately complies with what has been announced in its prospectus. A minority of the Group members considers that control mechanisms already exist for national regulators for ETFs but should be extended to all ETPs.

IV.VI Synthetic ETFs – counterparty risk (Questions 16 to 18)

33. The Group supports the disclosure proposals in relation to underlying exposure, counterparty(ies) and the portfolio fund.

34. The Group has diverging opinions in respect to the requirements in terms of the composition of the collateral. A minority of the Group members believe that the existing CESR's Guidelines on Risk Measurement for UCITS are sufficient, and that it is important to leave a level of flexibility to the managers of the funds. Also, some members raised the question of the interest and the benefit for the investor in the synthetic approach when the portfolio held by the synthetic ETF (or a part of it) is less liquid than that of the index tracked.

35. The majority of the Group members fully support ESMA's suggestions regarding stricter requirements in respect to the quality of the collateral. The Group agrees that liquidity is an essential factor for the quality of the collateral. The majority of the Group members believes that an appropriate way to ensure that the collateral is sufficiently liquid would be to set qualitative as well as quantitative requirements on the quality of the collateral. The Group suggests that 70% of the collateral should consist in liquid assets, that is to say listed assets such as large caps. In requiring that the majority of the collateral be made out of listed assets, the valuation issues arising in respect to the

collateral will be solved, since the valuation of 70% of the collateral will correspond to stock market prices. Furthermore, an over-collateralisation is necessary when the ETF index type and the collateral posted are not significantly correlated (for instance, are not from the same asset class). The minimum level of over-collateralisation should be explicitly stated in the prospectus. It should not be less than 5x when asset and liability match and not less than 10x when asset and liability do not match. Also collateral should be posted on a daily basis. The level of haircut should also be revised in function of market volatility.

36. In addition, the majority of the Group members believes that regulators (and potentially ESMA) should regularly control the quality of the collateral used throughout the life of the product. A minority of the Group members consider that enforcement powers already exist for national regulators for ETFs but should be extended to other ETPs.

37. Finally, the majority of the Group members believes it necessary to better regulate the risks of conflicts of interest that may arise from the dual role that entities from the same group may have as the synthetic ETF provider and as a derivative counterparty. Such a dual role should be prohibited. A minority of the Group members considers that for UCITS ETFs conflicts of interest involving the management company and other members of the same financial group are already well regulated and appropriately mitigated.

IV.VII Securities lending activities (Questions 19 to 25)

38. The majority of the Group members believe that securities lending activities are among the most critical issues in respect to ETFs (although they are not specific to UCITS ETFs). They exacerbate the risks that may derive from these products, since they add-up to the collateral risk. In fact, the securities and lending risks in respect to ETFs is particularly high because for these products the collateral and the underlying do not necessarily match. Therefore, these members suggest that lending and borrowing should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, because the risks is heightened and the tracking of the underlying is made more difficult.

39. Furthermore, they believe that the lending agent should be required to indemnify the UCITS in the case of a default of a counterparty. This indemnification requirement could also be requested in the case of physical replication ETFs.

40. However, a minority of the Group members believes that securities lending is not risky by itself, but should, nonetheless, be made more transparent to investors, through greater disclosure requirements. Securities lending is a well-established part of the investment management industry. It plays a key role in increasing liquidity in equities markets throughout the EU. That said, the level of stock lending in most markets is relatively low. For example, in the UK in June 2010, less than 5% of stock in the FTSE 100 index was out on loan. If indeed securities lending is an issue to be addressed, it should be done in a broader context and not solely around ETFs.

41. Also, some members raise a fund governance issue regarding the disclosure and the profits allocation of the securities lending activities, as the fund investors provide the funding and bear the risks.

IV.VIII Actively-managed UCITS ETFs (Questions 26 to 28)

42. The Group agrees with ESMA's proposed policy orientations. In particular, the Group believes it is important to inform investors through an explicit statement that actively-managed ETFs are not aiming to track an index, and the investment policy is under the sole discretion of the fund manager.

IV.IX Leveraged UCITS ETFs (Questions 29 to 32)

43. The Group believes that leveraged UCITS ETFs are not as easy to understand for retail investors as other forms of ETFs, and should be subject to additional disclosure requirements. In particular, some Group members consider that their title should specify that they constitute leveraged UCITS ETFs, and the level of leverage should also be disclosed, so as to ensure that investors have a real understanding of the product at stake. The word "daily" or "monthly" should also be included, as appropriate, in the identifier.

IV.X Secondary market investors (Questions 33 to 38)

44. End investors buying individual units of a UCITS ETF from a market participant on the secondary market may not be informed of the possibility to redeem directly the units (not on an individual basis from the fund, but through their regular intermediary, that is to say without having to go through a limited number of market participants selected but the UCITS ETF's issuer). Investors should be better informed of the possibility to redeem any amounts against the fund, although fees would apply.

45. In addition, in order to reinforce investor protection in case of default of the counterparty, some Group members suggests that the UCITS ETF manager should be required to pay for the difference between the collateral and the index underlying the swap. In order to enforce this requirement, it is necessary to apply a haircut on the collateral, and, as previously stated, the swap counterparty should not be from the same group as, the UCITS manager.

46. Furthermore, some Group members consider that the iNAV of an ETF should be made accessible to the retail investors, along with its order book, so that private investors have a sense of the magnitude of the difference between the ETF market bid and offer and its iNAV. Also, investors - especially retail ones who are only trading on the secondary market – should have access to information on the average and maximum bid/offer spreads, as they are an important cost element in buying or selling ETFs.

IV.XI Structured UCITS

a) Total Return Swaps (Questions 39 to 42)

47. The Group believes that policy recommendations as submitted by ESMA are adequate, as long as they respect UCITS diversification rules, and the majority of the Group members consider that the TRSwap should be over-collateralised and the collateral should be posted daily. However, a minority of the Group members has reservations regarding the ESMA's proposal to treat discretionary decisions relating to the underlying swap as delegation of investment management, and regarding the imposition of diversification rules to the swap underlying.

b) Strategy indices (Questions 43 to 46)

48. The Group broadly supports the proposed policy orientations on strategy indices as they reflect most current standards already applied and relating to, amongst others, standards applying to sufficient diversification, adequate benchmarking, transparent methodology, transparent portfolio and the right level of independence between the index provider and the asset manager. Such requirements are particularly important considering the potential complexity and risk of the model or strategy tracking the “index” on which the UCITS ETF has been built on. However, diversification rules might be difficult to implement on some benchmarks (especially bond ones representing a thin bucket of maturity) and a minority of the Group members have concerns on some details of ESMA’s proposals.