



The Law Society

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

Response of the Law Society of England and Wales

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

Response by the standing committee on company law of the Law Society of England and Wales

1. The Law Society of England and Wales is the representative body of over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations to regulators and Government in both the domestic and European arena.
2. This paper has been prepared on behalf of the Law Society by members of the Company Law Committee. The committee is made up of senior and specialist corporate lawyers.

General comment

3. There are a number of initiatives underway in the EU which may have an influence on structured UCITS and UCITS which are exchange traded funds. The discussion paper refers to the Packaged Retail Products initiative, but there is also the European Markets and Infrastructure Regulation, which will be very relevant for the central clearing of derivatives. It is necessary that the important questions raised in the Discussion Paper are considered against this wider European background, and not just in isolation.
4. A general thrust of the policy orientations in the paper is that investors should be given adequate information so that they fully understand the nature of the product in which they are investing. We fully support this.
5. In this context, we believe that the impact of UCITS IV on ETFs was insufficiently considered. There is no requirement on ETFs to produce country supplements of listing addenda, but we believe that retail investors cannot be expected to understand how ETFs work on the basis of a two-page document.

Retailisation of complex products

Q1. Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.

6. For reasons set out in more detail in the replies to subsequent questions we think that there is great merit in making detailed information available to retail investors. We do not, however, agree with the proposed limitation on the distribution of certain products to retail investors. Our reasons are contained in the answers to subsequent questions.

Q2. Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria

could be used to determine which UCITS should be considered as 'complex'?

7. A complex product is one where advice is needed before investing. It is a mistake to confuse the complexity of portfolio management with the complexity of the product in which the retail investor is investing. For example, a structured fund may aim to achieve a guaranteed return over a set period for its investors. The means of achieving this guaranteed return may be complex, but so far as the investor is concerned the actual product is relatively straightforward. The essential characteristics of a UCITS fund are that:
- (a) the investor cannot lose more than the amount invested;
 - (b) the fund has a spread of investments to diversify risk;
 - (c) the investor's share is worth a proportionate amount of the net asset value of the fund;
 - (d) the investor may redeem his share and receive the proceeds almost immediately, thus providing good liquidity.

So long as a UCITS fund retains these essential characteristics, it should be regarded as non-complex. Possible risks within the product should be met by disclosure rather than an inability to market.

Q3. Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

8. As mentioned above, we do not believe that there should be limitations on the marketing of any UCITS fund. Indeed, some of the structured UCITS may well be less risky for the investor than a conventional long-only fund. In general terms, a UCITS fund, whatever its investment policy, enables a retail investor to have exposure to those assets in which UCITS funds may invest. Any warnings, therefore, should be limited to this.

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

9. The test we would apply is whether the investment risks can be expressed simply, in a way which retail investors may understand without having to take advice. If this is not possible, then we think the particular fund should not be a UCITS fund, because, as stated above, we believe it should be possible to invest in the UCITS fund on a execution-only basis.

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

10. In order to comply with the UCITS requirements of allowing immediate redemption of shares, some of the derivatives entered into by structured UCITS funds may need to allow the fund to close out the transaction in whole or in part on immediate notice. It is possible, therefore, that the counterparty bank may, if there is a large number of redemptions at the same time, find that it unexpectedly owes a large sum of money which it was not expecting to have to pay until a future date. If, of course, the

derivative is one which has been centrally cleared, the counterparty bank is likely to owe the money to the CCP rather than the UCITS fund.

Q6. Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union? If not, please give reasons.

11. The UCITS directive provides a common standard for UCITS funds, on the basis that they may be sold anywhere within the European Union. Other funds may be sold only on a national basis, and it is thus appropriate that the rules for those other funds are laid down by the national regulator. Accordingly, we do not think that ESMA should give any further consideration to applying guidelines to regulated non-UCITS funds.

Q7. 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.

12. As mentioned in our general comments, we do agree that the policies currently being considered in relation to UCITS should be considered against the wider EU background.
13. It should be remembered that exchange traded notes must, before they can be listed on an exchange, produce listing particulars so that there is an adequate supply of information available. Similarly SPVs may only sell their products to retail investors to the extent that they comply with requirements such as the prospectus directive, and because any such products would be regarded as complex under MIFID, they could only be sold to retail investors with advice.

Q8. Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.

14. The discussion paper states that ETFs are often confused with other types of exchange-traded products such as exchange-traded notes and exchange-traded commodities. We are not convinced that identifying a fund as “ETF” or “Exchange-Traded Fund” will remove this confusion, but nevertheless support the proposal.
15. There is, however, a wider question, which is that if shares in such funds can in practice only be bought in the secondary market, should they be eligible to be UCITS funds? It is quite possible that the market price of a share will differ from the net asset value of the share (in particular, reflecting brokers costs plus also supply and demand) and it may thus be said that one of the essential characteristics of a UCITS fund is missing. This is raised again in question 33.

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

16. If there is to be an identifier, we do agree that there should be a further distinction between synthetic and physical funds.

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

17. Yes

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

18. We agree.

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

19. We agree.

Q13. Do you think that the information to be disclosed in the prospectus in relation to index-tracking issues should also be in the Key Investor Information Document of UCITS ETFs?

20. Yes. In most instances the investor will not see the prospectus, but only the Key Investor Information Document.

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

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

21. We have no comment.

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

22. We have some doubts as to the value to investors of the proposed disclosures in the annual report. Because of the time taken to produce the annual report, the information given to investors may well be out of date, and there is in addition the risk that because the information appears in the annual report investors may regard the position stated there as being one that will apply throughout the year. At the same time, we wonder whether most retail investors will actually be able to make use of the information if it does appear in the annual report. We think it would be preferable, instead of detailing specific transactions, to repeat the information and risk warnings which it is proposed should be contained in the prospectus.

Q17. For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.

23. We do not agree. In the majority of instances the obligation of the counterparty, when the derivative is closed out, will be to deliver cash rather than assets. The collateral to be delivered by the counterparty is security for this obligation, and should, therefore, be

capable of being turned into cash as quickly as possible. It is true that there may be some instances when the UCITS decides not to take out a replacement swap, but to invest direct into the underlying assets of the swap, and in such a case it would be convenient to have as collateral assets which match the relevant index. For reasons described in the Discussion Paper, however, physical tracking of an index is likely to involve greater tracking error than synthetic tracking, and to reduce the return available to investors because of the dealing costs.

Q18. In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

24. For reasons similar to those mentioned in reply to question 17, we do not think that collateral should comply with UCITS diversification rules. The collateral is essentially security for an obligation, and must thus be capable of being turned into cash as quickly as possible. In this regard, there would be no objection to having the whole of the collateral in prime quality government bonds.

Securities lending activities

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

25. We agree.

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

26. It should be remembered that securities lending provides valuable liquidity in the market place, and the proposal that collateral should not be re-lent, but may be invested if it is cash, is likely to have the effect of reducing liquidity generally. Accordingly, before a firm decision is taken that the collateral criteria for OTC derivatives should also apply to securities lending collateral, we believe that further research is needed into the effect that the effective freezing of such collateral will have on the market generally.
27. We do, however, agree that it is illogical for the rules applicable to securities lending and to OTC derivatives to be different, and we are in favour of bringing the two into line.

Q21. Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced? If yes, please specify.

28. We are happy with the proposed principles

Q22. Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral? If not, please give reasons.

29. See the answer to question 21.

Q23. Do you consider that ESMA should set a limit on the amount of a UCITS portfolio which can be lent as part of securities lending transactions?

- 30. We do not think there should be any limit on the amount of a portfolio which may be lent. Most standard securities lending agreements provide for loans to be recalled on demand. If there is a failure to return stock when required, then the collateral should be available to cover the position.
- 31. Against this, we are aware that in some cases there has not been enough stock available in the market place for borrowers which have borrowed stock to be able to buy it in order to return it when it has been demanded. We think that further research would be valuable in this area.

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

- 32. No

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

- 33. Not applicable.

Actively managed UCITS ETFs

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

- 34. We agree with the proposed policy orientations, except for the proposal that it should indicate that it is not an index tracker. Although at the moment the majority of ETF may be index trackers, it cannot be assumed that that position will always continue. The other requirements for information should be sufficient.

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

- 35. No.

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

- 36. Not applicable.

Leveraged UCITS ETFs

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

- 37. We have no comments.

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

38. We do support the policy orientations.

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

39. We believe it would be helpful for ESMA to publish some examples of wording that might go in the prospectus because the experience of prospectus wording in connection with OTC derivatives is that there is no consistency in the approach which fund managers take.

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

40. We have no suggestions.

Secondary market investors

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

41. As a preliminary point, we think it worth considering further whether such funds should be regarded as UCITS funds. Under the Directive a UCITS fund must raise money from the public and if, in practice, the shares are never offered to the public and there is only a single shareholder, we do not see that money can be said to be raised from "the public", though we agree that on one view the shareholder might also be regarded as being in the nature of a distributor of shares. Such funds also lack the essential characteristics which we referred to in our answer to question 2 of the shareholder being able to redeem at net asset value.

42. It should, however, be borne in mind that although an investor may pay brokerage costs when buying on an exchange, such costs may well be less than the initial charge which a fund may levy on the sale of shares, and which it uses in part to pay commission to intermediaries. In the United Kingdom there are proposals which will, when permitted, ban the payment of such commission, and it will be interesting to see if the initial charge survives this.

43. Although the suggestion is made that investors should be entitled to redeem units directly from the UCITS, it is very likely that in practice, most investors will be obliged to hold such units through the corporate nominee of the broker they have used to buy the units, and that the broker will levy a cost for the direct redemption of units which may well be higher (because new systems will be required) than the cost of selling in the market place.

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

44. See the answer to question 33

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

45. See the answer to question 33.

Q36. In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

46. See the answer to question 33.

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

47. If a direct right of redemption is to be given then we think it impracticable to say that it should apply only if there is a lack of liquidity in the units, because there may well be differences of opinion as to whether a lack of liquidity exists. A lack of liquidity is likely to be reflected by a deviation from the net asset value, but working out how much of this deviation is attributable to a lack of liquidity and how much do other factors would be almost impossible.

Q38. 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?

48. They cannot, unless the stock exchange itself places trading limits based around the net asset value. This is a common problem for investment funds which are closed-ended, and various devices have been used to try to eliminate the difference between the market price and the net asset value, but none has been entirely successful in doing so. Although UCITS are open-ended, the particular structure of ETFs means that they have many similarities with closed-ended funds.

Total return swaps

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

49. Paragraph 56 raises the important question of whether a structured UCITS which has only one investment (i.e. a total return swap) is complying with the diversification requirements of Article 52. It is important that ESMA answers this question, because it is unacceptable to have uncertainty in the market place as to whether such funds are in fact UCITS funds or not.

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

50. It is suggested that where the swap counterparty has discretion over the composition of the underlying portfolio, the arrangement with the swap counterparty should be considered as an investment management delegation. This raises issues which need further thought. For example, there is a clear conflict of interest. The investment manager (and its delegates) must act in the best interest of their fund, but the counterparty will be acting only in its own interests. In addition, in the United Kingdom

the delegate of an investment manager might be regarded as an agent of the fund, and thus obliged to pay over any profits which it makes from its agency. It is possible to contract out of this, but it is no means certain that this point would be in the minds of the counterparties when negotiating the total return swap.

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

51. Subject to this, we support the other policy orientations.

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

52. We have no comment.

Strategy indices

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

53. We agree with the proposed policy orientations. In particular, we support the proposal that the guidelines which currently apply to Hedge Fund Indices should be extended to all financial indices.

54. So far as conflicts of interest are concerned, we question whether it is acceptable for the index provider and the counterparty to the swap to be in the same group. However much this potential conflict may be disclosed, disclosure cannot alter the situation itself. The temptation on the index provider to work in the interest of the counterparty and against the interests of the fund are too great, especially where the index provider has a discretion as to the completion of the index from time to time.

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

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

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

We have no comment.

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