Setting the global standard for investment professionals

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

30 March 2012

Re: ESMA's guidelines on ETFs and other UCITS issues

Dear Mr. Maijoor:

CFA Institute[1] is pleased to comment on the Consultation paper for *ESMA's guidelines on ETFs and other UCITS issues.* The mission of CFA Institute is to lead the investment profession globally by setting the highest standards of ethics, education, 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.

In order to provide the most meaningful input to ESMA as it formulates its guidelines in these areas, we have consulted with our Capital Markets Policy Council, members of that Council's Investment Products Working Group, members of several CFA Institute societies, and others for their views. The following references to CFA Institute in response to ESMA questions below are intended to reflect these views.

Executive Summary

As an overarching issue, CFA Institute has a longstanding position of supporting measures that provide important safeguards for investors as a means of ensuring the integrity of capital markets. Thus, we applaud ESMA on its approach to implement measures aimed at providing investors with the information they need while also ensuring important investor protections. We believe that while investor protections are paramount for the integrity of capital markets,

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[1] CFA Institute is a global, not-for-profit professional association of over 108,000 investment analysts, advisers, portfolio managers, and other investment professionals in 139 countries, of whom more than 99,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories.

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they must be balanced with allowing market forces to operate without unnecessary restrictions. We believe that in both this Consultation paper and the earlier Discussion Paper on guidelines for UCITS Exchange-Traded Funds and Structured UCITS, ESMA has strived to achieve this balance.

General Discussion/Comments

As noted in our response to the Discussion Paper, CFA Institute strongly supports requiring disclosures that inform investors of strategies, risks and conflicts in UCITS that may not otherwise be obvious to them. Long an advocate of providing investors with the information that they need to make meaningful investment decisions, we believe that this approach to transparency ultimately benefits the financial markets by restoring investor confidence.

We strongly support providing investors with a range of viable investment options, including the use of investment vehicles such as UCITS and ETFs, including synthetic and leveraged ETFs. At the same time, as noted above, we also strongly believe that investors need information about the strategies, risks and potential conflicts inherent in certain instruments. Thus, we agree with much of the approach taken by ESMA in formulating these guidelines. As an example, as noted in our comments on the Discussion Paper, CFA Institute strongly supports better disclosure on synthetic ETFs and structured UCITS to investors to enable then to make informed investment decisions, rather than limiting their sale to retail investors, who would then be deprived of some benefits associated with these products.

We recognize that "plain vanilla" ETFs have not raised many issues with regulators in the past. However, as ETFs evolve and use more complicated strategies and structures, investors may have more difficulty fully understanding what they are buying and thus it is important that they receive clear disclosures and comparability of disclosures across products. This development has triggered actions of regulators globally as they strive to address issues that may raise investor protection concerns. We agree with sentiments of the ESMA's Securities and Markets Stakeholder Group[2] that these "new" UCITS ETFs present concerns about systemic risk and that in some cases, investor protection requires more than disclosure.

Finally, we believe that the types of disclosure and other requirements described in this Consultation should apply to all types of exchange-traded instruments, regardless of whether they comply with UCITS rules or not. In particular, we are concerned that sophisticated strategies might be structured so as to avoid oversight as a UCITS ETF, while exposing investors to the same types of risks and uncertainties described in the questions below, but without the safeguards proposed here to prevent regulatory arbitrage on the part of issuers.

[2]ESMA's Securities and Markets Stakeholder Group notes that ETFs "may raise significant issues both in respect to investor protection and to systemic risk." It also notes that "while the whole group agrees that greater disclosures are required," the majority believes that in addition to disclosures, "regulators should adopt a more interventionist approach." Annex IV, p.68.

Specific Questions

With the intent to provide focused and meaningful input in keeping with our collective expertise, specific questions from the Consultation paper and our comments are provided below.

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?

We agree that information in the prospectus of the UCITS should contain enough detailed information to alert investors to the risks of the particular strategy used or the index or benchmark tracked by that UCITS. We strongly support ESMA's proposal to require broader information in the prospectus on the underlying components comprising the index, as well as the risks associated with the strategies used to track the indexes (e.g., passively managed index or synthetic or swap-based). Investors need this type of information to fully assess their investment options. We also support the requirements that the tracking error of an index-tracking UCITS be addressed in the fund's annual and semi-annual reports, though we

suggest that such disclosures should include how well the UCITS has tracked the index over a longer term than just one reporting period. A minimum of three years of data is needed to enable investors to assess whether the current period's performance is normal or an anomaly.

We also note in response to Q3 below the issue of performance measurement as it relates to total costs and to whether performance reflects bid or offer prices.

As mentioned in our response to the Discussion Paper, we support giving investors information about the risks associated with the particular structure of the UCITS. We also concur with the approach taken here that urges providing relevant information to investors when the index-tracking UCITS holds collateral comprised of securities that are not part of the index being tracked.

While we appreciate the proposed guidelines requiring certain information to be disclosed in the UCITS prospectus, we encourage ESMA to consider requiring this, or an abbreviated version of this information to also be included in the Key Investor Information Document (KIID). Given the tenor of ESMA's proposed guidelines to disclose information to investors that aid them in understanding the features of differently-structured UCITS, the succinct and standardized KIID format, together with understandable descriptions, would aid investors in their understanding.

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.

On the one hand, CFA Institute believes that issuers of UCITS ETFs should adhere to a standard method for calculating tracking error. Without a common calculation methodology, investors would be forced to compare tracking errors from different issuers on the basis of potentially widely disparate, conflicted, and/or self-serving methodologies. The investment industry was forced to overcome similar problems in reporting investment performance over the past 20 years.

At the same time, we are concerned whether ESMA is the appropriate organization to develop such guidelines as this is not an area of expertise for the Authority. A better approach would be for ESMA to look to an existing or developing industry standard and endorse that standard. For example, one industry standard for the calculation of the tracking error is the volatility of the excess return compared to the benchmark index (typically this figure is annualized). Even if not currently used by all, we suggest ESMA consider proposing this measure as one such standard (both on a one-year and three-year basis).

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, we agree that disclosure of the tracking error should be complemented by information on the actual evolution of the fund compared with its benchmark index for at least the one- and three-year periods.

At the same time, tracking error is but one useful metric available to investors. Long-term investors, in particular, should consider tracking difference, which is the performance against the benchmark over a stated time reflecting the effect of costs not generally reflected in tracking error measures, such as dealing and rebalancing costs for physical funds or swap spreads for synthetic funds. Tracking error measures are more useful for short-term or institutional investors.

Moreover, funds should have to rely on a standard starting point for performance measurement. Depending on how it is measured against the bid-offer spread, tracking difference and performance may vary if the offer price is used to measure performance. It would be useful, therefore, to enable investors to assess the total cost of investing in a fund with estimates for the first year and thereafter in retrospect. Moreover, these issues are applicable, as well, to funds and the investment product industry, not just to ETFs.

IV. Index-tracking leveraged UCITS

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

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

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

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

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

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

As noted in our response to the Discussion Paper, we agree with providing disclosure on leverage policies, how these policies are achieved and their associated risks. We also agree that investors should be alerted to how leverage policies can expose them to losses, including the potential magnitude of those losses. Similarly, the effect of the frequency of calculation of leverage and its impact on investors' returns is the type of information that is important for investors to receive.

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

We support ESMA's proposed prospectus disclosure on the leverage policy, including the specifics on how leverage is achieved, and the associated costs and risks. In terms of the proposed required disclosure on "the impact of any reverse leverage (i.e., short exposure)," we encourage ESMA to provide clarification that disclosure to investors should include a clear statement that this impact may include loss of investment.

We also appreciate that the proposed information will be included in the KIID, as a means of allowing investors to better understand and be able to compare similar funds. ESMA notes that an index-tracking leveraged UCITS should comply with the requirements on global exposure established by Article 51(3) of the UCITS Directive and calculate its exposure in accordance with CESR's Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITS.

We find notably missing, however, a specific requirement that addresses the potential counterparty risks of leveraged UCITS. Investors should also be alerted to the risks of reduced liquidity in the event of financial problems at the counterparty and depending on the types of collateral involved.

We also are concerned about the need for greater disclosure at the point of sale. For example, distributors of these products may not need to provide KIIDs to clients with execution-only accounts. Such circumstances should be addressed in a manner that increases the urgency for the adviser/broker selling the instrument to a client to ensure the instrument is appropriate for each client in their specific circumstances. As a fall back, ESMA also may need to consider limitations on the distribution of more sophisticated ETF strategies.

V. UCITS Exchange Traded Funds

V.II. Definition of UCITS ETFs and Title

1. A UCITS exchange-traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradeable on at least one regulated market or multilateral trading facility (MTF) with at least one market maker which takes action to ensure that the

stock exchange value of its units or shares does not significantly vary from their net asset value.

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)?

In general, we concur with the proposed definition with two exceptions. First, we believe the definition, to be accurate, should address the creation and redemption processes that make ETFs unique from other listed funds. Second, we do not believe the definition should address the issue of market makers. In general, we agree with the desirability and value of an ETF having one or more market makers. This would enhance the likelihood that investors are able to buy or sell a particular ETF when they wish. This, in fact, is one of the foundational benefits of an ETF—the exchange-traded aspect.

Nevertheless, the issue of market makers is one typically left to the exchanges that list ETFs to determine market-maker requirements. So we do not believe ESMA should address how many market makers an ETF should have.

We are concerned about what might occur if ESMA were to define ETFs as having one or more market makers to ensure market value is relatively consistent with NAV. While such a situation is preferable, our concern is based on the fact that such a definition would imply a mandate that would give market makers pricing power over the ETFs, thus allowing them to charge high fees that investors would have to pay. In the absence of such a de facto mandate, we would expect that arbitrageurs would act to ensure market value does not stray far from NAV.

Equally important, however, is what such a definition would mean to an ETF if it were to lose its market-maker coverage, regardless of the reason. Such a definition would imply that the loss of market-maker support would mean that the ETF is no longer traded on an exchange.

Consequently, we suggest that the definition omit the reference to a market maker.

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

We strongly support the requirement that UCITS ETFs use the identifier of "ETF" in its name, when referenced in relevant documents, including its prospectus, incorporating document, KIID and marketing materials. We believe that the simplicity of this identifier, which is commonly known, will serve to alert investors to the type of product being offered.

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

We believe that sophisticated investors, pension trustee clients, as well as execution-only clients, would find such an identifier useful. Consequently, we do support an identifier to further distinguish between synthetic and physical ETFs. Such distinctions should be made clearly and prominently in the offering documents, KIID and regular reports on the specific ETF.

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

We do not recommend using the term "Exchange-Traded Fund" as an alternate to ETF. Rather than risk possible confusion relating to any significance attributed to the use of one alternative over another, we believe that "ETF" is widely known and should be used consistently.

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?

As noted in our responses to Q6, we do not support stricter requirements on the minimum number of markets makers. While we believe having one or more market makers would benefit ETF shareowners, we are concerned about what would happen should one or more market makers drop the ETF from coverage.

V.III. Actively-managed UCITS ETFs

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

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

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

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

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

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

Industry estimates are that actively-managed ETFs constitute less than 1% of total assets under management for exchange-traded fund instruments. Moreover, active ETFs may have difficulty in pricing to enable market makers to accurately price without revealing active strategies. Such matters also raise concerns about potential conflicts of interest where market makers and product promoters are affiliated entities.

In general, we think actively-managed UCITS ETFs will confuse UCITS ETFs investors because most ETFs are passively managed. We also doubt that the ability to trade intraday would bring additional value to the UCITS ETFs framework. However, if this category were to be maintained in the ETFs landscape, it should include the word "Active" in its name.

Beyond this concern, we generally agree with the proposed guidelines and appreciate inclusion of requirements to inform investors that the fund is not an index-tracker and of how it intends to meet its investment policy, including any intentions to outperform an index. At the same time, we believe the guidelines also should include information on ex-ante tracking error.

As noted in our response to the Discussion Paper, we also believe that the prospectus should include information on the types of securities that the fund intends to buy as part of its portfolio. We also reiterate our view that actively-managed UCITS ETFs should provide information on the types of transactions they contemplate using. Investors need to receive this information in order to consider the associated risks.

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 unitholders in the event of such a process of replacement or if the

redemption in the secondary market is disrupted. This may include making arrangements for investors who have acquired their units or shares on a secondary market to sell them directly back to the UCITS ETF or its management company.

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

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

Option 2

1. Investors who acquire units or shares of a UCITS ETF on the secondary market shall be able to redeem their shares directly from the UCITS ETF at any time.

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

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

We support the first option. These instruments are exchange-traded and therefore trading should occur on an exchange. If an exchange trading option is not available, then the UCITS ETF or its management company should make arrangements to facilitate liquidity for the units.

The second option, on the other hand, gives investors the option to bypass an exchange completely by going directly to the ETF or its management company. This type of structure would be more akin to a traditional UCITS and, therefore, would create confusion by calling such units, UCITS ETFs.

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.

We believe the steps suggested in paragraph 2 of option 1 provide ample options for redemption, including direct sales to the UCITS ETF or its management company in the case of market disruption.

During the market turmoil of late 2008 and early 2009, dealer-based markets for fixed-income securities, fixed-income collective investment schemes and dealer-based over-the-counter derivatives markets all experienced significant disruptions. In each case, the instruments involved were not traded on active exchanges, thus impairing the ability of investors to sell or buy shares. On the other hand, shares of company stock continued to trade on regulated exchanges—though not without significant volatility—in large part because of the transparency and open market that comes with exchange trading. The continued exchange-traded feature of option 1 provides an additional liquidity feature that is not available to the direct-redemption structure proposed in option 2.

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

We believe the guidelines provided in option 1 should be sufficient to cover all jurisdictions as long as the distinctions are clearly made on the certificates.

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

VI. Efficient portfolio management techniques

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 haircut, or to refrain from applying any haircut, to a certain class of assets.

10. The UCITS' annual report should also contain details of the following:
a) The underlying exposure obtained through EPM techniques;
b) The identity of the counterparty(ies) to these EPM techniques; and
c) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

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?

As described in the Consultation, EPM techniques include sale and repurchase agreements, reverse repos and securities lending. With these considerations in mind, we generally agree with ESMA's proposed guidelines in this area. A number of practices used by ETFs can raise collateral issues. As noted in our comments on the Discussion Paper, there is a significant risk when index-tracking ETFs hold collateral that includes securities not held by the index being tracked, particularly with respect to liquidity.

We therefore support requirements that inform investors of the intention to use various techniques and detailed explanations of the potential risks. We continue to recommend that information requirements on what should be disclosed should be expanded. In particular, we believe that investors should receive information (1) that clearly describes the type(s) of collateral that the UCITS may use; (2) on the credit quality and liquidity of the collateral; (3) on the UCITs valuation practices; and (4) on the segregation of assets.

At the same time, we do not believe that the type of fee-sharing arrangements described in paragraph 3 of Box 6 above, in the context of EPM techniques, should be allowed for UCITS. If allowed for non-UCITS products, which are outside the scope of this Consultation, they should follow strong disclosure requirements.

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

We believe the guidelines do a good job of ensuring that the collateral is adequately diversified. At the same time, we recognize that diversification is not a fail-safe structure against loss. On the contrary, diversification helps to mitigate the potential for loss from individual components of a portfolio.

The diversification requirements proposed are consistent with those already in place for traditional UCITS. We support this type of consistency to avoid regulatory arbitrage by issuers on the basis of lower collateral requirements. This, in turn, should ensure uniformity and ease of comparison for investors.

One issue that the guidelines should include is the issue of the liquidity of collateral and how that liquidity is measured. Some industry experts have suggested measuring liquidity on the basis of average daily trading volume.

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

We believe that reinvestment of cash collateral received in the context of EPM techniques should be made in risk-free assets.

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.

Yes, we believe that a higher correlation between collateral and the UCITS underlying portfolio provides added security for investors. In addition, conflicts of interest may arise when the collateral bears a lower correlation to the underlying portfolio and there is reduced market liquidity. These benefits, we believe, outweigh the lower potential fund returns that come with a higher degree of correlation between collateral and the underlying portfolios.

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?

Yes, the combination of the collateral received and the assets of the UCITS not on loan should comply with UCITS diversification rules. Again, we believe the benefits from these safeguards outweigh the potential additional costs of complying with UCITS diversification rules.

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

We support the current approach that provides criteria rather than providing an indicative list of eligible assets. This approach has the benefit of greater flexibility for regulators as the relative quality of instruments may change over time. For example, at one time, mortgage-backed collateralised debt obligations may have been considered appropriate. However, given changes in the acceptance and understanding of credit quality for such instruments, such instruments may not receive similar treatment today. ESMA would likely have to take formal steps to alter the indicative list to remove such instruments from inclusion. Nothing would have to change under the criteria approach, on the other hand.

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

Please see our response to Q21 for our views about using an exhaustive or even indicative list of permissible assets for collateral purposes.

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?

Article 52.1 limits a UCITS exposure to a counterparty in an OTC derivatives transaction to either 10 percent of its assets when the counterparty is a credit institution, or five percent of its assets otherwise. We believe the same limits should apply to EPM techniques, as suggested in Q22, as apply under Article 52.1. Consistency in this regard will both limit the potential for regulatory arbitrage by fund sponsors, and make it easier for investors to compare UCITS and UCITS ETF instruments without having to know and understand different regulatory treatment for such transactions.

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

Article 50(f) refers to the kind of investments UCITS can make in demand or short-term deposits with credit institutions. Such investments are permitted so long as the bank is either domiciled in a Member State or, if domiciled in a third country, is subject to substantially equivalent prudential rules, as determined by the competent authority in the UCITS home Member State. We believe these rules are appropriate and should be applied in this case.

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?

We recognize that the lack of a limit on the proportion of a portfolio that can be on loan may increase risks. While securities lending may help boost potential returns in normal circumstances, securities lending may create liquidity concerns and potential losses for investors.

We are not in favor of a bright-line rule that applies in all cases. A better solution, though one that may not be practical in all cases, would be based on a combination of the outstanding short volume and the total market float for each specific security. Such an approach would take into consideration the ability of share borrowers to unwind short positions.

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

The proportion of assets that are lent should be disclosed to investors, as well as the proportion of the UCITS revenues that are attributable to EPM techniques. Guidelines should be developed to show concentrations of securities lent by issuer, industry and, in some cases, regions on the way that these proportions (and frequency) should be calculated to make the information comparable.

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)?

We view this as a question of whether ESMA should set hard limits on the proportion of investment assets that may be lent to other market participants in light of the ability of funds to trade with affiliated entities. In general, we do not support the conflicts of interest created by such structures. Without changes to the rules that might prevent such conflicts, however, then ESMA must, at the very least, impose the types of collateral requirements described above that ensure that collateral in sufficient amount, quality and diversification are available to mitigate problems.

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?

To reiterate, Paragraph 2 relates to disclosures about the UCITS' collateral policy. Paragraph 1 refers to Article 51(2) of the UCITS Directive as a guide for disclosure about investment techniques and instruments. Under Article 51(2), Member States are authorized to set conditions and limits on the use of techniques and instruments relating to transferable securities and money market instruments, so long as the techniques and instruments are used for efficient portfolio management. When these efforts involve derivative instruments, the conditions and limits must conform with the provisions stipulated in the Directive. Finally, the UCITS cannot diverge from its investment objectives as stated in UCITS' fund rules, its instruments of incorporation, or its prospectus.

We support the required disclosure of these factors to investors. This information will enable investors to more clearly understand and assess the potential risks involved in such investments.

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?

In general, we support the identification of EPM counterparties, but we believe it should be done at least semi-annually, if not quarterly. We also believe that funds should provide such identifications whenever they make changes to their EPM counterparties.

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

We believe that conflicts of interest exist for all depositories (affiliated/non-affiliated) as asset managers are the clients of the custodians and therefore more interested in the needs of the asset managers than of the ultimate investors. To help mitigate this type of risk, we suggest that disagreements on valuations between the depositories and asset managers should be tracked and investigated, when possible. Also, differences in valuation across various custodians also should be investigated, when possible.

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.

We do not believe automation of portfolio management, on its own, can adequately safeguard against potential conflicts of interest. For example, a firm could program its systems to give firms affiliated with the fund preferential treatment on collateral matters, rather than seeking other, potentially less conflicted and affordable options.

Nevertheless, if set to ensure minimum best practices, automation could minimize conflicts of interest and ensure the minimum quality and quantity for the collateral. However, it is difficult to determine under which circumstances it would be possible to resort to a non-automation mode; decisions not to resort to the automation mode should be reported and documented. In any case, it should be only part of wider provisions described in a code of best practices set by industry participants.

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

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

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

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

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

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

c) Where the swap counterparty assumes any discretion over the UCITS portfolio the extent to which the counterparty has control over the investment policy and the limitations imposed in the management of the UCITS should be disclosed to investors in the prospectus.

d) Where the swap counterparty has discretion over the composition or management of the UCITS portfolio or can take any other discretionary decision related to the UCITS portfolio then the agreement between the UCITS and the swap counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation. Thus, the counterparty should be treated and disclosed as an investment manager.

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

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

a) The underlying exposure obtained through financial derivatives instruments;

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

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

Q32: Do you agree with the proposed guidelines?

We particularly support the requirement that specific information on the use of total return swaps be provided to investors through the prospectus. We believe that providing this information is especially important where the total return swaps are not passively managed and where counterparties have discretion over the UCITS investment policy.

We also wish to reiterate the points addressed in the third paragraph of our response to Q3 above about the need for a standard metric to assess the total costs of investing in a fund.

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

We do not see diversification as a mechanism for ensuring high-quality collateral. The collateral can be widely diversified across a wide range of assets but still be of low quality. Rather, we see diversification of collateral as a mechanism to mitigate the potential loss of value on any of the elements of the diversified collateral portfolio.

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?

We are unsure of the benefits that might derive from including these disclosures in the fund's rules. While we believe that a fund's strategy and the target composition of the investment portfolio or index should be part of the fund rules, we do not see the need for the remaining, including a provision in a fund's rules that the swap counterparty will have discretion over the composition or management of the UCITS portfolio. We anticipate that such a structure is already covered in a legal agreement between the swap counterparty and the UCITS, and therefore not needed to be included in the fund's rules. So long as the information is disclosed to fund investors, it does not matter where these agreements are made.

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?

As noted above in our response to Q21, we believe qualitative criteria is preferable to an indicative list of eligible assets.

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

Likewise as found in our response to Q21, we do not support an exhaustive list of eligible assets as such a list could be out-dated very quickly.

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?

The concern raised by the question would seem to relate to a situation where the assets received as collateral may lead to a larger-than-permitted concentration with respect to a specific issuer, sector or asset type. Such a situation, while likely to be short-lived, could subject the UCITS to risk of significant loss if the value of the concentrated holdings experiences a sudden decline in value.

In those cases, we agree with this approach of requiring compliance with UCITS diversification rules for both the UCITS investment portfolio, the return of which is swapped, and the underlying collateral to the swap. We suggest required compliance with all UCITS Directive requirements, including CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS for both the UCITS portfolio and the collateral. Such an approach seems consistent with an overall risk management framework and which will help limit risks for investors.

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?

We believe the collateral diversification and haircut policies outlined in Box 7 should apply to all OTC derivative transactions and not just to TRS. Different rules for instruments or transactions that are significantly similar in nature could lead to systemic problems as firms' regulatory arbitrage creates a significant concentration in the use of one type of instrument or transaction.

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;

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

c) If cash management is included as part of the index strategy, the UCITS must demonstrate that this does not affect the objective nature of the index calculation methodology.

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

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

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

8. A financial index must publish the constituents of the index together with their respective weightings. Weightings may be published after each rebalancing on a retrospective basis. This information should cover the previous period since the last rebalancing and include all levels of the index.

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

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

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

12. The UCITS must carry out appropriate documented due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark. The UCITS must also assess the availability of information on the index including whether there is a clear narrative description of the benchmark, whether there is an independent audit and the scope of such an audit, the frequency of index publication and whether this will affect the ability of the UCITS to calculate its NAV. The due diligence should also cover matters relating to the index components.

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

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

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

Under Article 53 of the Directive, Member States have the authority to raise the limits on holdings of one issuer's shares or debt securities under certain conditions to 20 percent. In particular, the fund's rules or instruments of incorporation must stipulate that the UCITS' investment policy is to replicate the composition of a sufficiently diversified and public stock or debt securities index. The Article gives Member States authority to raise the concentration limits further to 35 percent when justified by "exceptional market conditions," such as when securities or money market instruments "are highly dominant." The additional increase in concentration limits applies to just one issuer.

In general, we believe it would be useful for investors to have a complete understanding of the strategy. In some cases, this could even result in an investor replicating the strategy, maybe with a cost advantage.

We do not think the disclosure of such information (if stated clearly) would lead to confusion for non-professional investors.

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

Yes. We believe that such an affiliation provides a potential conflict of interest and should receive additional scrutiny. Such conflicts, like those noted in paragraph 10 of Box 8, may affect the quality of the index—not indicative of a sector, region or industry, for example—and impair the ability of the UCITS to adequately and closely track performance of the index.

Absent preventing such arrangements, we urge ESMA to require notification to investors that these arrangements may occur and a description of how investors may be disadvantaged.

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) Uninvested cash collateral should comply with Box 6 paragraph 7 and Box 7 paragraph 2 no later than X months after these guidelines come into effect; and b) Fees arising from EPM techniques should be returned to the UCITS in accordance with Box 6 paragraph 3 with immediate effect unless the UCITS has engaged in fee-sharing agreements prior to XX 2012.

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

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

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

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

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

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

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

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

In general, we support these provisions as reasonable and appropriate, with one exception. We are concerned that the call for immediate return of fees arising from EPM techniques in paragraph 3a may not provide sufficient time for EPM counterparties to make arrangements to return to such fees. Moreover, the guidelines do not prescribe a period at which point any fees earned under EPM arrangements are returned. For example, will the EPM counterparties be expected to return such fees generated since the launch of the UCITS, or any fees beginning as of the date of adoption of the rules, to consider two extremes?

We suggest that ESMA stipulate that EPM counterparties return any fees arising from the use of these techniques, and which are not subject to fee-sharing arrangements, over a transition period of no more than three months. This period is short enough to ensure that the UCITS and its investors receive what is legally owed to them under the new rules, but long enough to give the EPM counterparties time to raise the liquidity needed to fulfill this obligation.

Concluding Comments

CFA Institute is pleased to submit its views on the Consultation paper for ESMA's guidelines on ETFs and other 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, nitin.mehta@cfainstitute.org; or Claire Fargeot, at +44.207.330.9563 or Claire.fargeot@cfainstitute.org.

Sincerely,

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