Setting the global standard for investment professionals

CFA Institute
Square de Meeus 38/40
1000 Brussels
Belgium

Interest Representative
Register ID (EC register):
ID 89854211497-57

Mr Steven Maijoor
Chair
European Securities and Markets Authority (ESMA)
103, rue de Grenelle
75007 Paris
France

Brussels, 22 September 2011

Re: ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS (Undertakings for Collective Investment in transferable Securities)

Dear Mr. Maijoor,

CFA Institute[1] is pleased to comment on the discussion paper for *ESMA's policy orientations on guidelines for UCITS Exchange Traded Funds and Structured UCITS* (the "paper"). CFA Institute's mission is to lead the investment profession globally by setting high standards of education, integrity, and professional excellence. CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency and integrity of global financial markets.

Executive Summary

ESMA states that it has started "working on the development of guidelines applicable to UCITS, ETFs and structured UCITS" and examining "possible measures that could be introduced to mitigate the risk that particularly complex products, which may be difficult to understand and evaluate, are made to retail investors". CFA Institute applauds these efforts, as this investor protection objective is consistent with the commitment of CFA Institute and its more than 107,000 members to protecting investors and putting the interests of clients first. This commitment is reflected throughout the CFA Institute Code of Ethics and Standards of Professional Conduct[2]. In our view, the developments of such guidelines fully fall in ESMA's mission.

[1] CFA Institute is a global, not-for-profit professional association of over 107,000 investment analysts, advisers, portfolio managers, and other investment professionals in 137 countries, of whom almost 96,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

[2] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1

Square De Meeûs 38/40
1000 Brussels
Belgium

+32 (0)2 401 68 28 tel
+32 (0)2 401 61 18 fax
info@cfainstitute.org
www.cfainstitute.org

CFA INSTITUTE

CFA Institute is nevertheless worried by ESMA's particular focus in this discussion paper on the protection of retail investors. We are fully aware that, contrary to Alternative Investments Funds ("AIFs") falling under the Alternative Investment Fund Managers Directive ("AIFMD"), UCITS products may be sold to retail investors. We also strongly believe that, in the case of UCITS, ETFS and structured UCITS, particular attention must be paid to the protection of retail investors, notably to avoid mis-selling. However, while we salute the fact that enhanced investor protection measures for UCITS ETFs and structured UCITS will benefit retail and institutional investors alike, it should not be forgotten that about 80% of the money invested in European ETFs comes from institutional investors[3]. It is because of the scale of their investments in ETFs that such products today pose a systemic risk for global financial markets. In particular, the fact that investments in synthetic ETFs have been growing so fast that they now represent about 45% of the total amount invested in ETFs in Europe[4] is a cause of concern to CFA Institute, because of the systemic risk implications.

CFA Institute believes that regulators worldwide should work hard and in a coordinated manner to better appreciate the systemic risk caused by ETFs and mitigate it. We believe that protection of retail and institutional investors in UCITS ETFS and structured UCITS can help mitigate the systemic risk posed by these complex products. That is the reason we strongly advise ESMA to not forget that its objective on should be the protection of retail and institutional investors alike.

Specific Questions

II. General policy discussion

1. 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.

A key concern of CFA Institute is mis-selling of financial products to investors. In a poll that CFA Institute conducted among its membership in January 2011 and to which 5,735 CFA Institute members responded, "mis-selling of products by financial advisers" was reported as the most serious ethical issue facing the respondents' local market[5].

CFA Institute does not believe it is appropriate for synthetic ETFs and structured UCITS to qualify like all other UCITS products as "non-complex products" under MiFID Article 19(6). The complexity of synthetic and structured UCITS ETFs and the implications this qualification as "non-complex products" currently has, is troublesome because:

(i) it allows synthetic ETFs and structured UCITS to be sold to retail investors on an "execution-only" basis, meaning that the product can be sold without a prior "appropriateness test" (as defined under MiFID). The purpose of this test is to prevent complex products from being sold to retail clients who do not have the experience and/or knowledge to understand the risk of such products; and

(ii) requirements in terms of disclosures to investors are limited.

All CFA Institute members and CFA candidates must abide by the Code of Ethics and Standards of Professional Conduct, and violations may result in disciplinary sanctions by CFA Institute.

[3] Source: Bank of International settlements Working Paper: "Market structures and systemic risks of exchange-traded funds" (April 2011)

[4] Source: BalckRock, 2010 figures

[5] http://www.cfainstitute.org/Survey/financial_market_integrity_outlook_2011.pdf

CFA INSTITUTE

As a result, CFA Institute believes that retails investors' protection in regards to UCITS ETFS and structured UCITS is currently insufficient, and that the risk of mis-selling is significant.

In our view, two options exist to enhance the protection of retail investors:

(i) limiting the distribution of synthetic ETFs and structured UCITS to retail investors;
(ii) not limiting the distribution of synthetic ETFs and structured UCITS to retail investors, but significantly increasing the disclosure requirements of marketers of such products and of investment advisers.

Synthetic ETFs, when compared with plain vanilla ETFs using physical replication, provide significant advantages to investors. First, they widen the investment spectrum. They also often offer lower costs (and therefore higher returns) and lower tracking error in the case of index-tracking ETFs. In the view of the CFA Institute, retail investors should have access to these products and their associated benefits. We therefore oppose limiting the sale of these products to retail investors, provided that they are adequately protected.

As indicated earlier, we do not believe it is appropriate for synthetic ETFs and structured UCITS to qualify like all other UCITS products as "non-complex products" under MiFID Article 19(6). We would therefore support aligning the marketing obligations of investment firms when selling synthetic ETFs and structured UCITS consistent with the marketing obligations applying to products qualifying as "non-complex" under MiFID Article 19(6). This would mean that the sale of synthetic ETFs and structured UCITS on an "execution-only" basis should be limited, as retail investors considering buying synthetic ETFS and structured UCITS should be subject to the "appropriateness test" applying to all products that do not qualify as "non-complex." Through this appropriateness test, defined under MiFID Article 19(5), the sale of complex products to retail clients who do not have the experience and/or knowledge to understand the risk of such products should be prevented and the risk of mis-selling reduced.

To protect investors' interests, CFA Institute believes that it is also necessary to significantly improve disclosures to investors on the characteristics and risks of synthetic ETFS and structured UCITS. We will specify what these disclosures should cover below, in our answers to ESMA's further questions in this discussion paper. We note that retail and institutional investors alike would greatly benefit from these enhanced disclosures and improved transparency.

2. 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'?

As explained above, CFA Institute does not believe that it is appropriate for synthetic UCITS ETFs and structured UCITS to qualify like all other UCITS products as "non-complex products" under MiFID Article 19(6), given their complexity.

CFA Institute would support ESMA if it were to create a new type of UCITS products, called "complex" UCITS (versus the existing "non complex" UCITS), to which additional requirements in terms of marketing and disclosure would apply. Another possibility would be to create a completely new framework to regulate such products, outside the UCITS framework and outside the AIFMD framework, since AIFs are sold to professional investors.

CFA Institute believes that because many requirements under UCITS should apply indifferently between "non-complex" and "complex" investment products (notably in terms of organization and registration requirements), the most efficient solution would be to add requirements in terms of marketing and disclosure to UCITS products considered "complex," in particular synthetic ETF and structured UCITS.

CFA INSTITUTE

As regards the criteria that should be used to determine if an UCITS should fall under the "complex" qualification, CFA Institute believes that further thinking and consultation by ESMA will be necessary, but would invite ESMA to consider a combination of all or several of the following characteristics:

- use of leverage;
- exposure to a collateral that is different from the index/basket of securities being tracked;
- use of a synthetic strategy (instead of physical replication) to gain exposure to certain assets;
- significant use of derivatives and securities lending (level to be defined).

Notwithstanding the above, CFA Institute notes that MiFID requires that firms provide "appropriate information" in a "comprehensible form" about any MiFID "financial instruments and proposed investment strategies" (whether complex or not complex). This requirement extends to "appropriate guidance on and warnings of risks associated with investments in those instruments or in respect of particular investment strategies" so that clients are "reasonably able to understand the nature and risks of the investment service and of the specific type of financial instrument that is being offered."

CFA Institute also wishes to note the fact that stopping to brand some complex ETF products as "non-complex" UCITS products would also have significant consequences on both the due diligence obligations of a certain number of professional investors and the willingness of some professional investors to conduct adequate due diligence. This is particularly important for the assessment of counterparty and collateral risks.

3. 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?

As stated above, CFA Institute believes that limiting the sale of complex UCITS to retail investors is not appropriate. Educated retail investors should be allowed to buy complex products, notably because (i) it broadens their investment opportunities, and (ii) it allows them, for some products, to benefit from lower fees and, therefore, higher returns.

At the same time and as detailed in our answer to Question 1, the sale of complex products to retail investors should be subject to strengthened marketing obligations and improved disclosures. CFA Institute believes that retail and professional investors alike would greatly benefit from greater transparency on the characteristics and risks of complex UCITS.

In order to draw the attention of investors to the risks associated with complex ETFs and increase the overall awareness of investors towards these risks, CFA Institute believes that ESMA should use its power to issue warnings. CFA Institute believes that ESMA should not distinguish between retail and professional investors in these warnings.

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

As discussed above, the CFA Institute believes that complex products such as synthetic ETFs and highly structured UCITS do not respect the "non-complex product" qualification given by UCITS. But neither would such products qualify as AIFs since they can be sold to retail investors as well as to professional investors.

Given that the general UCITS framework is appropriate in many regards to all UCITS, including complex UCITS - notably in terms of registration - and in order to not introduce further confusion among investors, CFA Institute believes that these products should still qualify as UCITS. However,

CFA INSTITUTE

they should qualify as "complex" UCITS which would carry additional requirements in terms of marketing and disclosures.

5. 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.

ESMA's suggestion to create a new category of "complex" UCITS products addresses only those UCITS, ETFs and structured UCITS which can be sold to retail investors.

The risk is in an attempt to avoid the additional regulatory requirements associated with "complex" UCITS products, marketers of ETFs would create synthetic and structured ETFs sold only to professional investors and qualifying under the AIFMD framework. While strengthening marketing requirements for products sold to professional investors may not be relevant, CFA Institute nevertheless believes it is essential for professional investors to also have access to high-quality information about the counterparty and collateral characteristics of the synthetic and structured ETFS they purchase. Such information is needed for them to be able to conduct their own due diligence, assess the various risks that the products they are investing in carry, and to fulfill their own obligations towards their investors. Such activities would fall under the requirements of Article 15(2) of the AIFMD.

CFA Institute therefore believes that some of the guidelines agreed for "complex" UCITS should also apply to regulated non-UCITS funds established or sold within the European Union.

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

CFA Institute has long been supporting regulations that help create an even playing field in capital markets. We would therefore support policy recommendations from ESMA which would contribute to reducing or eliminating regulatory gaps that could harm European investors and markets.

One example of different regulatory treatment leading to regulatory arbitrage identified by the Bank of International Settlements relates to equities posted as collateral. In Ireland, such collateral is subject to a 20% haircut, whereas in Luxembourg the fund custodian and the fund management company negotiate the haircut. The result is that that UCITS-compliant ETFs that are synthetically replicated tend to be registered in Luxembourg. (*Source: BIS working paper "Market structures and systemic risks of ETFs" April 2011*).

III. Exchange Traded Funds

III.I. Title

7. 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.

CFA Institute agrees that UCITS ETFs should include an identifier in their names, fund rules, prospectus and marketing material. We believe that this identifier should be simple and should enable the investor to understand immediately which type of product he/she is buying. We therefore consider

that this identifier should include the three letters ETF, which are commonly known as meaning exchange-traded fund.

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

We do not believe that the identifier should further distinguish between synthetic, physical and actively managed ETFs because doing so would make the identifier too complicated.

However, we believe that this distinction should be made at a very high level in all such funds' documents (prospectus, fund rules, marketing material), so that investors considering buying such a product would immediately be made aware of their structure.

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

Yes, it should be included in the KIID.

III.II. Index-tracking issues

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

ESMA identifies the main index-tracking issues as being the following:

- Index-tracking ETFs track a broad range of indices either by directly investing in all securities of that index or a representative sample of those securities (physical replication), (or by holding a basket of securities as collateral and exchanging the performance of these securities with a counterparty in return for the performance of the index (synthetic replication).
- In the case of physical replication, full replication may be difficult to achieve and involve significant transaction costs, particularly for indices with a large number of constituent parts, some of which may need to be purchased or sold in small amounts.
- Physical replication also results in higher tracking error, because of transaction costs and difficulties in buying and selling illiquid components of the index. The use of a sampling strategy when it is not possible or too costly to faithfully replicate the index also involves a higher degree of tracking error.
- Synthetic or swap-based index tracking ETFs avoid the high rebalancing costs and reduce the tracking error associated with physical replication but introduce other risks such as counterparty risk.
- The UCITS' prospectus may not currently provide sufficient information to investors on (i) the components of the index being tracked, (ii) the replication mechanism being used (physical or synthetic), and (iii) the sampling method used, if any.

CFA Institute agrees with ESMA's analysis of the main index-tracking issues. However, we believe that a significant risk not mentioned is the risk associated with holding collateral that is not composed of securities held in the tracked index.

In such circumstances, there is an incentive for banks to sell synthetic ETFs through their asset management branches in order to raise funding against illiquid portfolios of securities which could not otherwise be financed in the repo market, or at a significant haircut. In the case of market disruption, high redemption calls and failure of the swap counterparty, the ETFs will seek to liquidate the

collateral held to meet redemptions. These kinds of circumstances create risk that the less-liquid securities held as collateral would have difficulty finding buyers willing to pay prices that would enable the ETF to redeem the shares at NAV. The liquidity risk associated with collateral composed of securities not following the tracked index is, therefore, significant.

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

ESMA's proposal is to require 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, including:

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

CFA Institute believes that this information should indeed be provided to investors in the prospectus. However, we also feel that information on the risks associated with one or another ETF structure should also be disclosed and explained. In particular, such disclosures should notably include information about the counterparty risks when a derivative is embedded in the ETF. It also should describe the collateral/liquidity risk when the collateral held by the ETF is different from the securities included in the index tracked.

12. 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?

The Key Investor Information Document (KIID) for UCITS is a one-page document. Its standardized format and content allow investors to compare the main characteristics of an UCITS fund. We believe that this KIID is a success of UCITS regulations, as it allows investors to effectively compare different funds and make an informed decision before buying or selling.

We believe that the KID should reflect the index-tracking issues discussed above. As it is impossible to include all the above information in a one page document for which the format is already pre-defined, we believe the KIID should only include the characteristics that an investor should be aware of "at first sight".

13. Are there any other index tracking issues that ESMA should consider?

14. If yes, can you suggest possible actions or safeguards ESMA should adopt?

Under UCITS 3, the collateral held by UCITS ETFs may differ from the securities held in the index being tracked. The only restriction is that the collateral should be selected among OECD equities and bonds.

In the case of market disruption in a certain asset class, high redemption calls, or the failure of a swap counterparty in synthetic ETFs, there is a risk of increased correlation between sectors and asset classes as synthetic ETFS seek to sell the various types of securities held as collateral. This could contribute to systemic risk.

CFA Institute is worried by the conflict of interest arising from the dual role of a bank acting as ETF provider and derivative counterparty. Entering into a derivative transaction with an ETF for this purpose may enable a bank to raise funds against an illiquid portfolio of bonds and stocks that would otherwise be difficult to finance in the repo market, at least not without significant haircuts. This could create an incentive for banks' asset management divisions, who are responsible for creating synthetic ETFs for this purpose. CFA Institute believes such conflicts of interest should be clearly disclosed to investors.

CFA Institute also is concerned with two other risks carried by synthetic ETFs created with derivatives. In particular, such structures subject investors to contango risk and backwardation risk.

- Contango risk is the result of the need for an ETF to cash in any expiring derivatives contracts and to purchase others that will expire months in the future. The value of a derivatives contract at expiration typically tracks closely with the value of the underlying reference asset. Derivatives contracts with longer durations, however, often are priced above the current market value to reflect the potential for an increase in price before expiration. Consequently, when the ETF provider cashes in an expiring contract, it receives less cash than it will cost to purchase a replacement contract. The loss from this exchange will be passed on to the investors in the ETF.
- Backwardation risk is the opposite of contango risk. In backwardation risk, the cash price for the reference asset at expiration is greater than the futures price on the reference asset for some period in the future. This type of a risk would be detrimental to investors who are invested in inverse ETFs that are betting on declines in market prices.

CFA Institute believes ETFs also should have to disclose and describe the potential for these risks, as well.

III.III. Synthetic ETFs – counterparty risk

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

CFA Institute notes that information obligations towards investors in the Key Investor Information Document as described in the Level 1 Directive 2009/65/EC have been the subject of detailed obligations in Regulation 583/2010 implementing Directive 2009/65/EC. This has not been the case for information obligations towards investors in the prospectus and the annual report, which may explain why a higher level of detail in those requirements is now necessary.

In Article 70 of Directive 2009/65/EC on information requirements in the prospectus, those requirements pertinent to the synthetic ETF structure are limited to the following:

> *"1. It (the prospectus) shall mention if transactions in financial derivative instruments are authorised, in which case it shall include a prominent statement indicating whether those operations may be carried out for the purpose of hedging or with the aim of meeting*

investment goals, and the possible outcome of the use of financial derivative instruments on the risk profile.

2. Where a UCITS invests principally in any category of assets defined in Article 50 other than transferable securities or money market instruments, or where a UCITS replicates a stock or debt securities index in accordance with Article 53, its prospectus and, where necessary, marketing communications shall include a prominent statement drawing attention to the investment policy.

3. Where the net asset value of a UCITS is likely to have a high volatility due to its portfolio composition or the portfolio management techniques that may be used, its prospectus and, where necessary, marketing communications shall include a prominent statement drawing attention to that characteristic."

CFA Institute agrees that the above information requirements are insufficient for synthetic ETFs and should be made more specific.

In this discussion paper, ESMA suggests that information provided to investors in the prospectus of synthetic ETFs should include at least the following:

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

CFA Institute believes that information requirements on the collateral should be more specific and should consider: the type of collateral; the credit quality and liquidity of the collateral; valuation practices; and the segregation of assets.

ESMA suggests that the annual report contain "details of the following:

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

CFA Institute believes that the annual report should also give an indication of the credit quality of the counterparties to derivatives and specific information on the collateral held (see Question 15).

16. 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.

The collateral received by an UCITS ETFs may consist of securities different from the securities in the index the ETF is tracking. Currently, the investment manager of the ETF may select this collateral among OECD equities and bonds. CFA Institute does not object to investment managers engaging in such activities, so long as there is clear disclosure as to the type of collateral to be used and so long as the manager does not seek to mislead potential investors through marketing or other means.

At the suggestion of the members of our global Capital Markets Policy Council[6], CFA Institute would like to draw ESMA's attention to the existing US regulation on this issue, which differs from the UCITS regulation. In particular, one of the requirements under the 1940 Investment Company Act in the United States is a requirement that funds hold at least 80% of their assets in securities matching the fund's name. This provision came into force in July 2002.

---

[6] For a description of the Council's role and its composition, please see http://www.cfainstitute.org/about/governance/committees/Pages/capital_markets_policy_council.aspx

As explained on the SEC website[7]:

> "*The SEC is adopting a new rule under the Investment Company Act of 1940 to address certain broad categories of investment company names that are likely to mislead investors about an investment company's investments and risks. The rule requires a registered investment company with a name suggesting that the company focuses on a particular type of investment (e.g., an investment company that calls itself the ABC Stock Fund, the XYZ Bond Fund, or the QRS U.S. Government Fund) to invest at least 80% of its assets in the type of investment suggested by its name. The rule also would address names suggesting that an investment company focuses its investments in a particular country or geographic region, names indicating that a company's distributions are exempt from income tax, and names suggesting that a company or its shares are guaranteed or approved by the United States government..... An investment company seeking maximum flexibility with respect to its investments would be free to select a name that does not connote a particular investment emphasis*."

One cannot be fully confident that this rule will systematically result in a reduced mismatch between the collateral held and the index being tracked since the rule provides for "maximum flexibility." However, this rule prevents specifically misleading the investor by virtue of a fund's name, and is therefore worth considering by ESMA.

As explained under Question 15, CFA Institute also believes that more detailed information on the assets comprising the collateral has to be provided. We also believe that investors should be informed of the circumstances in which the ETF would seek to liquidate the collateral, and what may be the possible obstacles.

In particular, investors should be made aware that the ETF will have access to the collateral only after a default by the counterparty in the swap. As counterparties in such swaps are typically banks, a failure by a bank may mean: (i) serious disruptions in the market; (ii) downward pressure of the value of the collateral; and/or (iii) reduced liquidity. As a consequence, it may be difficult for the ETF to sell the securities held as collateral at a price close to their NAV- meaning losses for the investors.

The risk of this "chain" of events materializing should be explained to investors. In those cases where the collateral is held in a custodian account to which the ETF has legal claims but not direct ownership, this also should be disclosed to investors to make them aware that orderly liquidation of collateral may be cumbersome.

17. In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

The two main UCITS diversification rules are:

- no individual body may represent more than 20% of a fund's net asset value (this figure can be relaxed at the national regulator's discretion to 35%, provided other concentration limits are respected)
- maximum 5% of a fund's net asset value may be invested in transferrable securities or money market instruments issued by the same body (this figure can be relaxed at the national regulator's discretion to 10%, provided other concentration limits are respected)

The objective of these rules is to reduce the risk of investments through diversification of the portfolio. Since in the case of synthetic ETFs direct investments are replaced by collateral, the same

[7] http://www.sec.gov/rules/final/ic-24828.htm

diversification rules should, in our opinion, logically apply to the collateral in order enhance the risk profile of the collateral.

III.IV. Securities lending activities

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

In general, CFA Institute agrees with ESMA's analysis of the issues raised by securities lending activities. In particular, CFA Institute agrees that the level of disclosures to investors on the use of securities lending is currently insufficient. We also believe that securities lending transactions introduce a collateral risk.

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

ESMA's policy orientations are:

- "*A UCITS ETF should clearly inform investors in the prospectus of the intention to engage in securities lending. This should include a detailed description of the risks involved in this activity including counterparty risk and the impact securities lending will have on tracking error for index-tracking ETFs.*
- *The prospectus should also clearly inform investors of policy in relation to collateral. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks attached to the re-investment policy.*
- *The extent to which fees arising from securities lending are earned by the UCITS ETF should be disclosed. Where an UCITS ETF engages in fee-sharing arrangements in relation to securities lending, this should be clearly disclosed, together with the maximum percentage of fees payable to the securities lending agent or other third party.*
- *Where the securities lending agent is the investment manager or a connected party to the manager/investment manager this should also be disclosed.*
- *Collateral received in the context of securities lending activities should comply with the criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement.*"

The first three policy orientations identified by ESMA are aiming at improving the level of information provided to investors on the ETFs' use of securities lending, the implications and ensuing risks. CFA Institute supports this as it will allow investors to do their own due diligence and make informed investment decisions.

CFA Institute believes that the disclosure on the allocation of fees received in the framework of securities lending is particularly important and should be written in a manner easily understandable by investors. In particular, we believe that transparency about fees enhances investors' awareness and creates an incentive for the ETF manager to enter into securities lending transactions that are truly beneficial to investors in the ETF.

ESMA's 4th recommendation raises another question to CFA Institute. The situation described by this recommendation - "*securities lending agent is the investment manager or a connected party to the manager/investment manager*- is in our view a conflict of interest. There is indeed a conflict of interest when the investment manager of the ETF enters into securities lending with an entity that belongs to the same group. This may mean that the ETF investment manager is not acting in the best interest of the investors when (i) accepting to lend some securities against possibly lower-quality collateral, and (ii) when entering into fee-sharing arrangements with the securities lending agent, which may be a related party to the UCITS and the investment manager.

As emphasized in CFA Institute's Code of Ethics and Standards of Professional Conduct8, best practice is to avoid conflicts of interests. When this is not possible, we believe that such conflicts of interests should be clearly and prominently disclosed to investors.

20. 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.

We believe that information disclosed to investors on collateral should be more specific and notably describe: (i) the type of collateral; (ii) the credit quality and liquidity of the collateral; (iii) valuation practices; and (iv) the segregation of assets.

21. 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.

It seems illogical that the criteria for collateral received by UCITS in the case of OTC derivative transactions set out in CESR Guidelines on Risk Measurement do not also apply to collateral received as part of securities lending transactions since the risks are similar. We would therefore support applying collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral.

22. 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?

There is currently no limit in the UCITS regulation on the amount of a UCITS portfolio which can be on loan. However, while boosting potential returns, this lack of limits also significantly increases the risks for investors that aggressive share lending could backfire to the detriment of ETF investors.

To avoid such circumstances, we urge ESMA to review and consider rules similar to those in U.S. regulations, which limit how much of their portfolios mutual funds can lend. .

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

When an ETF provider engages into aggressive securities lending, it may have difficulty recalling the lent shares for liquidation to meet for example large redemption calls. In the case of serious market disruption, falling securities prices and large redemption calls, by the time the ETF recovers the securities it has lent and sells them, their value may have significantly dropped, resulting in a loss for investors.

24. If yes, can you suggest possible actions or safeguards ESMA should adopt?

The liquidity risk associated with securities lending described under Question 24 should be disclosed to the investors.

---

[8] http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2010.n14.1
All CFA Institute members (currently more than 107,000 members) and CFA candidates must abide by the Code of Ethics and Standards of Professional Conduct, and violations may result in disciplinary sanctions by CFA Institute.

CFA INSTITUTE

III.V. Actively managed UCITS ETFs

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

Actively managed UCITS ETFs do not aim to replicate the performance of an index like the majority of UCITS ETFS which are passively managed. Rather, their intention is to outperform an index or other benchmark.

In the interest of investors, CFA Institute agrees that disclosure requirements should be strengthened for actively managed UCITS ETFs. Notably, CFA Institute agrees that the UCITS ETF should clearly inform investors of the fact that it is not an index tracker, but that it is actively managed. It also should indicate how it will meet with the stated investment policy including any intention to outperform an index.

CFA Institute also agrees that actively managed UCITS ETFs should inform investors about the main sources of risks due to the investment strategy. Besides describing the policy regarding portfolio transparency and where the information on the composition of the portfolio can be obtained, CFA Institute recommends that the prospectus should explicitly indicate what type of securities the fund is likely to buy. This is needed because investors may not realize that an ETF will not invest at all or solely in securities which are constituting the index it is tracking. Mandating such disclosures for the securities potentially held by the fund should help avoiding this type of misunderstanding.

Finally, we believe ETFs also should disclose which type of transactions (derivatives, securities lending or otherwise) they are contemplating. The risks associated with the nature of the securities the fund is contemplating buying and the nature of the transactions it is considering entering into should also be disclosed.

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

27. If yes, can you suggest possible actions or safeguards ESMA should adopt?

See our reply under Question 25.

III.VI. Leveraged UCITS ETFs

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

CFA Institute agrees with ESMA recommendation that prospectuses of leveraged UCITS ETFs should disclose any leverage policies, how such policies are achieved, and the risks associated with their policies. It should notably explain in clear terms that investors are exposing themselves to losses that could be 2 or 3 times the loss in the market. In our view, particular attention should also be paid to informing the investors of the use of derivatives and the risks associated with such strategies, notably in terms of counterparty risk and collateral access and liquidity.

CFA Institute also agrees that the impact of reverse leverage, i.e. short exposure, should be disclosed to investors. Such disclosures should be made in simple terms that alert investors to the possibility that while their losses in a long strategy are limited to the value of the securities held at the time they were purchased, losses in a short strategy are potentially unlimited.

30. Are there any other issues in relation to leveraged UCITS ETFs that ESMA should consider?

CFA INSTITUTE

As long as the concerns and recommendations outlined by CFA Institute in its above answers to ESMA's questions (notably in terms of management of counterparty risk, collateral risk, disclosures obligations….) are also addressed for leveraged UCITS ETFs, CFA Institute believes that there is not further issue.

31. If yes, can you suggest possible actions or safeguards ESMA should adopt?

See our answer to Question 30.

IV. Structured ETFs

IV.I. Total Return Swaps

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

It seems to CFA Institute that on some particular issues the analysis of ESMA could be clearer. Doing so would help to define the objectives of any policy recommendations.

For example, ESMA says that, in the case of a "passively managed" Total Return Swap ("TRS"), "the role of the counterparty is limited to a replication of the portfolio specified in the swap contract." This is not the case in the case of a funded swap, where the UCITS transfers the entire portfolio of its investments to the swap counterparty, and in exchange receives collateral from the swap counterparty.

Our answer to Question 39 below addresses some other issues which, in our view, require particular attention.

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

It seems logical that in order to provide UCITS investors with a consistent risk management framework, both the UCITS' investment portfolio, which is swapped, and the collateral underlying the swap, which the UCITS obtains exposure to, not only comply with the relevant UCITS diversification rules, but also comply with all applicable UCITS Directive requirements. These would include "CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS" (CESR/10-788)[9].

Some UCITS may enter into TRS which are not passively managed by counterparties. Those counterparties may have some discretionary power over some elements of the swap. ESMA gives an example whereby the UCITS sets the investment policy but instead of selecting the individual assets and their weighting, it defines a pool of eligible assets and sets minimum and maximum exposure limits under which the counterparty can work. In this case, CFA Institute believes that the characteristics of these discretionary powers given to the counterparty should be disclosed in the prospectus.

In the case of a TRS where the counterparty may have some level of discretionary power over the portfolio, ESMA describes a TRS where "the agreement with the counterparty may also specify that the UCITS must purchase the securities included in the portfolio from the counterparty." The exact meaning of this sentence is unclear. Nevertheless, the worry is that a TRS agreement compelling a UCITS to purchase securities held by the counterparty could create a conflict of interest. As already

[9] http://www.esma.europa.eu/data/document/10_788.pdf

underlined above, in the view of CFA Institute, one of the most efficient means of protecting investors' interest is to avoid conflicts of interest.

CFA Institute agrees with ESMA's recommendation that the prospectus include information on the underlying strategy, the counterparty(ies) and, where relevant, the type of collateral which may be received by the counterparty(ies).

Concluding Comments

CFA Institute is pleased to submit its views on ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS. If you or your staff have questions or seek clarification of our views, please feel free to contact either:

- Nitin Mehta, CFA, at +44.207.330.9595 or nitin.mehta@cfainstitute.org
- Agnès Le Thiec, CFA at +32.2.401.6829 or agnes.lethiec@cfainstitute.org

Sincerely,

/s/Nitin Mehta
Nitin Mehta, CFA
Managing Director, EMEA
CFA Institute

/s/ Agnès Le Thiec
Agnès Le Thiec, CFA
Director, Capital Markets Policy
CFA Institute