ICMA
International Capital Market Association

ASSET MANAGEMENT AND INVESTORS COUNCIL

Mr Richard Stobo
European Securities and Markets Authority
103 rue de Grenelle
75007 Paris
France

March 30, 2012

Sent by email

Dear Richard,

Consultation paper – ESMA's guidelines on ETFs and other UCITS issues

The ICMA Asset Management and Investors Council ('AMIC' or 'the Council') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concern to its broad membership, rather than having a specific product focus.

The AMIC set up following its December 2010 quarterly meeting an ETF working group to highlight issues related to the evolution of the product. The Council ETF working group noted the increased interest from the official sector and regulatory authorities in the ETF space, and supports efforts to increase understanding of ETFs and other exchange-traded products, including notes, partnerships, grantor trusts, commodity pools and other non-fund structures. The working group, composed of ETF providers and investors, published in September 2011 its report and recommendations, and responded to the ESMA discussion paper.

The AMIC welcomes the opportunity to respond to ESMA Consultation paper entitled ESMA's guidelines on ETFs and other UCITS issues.

III. 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.

Q1: Do you agree with the proposed guidelines?

The AMIC ETF working group agrees that more disclosure regarding index-tracking UCITS is needed. It believes that it will be helpful to obtain a clear description of the index and details of its underlying components, as suggested under 1a. We would, support a drive towards greater transparency for investors in relation to the underlying exposure of the index fund. We would not however recommend an overly prescriptive description and recommend that the proposed guidelines are sufficiently high-level so as not to require frequent updating.

We agree that the prospectus for any index-tracking UCITS should include information on how the index is to be tracked, the mechanism used to gain exposure to the index and the implications of using a particular method (1b). Investors would benefit from knowing how their investments are constructed.

However, members of the working group explained that a tracking error is very difficult to estimate, particularly for newly created funds or indices and should not be disclosed as this may prove misleading for investors. The figure could vary from time to time depending on a range of circumstances (including liquidity in the market, taxes applied on the underlying securities, etc.). We do agree that it is appropriate to disclose certain information concerning the tracking error of

an index tracking UCITS but this should not prescribe a UCITS policy regarding ex-ante tracking error and its target level. It would be more appropriate to disclosure of the tracking difference and/or tracking error in the KIID or through appropriate risk disclosures contained in the relevant fund's prospectus (2).

Members of the working group agree that appropriate risk disclosure of such factors is necessary (1d) whilst ensuring a level playing field in terms of disclosure by physical and synthetic-based funds.

We agree that the prospectus for any index-tracking UCITS should include information regarding the mechanism used to gain exposure to the index and the implications of using a particular method (1e).

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.

Members of the ETF working group agree that there is merit in ESMA developing further guidelines on the way that tracking error should be calculated in order to ensure consistency across products domiciled in differing Member States. However, since different investors may wish to measure tracking error in different ways in order to suit their investment needs, any decision to adopt guidelines needs to be very carefully considered.

Tracking error and tracking differences will occur in all index tracking products. In the prospectus and KIID of all index tracking UCITS there should be clear disclosure on the type of index being tracked by the UCITS, i.e. whether they are based on price return or total return (including net or gross of any withholding taxes that may apply) and how dividends are reinvested to make clear on what data the tracking difference and/or tracking error calculations are based on. It is therefore important that any rules introduced in this area be applied on a level playing field across all index tracking funds regardless of whether they track using synthetic or physical means in order to produce a result that is meaningful and consistent for investors.

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?

Yes, the comparison should be contained in the past performance chart set out in the KIID. It should take the form of a realised tracking difference (the tracking difference of the fund share class versus the benchmark performance) and the tracking error (volatility of tracking difference) to be published on a semi-annual and annual basis.

IV. Index-tracking leveraged UCITS

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

ICMA International Capital Market Association

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.

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

The AMIC ETF working group agrees with the proposed guidelines for index-tracking leveraged UCITS. Members would appreciate further clarification regarding the disclosure of the cost of leverage. Indeed the cost of any leverage is understood to be only one component of the total expense ratio (TER), and some members felt that there was only limited advantage, and potentially some commercial consequences, from offering transparency on some components of the TER in isolation.

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

Some members of the working group believe that the current definitions are appropriate. Others suggest that leveraged and/or inverse ETF should 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.

V. UCITS Exchange Traded Funds

V.II 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 tradable 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.

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)?

Yes, we agree with the proposed definition. As explained in our September 2011 report, the term 'ETF' is also used for non-UCITS ETFs. It is therefore not practicable to attempt to reserve the term 'ETF' for UCITS funds. ESMA is, of course, unable to control ex-Europe providers from using such terms in the names of their funds so the risk of confusion may still exist, although will be reduced by the proposals contained in this consultation paper.

We suggest that for clarity the definition refers to "regulated execution venue" in addition to "regulated market" and "MTF". Note that numerous funds have technical (non-trading) listings (particularly on the Irish stock exchange) which need to be distinguished from ETFs where there is a full/primary listing.

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

Please refer to our response to Q6.

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

AMIC ETF working group members believe that ESMA should be interested in the protection of the UCITS brand and it remaining a clear market of quality for investors. Further transparency as discussed earlier in our response, and in our September 2011 report, would provide relevant and useful information to investors. As noted in our response to Q1 (1b), the working group agrees that the prospectus for any index-tracking UCITS should include information on how the index is to be tracked, the mechanism used to gain exposure to the index, and the implications of using a particular method. As regards an identifier to further distinguish between synthetic and physical ETFs, members were wondering how an ETF which was partly physical, partly synthetic, for instance, may be identified in this instance. It may perhaps prove difficult to preserve clarity and simplicity by asking for the ETF's <u>name</u> to include information which is best explained in its prospectus – the name cannot be very long and therefore risks oversimplifying the true nature of the ETF, whereas the prospectus can explain all at length.

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

Yes.

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?

AMIC ETF working group members believe that there should not be a set limit on the number of market makers, as long as issuers of the ETF have in place adequate measures to ensure sufficient

liquidity in the market and therefore, that the stock exchange value of the ETF units or shares do not vary significantly from their NAV.

V.III Actively-managed UCITS ETFs

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 indicative net asset value ('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.

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 either the prospectus, the KIID or any marketing communications of the UCITS ETF?

AMIC ETF working group members agree with the proposals. One member of the working group noted that disclosure of how the indicative net asset value is calculated may not be appropriate. Accordingly the calculation may not be relevant to investors as they will buy at the offer price on an exchange. There is no guarantee that this will be close to the indicative NAV, especially where markets for the underlying securities are closed. The exchange price has economic value to market participants. In contrast, the indicative net asset value has only theoretical value which cannot be corrected by market forces if incorrect. Also, the calculation of the indicative NAV is not part of a fund manager's duties and is typically performed by an external service provider based on proprietary systems and methodologies.

V.IV 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 unit-holders 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 their shares directly from the UCITS ETF at any time.

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

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

The AMIC ETF working group members prefer Option 1.[1]

ETFs as an asset class are structured to be traded by investors on exchange in the secondary market. The main reasons behind this are:

1. Investors are able to access intraday markets. For many ETF investors this is an advantage over some cash products or traditional mutual funds which only trade once a day at a NAV level.

2. Benefits from using exchanges to conduct trading:

    - Exchanges are highly regulated trading platforms, with associated regulatory, compliance and price monitoring requirements. This provides a transparent robust platform for investors to conduct business on.

[1] In point 2 of Option 1, please note that the issuer can only work within the constraints set by the exchange and settlement system (e.g. CREST) when replacing market makers. Such entities should be consulted before any change to current requirements is implemented in case what is proposed is not viable.

- All exchanges require the presence of liquidity providers and market makers to ensure investors receive the best possible pricing. This is highly regulated by exchanges with continual price and spread performance monitoring.

- The benefit of after trade exchange process. All exchanges have highly regulated post trade process. All use a central counterpart to minimise any settlement credit risk.

3. Transparency of the product. PCFs are made available to product market makers to empower them to be able to make competitive secondary prices on the product.

Option 2 would be more appropriate for UCITS products which are not exchange traded , where there is no active secondary market and where holdings in the funds are held under a direct rather than indirect custody regime,

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.

The AMIC ETF working group members consider that the measures proposed in Option 1 are sufficient and do not believe that further investor protection measure are required.

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 de-tails on the main issues related to such certificates.

The reason behind using certificates is inconsistencies between different legal systems in the treatment of securities holdings. Many continental European Central Securities Depositaries (CSD's) cannot deal with registrars that are different to a CSD. This gave rise to the certificate model to facilitate dealing within these constraints. It should be made clear the instrument is a certificate, to eliminate any potential confusion by the investor between an ETF and a certificate issued on the ETF.

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?

In the UK registration is required at a custodian level with the register maintained by third party registrars under the indirect holding system. Elsewhere in European countries operating a direct holding system, registration is required at a beneficiary level, and held by the central securities depositaries.

VI. Efficient Portfolio Management

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. 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 hair-cut, 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.

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?

The proposed guidelines are suitable as long as they can ensure that an investment manager is able to obtain a fair remuneration as regards the administration of a securities lending platform, accompanied by both fixed and variable costs. These costs should be fully covered by the additional return associated with securities lending before additional return is provided to the fund.

Also, the draft guidelines would benefit from adaptation with regard to a number of technical aspects:

Paragraph 3: Fees arising from EPM, particularly from securities lending typically are a percentage of total securities lending revenues which depend on the amount of assets lent and the fee received on the asset lent. As both factors vary across time and are unknown in advance they cannot be disclosed as a fee in the prospectus like e.g. the management fee of fund. Securities Lending has rightly been identified as benefiting investors by reducing costs and contributing to performance. As such it is in the best interest of the UCITS to identify a securities lending provider that has the capabilities to generate additional returns whilst maintaining a low risk profile. Securities Lending is an expensive activity to run. To generate incremental returns, significant investment in research and technology is required. Especially in an OTC market, where pricing is opaque and many variables influence pricing, applying research and analytics can make a significant difference. Equally, significant investment in risk management capabilities is required to constantly review counterparties and collateral parameters. Since it may be difficult to assign costs such as risk oversight and trading tools to a specific fund, in our view a transparent revenue sharing agreement is the most appropriate way of ensuring a UCITS can benefit from securities lending. However AMIC ETF working group members believe that gross fees (look back) from lending should be easy to calculate as can be reinvested proceeds (in bps). The split of that should be disclosed.

Paragraph 4: The fee split requires further clarification. It is not clear enough in which cases the securities lending agent may be a related party to the UCITS or the investment manager (see 44. on page 17). However related parties involved in the securities lending transactions should be disclosed.

Paragraph 5: The guidelines in paragraph 5 could prevent a UCITS from entering into securities lending transaction for a fixed term. This is would not be in the interest of investors. Any potential liquidity concerns resulting from such transactions can be taken into account by imposing limits on duration or on the proportion of the UCITS' portfolio which can be subject to such transactions. A broad brush comment as suggested in paragraph 5 may even lead to liquidity mismatches.

Paragraph 6: The collateral received should comply with the CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS. However, it should be clear that a UCITS is free to accept other collateral, but that such collateral cannot be considered when calculating the 20% limit referred to in Article 52.2 of the UCITS Directive.

Paragraph 8: Cash collateral is addressed later in this response.

Paragraph 9: It should be highlighted that in practice haircuts for collateral are subject to negotiations between the involved parties. The negotiations involve economic and risk aspects. An investment manager should have the possibility to agree on margin on a bilateral basis with the counterparty taking into account its own credit risk evaluation and should therefore not be forced to take into account margin requirements of exchange-traded derivatives which follow a different approach, as proposed in the draft guidelines. However, investors would like to receive a list of securities with their haircuts.

Paragraph 10: With regards to the disclosure of the type and amount of collateral received by the UCITS to reduce counterparty exposure we would argue that in addition to the type/quality and amount of collateral as well as statistics of securities recall time, the value of the collateral received relative to the value of the securities lent (as an average over the fiscal year) is an important information for the investor. We would also consider the net securities lending revenues to the UCITS to be important.

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.

Generally speaking, the proposed guidelines should help ensure that the collateral received in the context of EPM techniques is of good quality.

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)?

AMIC ETF working group members believe that any applicable guidelines should be consistent with the rules under UCITS in respect of the reinvestment of cash collateral. In addition the possibility to re-invest cash collateral should be identical in the context of both EPM techniques and OTC derivatives. In both cases the recipient is obliged to return the cash collateral and as such, different approaches are not justified. Within conservative reinvestment parameters, cash can be a useful collateral type for investors, but requiring 'risk-free' reinvestment will reduce the viability of cash as collateral. Primary investment objectives of cash collateral should be preservation of principal and maintaining appropriate liquidity, as in the first instance the investors should be able to access their money as quickly as possible with minimal loss. AMIC ETF working group members mentioned that it potentially makes sense to publish the Weighted Average Maturity (WAM).

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.

AMIC ETF working group members note that the CESR Guidelines on Risk Measurement for UCITS (box 26) already address the issue of the quality of assets. Collateral is only functional in the funds/investors hands when there is a counterparty default. The correlation proposal implies that the fund/investor remains exposed to the collateral holdings over an extended time period. The objective of collateral is to cover counterparty risk. For this objective the quality of assets – as set out in the CESR guidelines - should be the main criteria. A high correlation between the collateral and the composition of the UCITS' portfolio may in fact be problematic. In case of a counterparty default the collateral will be liquidated and the proceeds will be used to buy the loaned securities in the market. Most important is therefore that the collateral is liquid and the sale of collateral and the purchase of the securities can take place simultaneously.

The working group also notes for example, that the European Markets Infrastructure Regulation (EMIR) does not require collateral to mirror the underlying index or instrument. Rather, the EMIR requirements reflect the purpose of collateral.

Therefore members do not believe that a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio is helpful. In fact the emphasis should be on having collateral which is highly liquid. The suggestion in Q19 implies that ESMA see some connection between the collateral held and the economic exposure of the underlying positions when in fact there is no connection between the two. The collateral serves one purpose and one only: to protect the collateral holder against the consequences of counterparty default – and working members see no reason why this should require or benefit from a correlation with the economic exposures of the ETF.

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?

AMIC ETF working group members do agree that collateral should be sufficiently diversified to meet its prime function as explained in Q19, but do not believe that the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules. The assets of the UCITS (whether lent or not) and the collateral received must be viewed and treated separately as the collateral is not part of the UCITS asset portfolio. Rather, the collateral is the insurance against the likelihood that the securities lending counterparty defaults, and therefore the liquidity and quality of the collateral are of a higher importance than diversification rules. It would not be in the interest of the investors to be forced to accept less liquid collateral in order to adhere to 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?

AMIC ETF working group members favour a list of qualitative criteria as set out in CESR's guidelines on risk and measurement. An indicative list could be interpreted differently by regulators, and may become static and as a result easily outdated. A list of examples may also be useful, but it should not be exhaustive. Faced with these challenges, AMIC ETF members noted

that the key point is to publish the actual collateral on a fairly regular basis, which should be technically feasible.

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 as-sets in paragraph 52 is appropriate.

Please see response to Q21 above. As indicated previously, the focus should be on liquidity. An exhaustive list of assets may not reflect current market conditions in terms of liquidity.

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?

Such an approach would create a contradiction between these guidelines and existing CESR guidelines. CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (July 2010) already provides that any net exposure to a counterparty generated through a stock-lending or repurchase agreement must (also) be included when calculating the issuer concentration limits of 20% specified in Art. 52 para 2 of the UCITS Directive. Such fact has already been highlighted in no. 46, on page 18 of this consultation paper.

The counterparty risk created by EPM techniques should not fall under the counterparty risk as defined in Art. 52 para. 1 of the UCITS-Directive but should rather fall under Art. 52 para. 2. 2nd sub-paragraph (c) of the UCITS-Directive.

In the context of this question, members also raised an issue related to the current UCITS Directive and its position regarding counterparty limits of OTC derivatives and central clearing. In short, the counterparty limits included in the UCITS Directive reflect the bilateral world of OTC derivatives, but are not drafted in anticipation of new legislative measures encouraging derivatives being executed on an OTC basis but subject to clearing. UCITS funds have a regulatory 5% limit on their exposure to a single counterparty on OTC derivatives (raised to 10% for exposures to a credit institution). Under Article 52 of the UCITS Directive OTC derivatives that are subject to clearing are not distinguished from those which are not. Clarity is needed as to which counterparty will be taken into account as regards the 5% (raised to 10% for exposures to a credit institution) limit, and AMIC ETF working group members believe that in fact this limit should be removed for any exposure to a clearing house. This consultation provides an opportunity for ESMA to clarify the issue of clearing house exposures. AMIC ETF working group members believe that exposures should not be subject to a 5% (or 10%) limit and that provided that the fund is insulated against clearing member risks (e.g. perhaps by some form of proper segregation of client assets or by effective porting arrangements etc). There is therefore an urgent need for ESMA to clarify the application of counterparty limits in the context of central clearing.

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

The AMIC ETF working group members 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?

No, we do not consider that it is appropriate for ESMA to prescribe such a limit. Within appropriate collateral parameters, over-collateralisation and a robust counterparty approval an monitoring process securities lending can be performed in a low risk manner that does not require it being limited at the fund or counterparty level. It is key that sufficient collateral is posted and it is of sufficient good quality as this would only serve to limit the benefits and hence performance in the ands of investors.

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

In the European market UCITS rules currently do not impose a limit on Securities Lending activities. AMIC ETF working group members understand that funds control risk through a combination of counterparty selection, continuous counterparty limits can be reduced quickly and levels of over-collateralisation can be increased. Therefore it is difficult to outline what the current market practice is, as it will vary between providers.

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)?

Please see our responses to Q25 and Q26.

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?

Provided the information is disclosed in the fund prospectus AMIC ETF working group members do not see the need to repeat the information in another document. Members would welcome a clarification regarding '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?

Requiring disclosure of counterparties once a year in the annual report is sufficient in our view. Counterparties need to be monitored on a regular basis by compliance and credit risk and actions need to be taken on an ad-hoc basis if requirements of the credit risk policy are no longer fulfilled.

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.

This risk is already dealt with by the conflicts of interest policy, and AMIC ETF working group members would in any case expect this risk to be fully disclosed to investors within the prospectus. It would be advisable that each of the collateral manager and custodian are independent from the counterparty.

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.

AMIC ETF working group members believe that the duties of a UCITS management or fund board for a self-managed UCITS include implementing an effective conflict of interest policy and implement a risk management policy whether an automated stock selection process is in place or not – if this is how 'automation of portfolio management' is defined.

VII. 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 counter-party 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 ac-count 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.

Q32: Do you agree with the proposed guidelines?

AMIC ETF working group members do not agree with paragraph 2 for the reasons set out in our response to Q20 regarding collateral diversification.

In paragraph 5, AMIC ETF working group members understand that during the lifetime of a fund the requested information changes often and, for example, counterparties may change due to economic reasons; therefore a more flexible approach has been suggested to provide relevant information to investors.

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.

Generally speaking yes, we would however refer to our response to Q19.

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?

Please see our response to Q28.

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?

Please see our response to Q21.

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 as-sets in paragraph 73 is appropriate.

Please see our response to Q22.

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?

Please see our response to Q20.

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?

AMIC ETF working group members do not see particular issues with a standard application to all OTC derivatives assuming that FX trades are not treated as OTC derivatives as different market standards apply here. Please see our response to Q20 regarding collateral diversification.

VIII. 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;

ICMA
International Capital Market Association

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 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.

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

The guidelines would benefit from a clear definition of 'strategy index' and 'UCITS which replicates strategy indices'. We understand that there is commercially sensitive information that providers may not wish to disclose. For anything other than full replication strategies (for example indexing via stratified sampling or optimisation), the indexing method is considered the core of the intellectual capital of an index manager. AMIC ETF working group members believe the emphasis should be on investors being able to understand that there are firm rules and methodologies in place to ensure the integrity of the index, rather than enabling investors to replicate the strategy.

We note in paragraph 7 that some for the requirements, if they extend to real time disclosure of full index constituents, may not be supported by some index providers and that accordingly disclosure with an appropriate time delay may be more appropriate. It is not in the interests of investors to reduce the diversity of UCITS available to them. Similarly in paragraph 9 AMIC ETF working group members are concerned that if this guideline is applied in a narrow sense it may exclude most popular market indices.

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?

AMIC ETF working group members believe that there should be clearly documented conflicts of interest policy. In addition it sees merit in index being calculated by an independent party.

IX. 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) un-invested cash collateral should comply with Box 6 paragraph 7and 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).

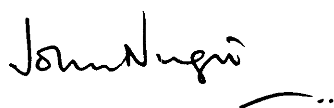
6. Requirements to publish information in the report and accounts of an existing UCITS do not apply in respect of any accounting period that has ended before XX 2012.

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

AMIC ETF working group members believe that implementation phase should take into account practical considerations for providers to implement fully the new requirements, and ensure orderly conduct of the market. Existing investors should however be permitted to continue to make further subscriptions into a sub-fund that does not comply with the new guidelines. It would be prejudicial to their interests if they were not permitted to manage their holdings by making further subscriptions over the life of the UCITS. In particular, large proportions of the fund investor base are actively allocating on behalf of several portfolios across multiple funds and therefore need to be able to make regular subscriptions and redemptions. It is not sufficient merely to allow existing investments to retain their existing holdings without this flexibility.

The AMIC, and the ETF Working group. would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,



John Nugée
Chairman of the ETF WG