

Response to ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

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1.- INTRODUCTION

The CNMV Advisory Committee is grateful for the opportunity to comment on ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS.

In that document, ESMA states that, because of the expanded investment possibilities available to UCITS following the approval of the UCITS III Directive and the Eligible Assets Directive, UCITS have been able to implement investment strategies that were previously barred to them, some of them more in line with the *modus operandi* of hedge funds.

For that reason, ESMA understands that it may be recommendable to establish specific guidelines for those classes of UCITS (ETF and structured) in order to protect investors, ensure market integrity, and preserve the UCITS brand, considering that, under the MiFID, all UCITS, regardless of their investment strategy, are classified as non-complex and may be sold on an execution-only basis.

To this end, ESMA has begun working on a set of guidelines applicable to UCITS ETF and structured UCITS and on examining potential measures to mitigate the risk that particularly complex products may be made available to retail investors.

2. REPORT BY THE ADVISORY COMMITTEE

(A) General comment (questions 1 to 7)

MiFID classified financial instruments into two groups—complex and non-complex—on the basis of a number of criteria set out in article 19.6¹, and in article 38 of Directive 2006/73, which implements MiFID. Depending on which group an instrument is assigned to, the level of requirements applicable when providing financial services in connection with the instrument varies; logically, the requirements are greater in the case of complex products.

Under MiFID, as amended, UCITS are automatically classified as non-complex. In general, this is due to their high liquidity, the fact that their valuation system is validated by parties independent of the issuer (depository and auditor), the fact that the client's liability is confined to the amount invested, and, above all, ***to the existence of full and simple information which enables the investor to ascertain the***

¹ Article 19.6 of Directive 2004/39 classifies the following as non-complex financial instruments:

- Shares listed in a regulated market or in an equivalent market in a third country.
- Money market instruments.
- Bonds or other forms of securitized debt (except embedded derivatives).
- Undertakings for collective investment in tradable securities.
- Other non-complex financial instruments that fulfill the requirements of article 38 of Directive 2006/73, in particular:
 - a) Those not falling into any of the listed categories. These are basically derivatives, rights to purchase and sell tradable securities or which are settled by differences on the basis of the performance of other tradable securities, interest or exchange rates, indices, etc.
 - b) There there are frequent opportunities to dispose of, redeem, or otherwise realise that instrument at prices that are publicly available to market participants and that are either market prices or prices made available, or validated, by valuation systems independent of the issuer.
 - c) There is no actual or potential liability for the client that exceeds the cost of acquiring the instrument.
 - d) Adequately comprehensive information on its characteristics is publicly available and is likely to be readily understood so as to enable the average retail client to make an informed judgment as to whether to enter into a transaction in that instrument.

characteristics and risks, to the extent that such information is now the standard applied by the European Commission when regulating other products aimed at retail investors.

For this reason, all UCITS must continue to be classified as UCITS until such time as MiFID is amended, even though the specific features of some of them may make it advisable to adapt the investor disclosure requirements.

Additionally, the *raison d'être* of collective investment is that individual investors entrust their savings to a manager who has the necessary knowledge and experience to manage them professionally and who has a fiduciary duty to pursue the investors' best interests. Therefore, although the investor should be given as much information as possible, that information should be aimed at ensuring that an average investor can comprehend the product (i.e. the risks and expected results of the investment) but not necessarily the management techniques (i.e. the technical details upon which the investment is based).

From the foregoing we can draw four conclusions upon which the answers to the questionnaire (see **Annex**) are based:

1. The key factor for assessing the complexity of an instrument should not be "*complexity of the portfolio management techniques*" but the difficulty for an investor of understanding the characteristics, returns and risks.
2. In so far as UCITS fulfil the criteria established in the Directives, they should generally continue to be classified as non-complex products, although the disclosures to investors would need to be adapted where the characteristics of the UCITS make this advisable. Classification by ESMA of certain particularly complex UCITS as complex products in its guidelines and recommendations should proceed in line with amendments to the MiFID in this connection; otherwise, the ESMA should make it clear that such guidelines are not imperative.
3. Disclosure of information to the investor is positive provided that it contributes to a better understanding of the product; however, in the opinion of this Committee, this does not occur where the disclosure includes technical concepts that the majority of investors do not understand. In these cases, it is necessary to bear in mind the philosophy which led to the replacement of the simplified prospectus with the Key Investor Information Document (KIID)².
4. Since the provision of investment services in connection with shares and units in UCITS is covered by MiFID, it would be inappropriate to implement distribution measures focusing solely on UCITS. Any such guidelines should refer to all products covered by MiFID, not just to UCITS.

(B) UCITS ETF (questions 8 to 38)

UCITS ETF simultaneously fulfil the requirements of the UCITS Directive and the demanding rules for tradable securities; i.e. they are subject to double oversight. Moreover, if an unlisted UCITS is non-complex and a listed share is also non-complex, then a UCITS ETF should qualify for the same treatment. In any event, the foregoing comments about the amendment of MiFID apply to the classification of any type of ETF as complex by ESMA.

The ESMA Discussion Paper proposes a number of measures with regard to ETFs, most of which refer to disclosures to investors and to the definition and harmonisation of management techniques, distinguishing between passively-managed (index-tracking) ETFs, synthetic ETFs, ETFs that engage in securities lending, actively-managed ETFs, and leveraged ETFs. The Paper also discusses the specific features arising from the fact that these instruments are traded in secondary markets.

In general, this Advisory Committee agrees with the ESMA's proposal regarding the definition and harmonisation of practices (e.g. in connection with collateralisation, since this would enable all ETFs to compete on an equal footing regardless of their home member state, provided that the specific measures arising out of these proposals enable these UCITS to continue to operate with sufficient flexibility.

² European Commission White Paper on the single market for investment funds (November 2006): "*The simplified Prospectus was intended to provide investors and intermediaries with basic information about the possible risks, associated charges, and expected outcomes of the respective product. However, it has manifestly failed. In most cases, the document is too long and not understood by its intended readers. It has been the victim of divergent implementation and 'gold-plating': the relevant Commission Recommendation has been honoured more in the breach than in the practice. The result is a massive paper-chase of limited value to investors and a considerable overhead for the fund industry.*" (p. 11-12)

The Advisory Committee also supports the proposals to improve disclosures to investors; in fact, the bulk of them are already enshrined in Spanish law, including the inclusion of the term “ETF” in the name of the UCITS, and disclosures to investors about the index composition and the maximum tracking error.

However, the philosophy underlying the KIID should be taken into account at all times when implementing these proposals. For this reason, this Committee considers that the inclusion of certain concepts and details may prove excessive and beyond the comprehension of the average investor. This Committee considers that, for example, the proposals regarding disclosure of the impact securities lending will have on the tracking error for index tracking ETFs (p. 15, paragraph 4) or the express disclosure in the name of the ETF of whether it is synthetic, physical replicating or actively-managed (p.10, paragraph 7) would be excessively complex for inclusion in a document addressed to investors.

Finally, the ESMA raises some questions about trading of ETFs in secondary markets. It raises the possibility that investors acquiring an ETF via the stock market should be entitled to direct reimbursement out of the Fund's assets if the fund proves illiquid. However, since the advantage of an ETF over an unlisted index tracking fund is precisely that the units can be bought and sold on the stock market, establishment of this right should be confined to cases where market makers do not provide liquidity; under Spanish law, such a situation could only arise in exceptional cases since market makers undertake strict obligations from which they may only be relieved with prior authorisation from the CNMV.

ESMA also requests information on possible mechanisms for assuring that the market price does not differ significantly from the net asset value. In this connection, Spanish law requires that funds provide firm bid and offer positions for their units, with a cap on the bid/offer spread, in order to ensure that the market price is aligned with the net asset value.

(C) Structured UCITS (questions 39 to 46)

As indicated above, the definition of complexity should not be based simply on the specific techniques or financial instruments used in the portfolio but, rather, on the complexity of the risks and results. Accordingly, if the amortisation is readily comprehensible to a retail investor, the product should not be classified as complex. Moreover, the risk/return profile of a structured UCITS is generally more certain and easier for a retail investor to understand than the majority of fixed-income or equity UCITS and even than that of a share listed on a regulated market (which, by definition, is not a complex instrument).

Consequently, this Advisory Committee supports any initiative that improves disclosure to investors and comprehension by them of UCITS characteristics, since this will be beneficial not only to investors but also to the asset management industry in general by strengthening the role of asset managers and their fiduciary duties.

- Additionally, although this Advisory Committee agrees that structured UCITS should be subject to the portfolio diversification requirements set out in the Directive, it considers that, since there is no restriction on packaging structured UCITS under other labels (e.g. structured notes), the application of diversification rules may be harmful not only for the asset management industry (in terms of competition with other segments of the financial sector) but also for investors, who would only have access to these structures through vehicles that are not so tightly regulated as UCITS.

Madrid, 26 September 2011

Annex 1

Retailisation of complex products

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.

Since the provision of investment services in connection with shares and UCITS units falls under the scope of MiFID, it is inappropriate to implement limitations on distribution that refer only to certain types of UCITS. Any such guidelines should refer to all products covered by MiFID, not just to UCITS.

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'?

MiFID classified financial instruments into two groups, complex and non-complex, on the basis of a number of criteria set out in article 19.6, and in article 38 of Directive 2006/73, which implements MiFID. Depending on which group an instrument is assigned to, the level of requirements applicable when providing financial services in connection with the instrument varies; logically, the requirements are greater in the case of complex products.

Under MiFID, UCITS are automatically classified as non-complex, particularly because of their high liquidity, the fact that their valuation system is validated by parties independent of the issuer (depository and auditor), the fact that the client's liability is confined to the amount invested, and, above all, because of the existence of full and simple information which enables the investor to ascertain the characteristics and risks, to the extent that such information is now the standard applied by the European Commission when regulating other products aimed at retail investors.

For this reason, all UCITS must continue to be classified as non-complex until such time as MiFID is amended, even though the specific features of some of them may make it advisable to adapt the disclosures that must be made to the investor. If the ESMA recommendation precedes an amendment of MiFID in this connection, it should be made clear that it is not imperative.

Moreover, the criteria for classifying instruments as complex or not complex are set out in article 38 of Directive 2006/73 and are appropriate. If any amendment is made, the key factor for assessing the complexity of an instrument should not be "complexity of the portfolio management techniques" but the difficulty for an investor of understanding the characteristics, returns and 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?

See response to question 1.

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

No.

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

No.

6. 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.

Non-UCITS funds established or sold in the European Union should be subject to the rules of MiFID or, if the latter is not applicable to them, to the legislation of their home states; accordingly the requirements applicable to UCITS should not be extended. Additionally, when they are distributed to retail investors, they should be subject to the provisions of MiFID.

7. 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.

Yes.

ETF

8. 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.

Yes.

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

The philosophy underlying the KIID should be taken into account at all times when implementing these proposals. For this reason, this Committee considers that the inclusion of certain concepts or descriptors—such as synthetic, physical or actively-managed—may prove excessive and beyond the comprehension of the average investor.

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

Yes.

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

Yes.

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

Yes, provided that the information that is included serves to enhance comprehension of the product and does not include concepts that are too technical for a document addressed to investors since, otherwise, there is a risk that investors would not understand the information and also of overproduction of documents of little value to investors with the consequent expense for the funds industry. This is precisely the situation which led to the introduction of the KIID in place of the simplified prospectus.

13. 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?

Yes, in line with the response to question 11.

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

No.

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

N/A

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

Yes. In general, this Advisory Committee agrees with the ESMA's proposal regarding the definition and harmonisation of the operation of ETFs, since this would enable all ETFs to compete on an equal footing regardless of their home member state, provided that the specific measures arising out of these proposals enable these UCITS to continue to operate with sufficient flexibility.

17. 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 Advisory Committee considered that the type and quality of assets that are eligible as collateral need to be elaborated upon further to ensure that managers' operating possibilities are equivalent in all member states. In contrast, it does not appear necessary that the collateral match the relevant index since it is collateral, not an investment.

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

No. Collateral received by synthetic ETFs must fulfil certain diversification requirements for the event that it has to be executed, but they should not be as strict as those applying to an ETF's investments (because they are collateral, not investments).

Securities lending activities

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

Yes.

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

Yes, although the information supplied to investors should be confined to fundamental, simple and specific aspects, avoiding aspects that are excessively technical and complex and which would not be readily understood by an average investor.

21. Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced? If yes, please specify.

No.

22. 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.

Yes.

23. 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?

In principle, there does not appear to be a need to set a limit; however, if one is established, it should be high enough (e.g. 75%).

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

No.

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

N.A.

Actively managed UCITS ETFs

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

See response to question 20.

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

No.

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

No.

Leveraged UCITS ETFs

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

Yes.

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

See response to question 20.

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

No.

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

N/A

Secondary market investors

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

Yes, except as stated in response to question 36.

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

No.

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

N/A

36. In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

No. Since the advantage of an ETF over an unlisted index tracking fund is precisely the fact that units can be bought and sold on the stock market, the establishment of this right should be confined to cases where market makers do not provide liquidity; under Spanish law, such a situation could only arise in exceptional cases since market makers undertake strict obligations from which they may only be relieved with prior authorisation from the CNMV.

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

See reply to question 36.

38. How can ETFs which are UCITS ensure that the stock exchange value of their units do not differ significantly from the net asset value per share?

Spanish law requires that funds provide firm bid and offer positions for their units, with a cap on the bid/offer spread, in order to ensure that the market price is aligned with the net asset value.

Structured UCITS- Total Return Swaps

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

Yes.

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

This Advisory Committee supports any initiative that improves disclosure to investors and comprehension by them of UCITS characteristics, since this will be beneficial not only to investors but also to the asset management industry in general by strengthening the role of asset managers and their fiduciary duties.

- Additionally, although this Advisory Committee agrees that structured UCITS should be subject to the portfolio diversification requirements set out in the Directive, it considers that, since there is no restriction on packaging structured UCITS under other labels (e.g. structured notes), the application of diversification rules may be harmful not only for the asset management industry (in terms of competition with other segments of the financial sector) but also for investors, who would only have access to these structures through vehicles that are not so tightly regulated as UCITS.

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

No.

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

N/A

Structured UCITS- Strategy indices

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

Any initiative to strengthen and clarify the requirements that an index must fulfil to be considered a financial index, and ensure compliance with the requirements, is to be welcomed, particularly considering the proliferation of strategy indices.

44. How can an index of interest rates or FX rates comply with the diversification requirements?

This Advisory Committee considers that an interest rate or currency index cannot fulfil the diversification requirements as currently defined since those requirements are established in terms of issuers, whereas interest rate and currency indices do not refer to any specific issuer.

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

No.

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

N.A.