

ESMA
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NATIXIS ASSET MANAGEMENT comments to ESMA's discussion paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS.

Natixis Asset Management welcomes ESMA's discussion paper on ETS and Structured UCITS.

Natixis Asset Management is one of Europe's leading asset managers. It offers a wide range of effective management solutions, based on extensive expertise in European and specialized asset management. Natixis Asset Management provides services to a diverse client base: institutional investors, large companies, distributors, Banque Populaire and Caisse d'Épargne clients.

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NAM wishes to express itself on the following points:

NAM supports the responses of the AFG and EFAMA broadly to ESMA's discussion paper on policy orientations on guidelines for UCITS Exchange – Traded Funds and Structured UCITS

ETFs and structured funds are UCITS if they are created according to the rules of the UCITS Directive. In your opinion, there is clear understanding that ETF are UCITS, except that they are listed and actively traded on a European stock exchange. UCITS should be treated the same, whether they are listed or not. Synthetic ETFs and structured UCITS are regulated under the UCITS rules that provide a strong European regulatory framework.

In our view, an effort of regulatory level playing field (ex: PRIIPS initiative) is absolutely fundamental and should be given priority.

RETAILISATION OF COMPLEX PRODUCTS

FINANCIAL STABILITY AND SYSTEMIC RISK

We are fully supportive of the efforts made by ESMA to better understand evolutions in the products offered by the asset management industry and in particular those offered to retail investors.

ETFs are only one of many different types of products sold to retail investors; therefore we believe that ESMA's review should not be limited to ETFs or even to UCITS. This work fits under the MiFID review and the PRIIPS initiative, not under the UCITS Directive; it should be horizontal, cross-sectoral.

A distinction between “complex” and “non-complex” UCITS should not be drawn on the basis of categories such as synthetic ETFs or structured UCITS but can only be made on a fund-by-fund basis. All UCITS are subject to the same strict rules, and ETFs are also subject to listing rules.

A definition of complexity should not be simply based on the use of specific techniques in a fund.

We disagree the ESMA's approach: the definition of “complexity” should be fine-tuned, as complexity is not equal to risk. For example, techniques such as derivatives used in structured funds might be complex to explain but result is investor protection, not build-up of risk.

A distinction has to be made between the financial product structure (i.e. portfolio management technique) and its payoff. From a retail point of view, product complexity should be linked neither to the portfolio management techniques, nor to the financial instruments used in the portfolio, but to the products' payoff -- especially because the fund's structure is well regulated under UCITS.

If the payoff is relatively easy to understand for a retail investor, the product is not complex.

We strongly believe there is no hard justification to split UCITS today between “complex” or “non complex”. However, in case we go further to the MiFID definitions and framework (and if we consider that some UCITS may be ‘complex’) it could be considered that ‘complex’ UCITS are more sophisticated products. Products ‘complexity’ should not be linked to the portfolio management technique (nor the financial instruments used in the portfolio) but to the products’ payoff itself (for example hedge funds UCITS that are indexed on a Hedge Fund index would be ‘complex’ while other UCITS, for example those tracking ‘vanilla’ market indices would not).

EXCHANGE TRADED FUNDS

We believe there is still a large amount of confusion on some ETF related aspects. **This is important for ESMA to find the correct definition of “ETF”.**

Inside the UCITS framework, ETFs need not be singled out, as they share common characteristics with other UCITS funds while already providing superior safety (liquidity, transparency) for the investors.

The marketing of complex products needs to be addressed globally, in the MIFID review process, and ETFs must not be penalized to this respect as they are part of a robust regulated framework

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 we agree, except on the following sentence in point 56: “While it may be considered that the composition of the physical assets held by a UCITS is not relevant to the asset diversification test, by virtue of the diversification provided through the swap, it is not clear that Article 52 of the Directive would allow for this interpretation.”

1. We believe that a constant interpretation of most regulators, all over Europe, has been that diversification has to be implemented after derivatives, and only after derivatives

2. We believe that this is reinforced by a simple economic analysis: the purpose of diversification is to diversify the exposure of investors. Exposure is real only after derivatives

Also, we do not agree with the following sentences in point 54: "While there are certain practices which are banned by the UCITS Directive, for example physical short selling and borrowing it is not entirely clear that a counterparty will not engage in these type of transactions are part of the investment strategy." The UCITS Directive regulates what the fund does, not what the counterparty does. The counterparty can hedge itself (or not), without any restriction.

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

We do not believe that diversification is required. The purpose of diversification regulations is to diversify the risks taken by investors. Risks taken by investors are the real exposure of the fund, after the effect of derivatives.

About the question whether to treat counterparty as an investment manager:

We agree if the counterparty has discretion and flexibility on investments that have an impact on the performance/NAV of the UCITS. But if the counterparty has discretion only on the collateral of the TRS (i.e. the investment portfolio that is swapped), it would be illogical to treat it as an investment manager. As for any swap, the investment manager of the UCITS sets guidelines for acceptable collateral and the counterparty has discretion within these guidelines to choose the securities it gives as collateral.

Regarding the investment management delegation agreement, we believe that this is not appropriate:

The manager can give to the swap counterparty some flexibility as regards the choice of the underlying of the leg of the swap where the fund pays the performance of the direct portfolio. The reason is that the composition of this underlying (which is also the composition of the portfolio directly owned by the fund) has not effect on the exposure of the fund. The position of the fund through this leg of the swap is exactly compensated, by definition, by the portfolio directly owned by the fund. The only relevant consideration for the manager is the net advantage of such structure and whether the portfolio give a proper guarantee to the fund in case the counterparty would default. This is exactly what the manager is looking at. This operation is very similar to lending securities and earning the appropriate proceeds from securities lending. The manager does not have to choose the precise securities that will be lent, provided that this is on line with its guidelines.

Obviously, such flexibility for the swap counterparty does not make the bank an investment manager. An investment manager is an actor which decisions have an effect on the return of the fund. This is not the case here.

In any case, we strongly disagree with ESMA's guidelines to allow banks to be investment managers of UCITS. Only an entity approved as asset managers should be able to manage UCITS. It's necessary to separate individual portfolio management (mandates) and the management of UCITS

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

No, we believe that derivatives are highly regulated by Europe, especially since the CESR Guidelines on Risk Measurement.

STRATEGY INDICES

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

For the sake of clarification, we believe that the proposed ESMA orientations as regards indices should be applicable to all indices, not only to strategy indices.

-Diversification: we do not understand the 'impact' concept and the definition (quantitative or qualitative) would need to be clarified. We agree with requirements proposed for commodity indices. We understand ESMA proposal as being, for example, that a WTI contract and a Brent contract should be seen as only one asset for the sake of diversification. ESMA should also be explicit about whether crude oil and gasoline, for example, should be seen as only one commodity

- Adequate benchmark: By suggesting that an index must be a benchmark for the market to which it refers, ESMA seems to restrict the scope of eligible financial indices to long only and beta financial indices not embedding any kind of strategy. In other words, the ESMA Discussion Paper might be construed as making a distinction between plain vanilla, long only and beta financial indices, on the one hand, and strategy indices relying on an optimisation process with a view to producing an alpha return, on the other hand.

In its advice of January 2006 (Ref: CESR/06-005), CESR advised that in order to be recognised as being an adequate benchmark for the market to which it refers, the index "must measure the performance of a representative group of underlyings in a way that is meaningful and useful". Strategy indices can be designed with a view to satisfying this condition. There are numerous strategy indices meeting that requirement that have been approved by the supervisory authorities across the EU over the last decade and in connection with UCITS products. It is also worth noting that some of those strategy indices have become benchmark indices themselves.

UCITS funds providing an exposure to strategy indices have been raising and are still raising subscription proceeds amounting to billions of Euros, which is per se already a strong indication that there is demand for those UCITS funds and that they have been delivering a performance deemed as being a competitive one in comparison with other types of UCITS funds and other investment products.

We are wondering which grounds are sustaining the perceived ESMA belief that strategy indices are not appropriate for UCITS funds where there are no clear evidences that strategy indices are failing in terms of risk & return by comparison with plain vanilla, long only and beta financial indices.

- Rebalancing: the rebalancing frequency (that has to be disclosed in the prospectus) is not a guarantee for transparency nor linked to the costs issue. Traditional indices have a rebalancing policy which is, in general, quarterly. However, the world of indices knows a lot of innovation these days and we do not see why having a more frequent rebalancing, even intra-day, would be in itself a problem in terms of public policy. ESMA mentions two problems: the costs and the transparency. Investors should clearly be informed that rebalancing can happen intra-day, but the costs are not necessarily significant, since the underlying concerned can be very liquid (futures etc.). Also, the rebalancing can affect only a small part of the portfolio so that would not be significant in terms of costs. Transparency may be an issue, but the frequency of rebalancing is not the issue. An index can be rebalanced quarterly and be completely non transparent. An index can be rebalanced intra-day and be very transparent. We believe there is no absolute relation between the two. We agree with the disclosure of the rebalancing frequency in the prospectus

- Published in an appropriate manner: Some index providers do not provide for free the components and weights of their indices. This is in fact very usual. Besides, the notion of the investors being able to "replicate" the performances of the underlying index is according to us not as relevant as it seems. Some
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well-known and recognized financial indices (e.g. the S&P GSCI) allow some discretion, though constrained through their index committee and some other indices do not disclose commercially sensible information (which would allow an investor aiming at replicating the index to arbitrage it). It seems to us that the right criteria as regards transparency should be that investors must be able to assess which market is exactly represented, what the objectives of the index are and how the rebalancing methodology works.

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

We believe that interest rate derivatives and FX derivatives should be disregarded for the sake of diversification of indices, i.e. their notional should not be taken into account for the sake of diversification.

There is no proper way to take them into account and they are already disregarded for the computation of diversification of assets held directly by UCITS according to article 52 of the UCITS Directive.

The reason is that such derivatives do not have an "underlying" according to article 51(3) paragraph 3 of the UCITS Directive.

However, we believe that an FX position has a diversification feature in itself, e.g. a portfolio having an index exposure and FX positions might be better diversified than a portfolio only exposed to the index. As a consequence, when evaluating the exposure of an index to a given asset, managers should be given the option to include the FX exposure gained through FX future contracts used for investment purposes (as opposed to hedging purposes) in the calculation.

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

The situation of "indices of indices", indices that contain some other indices among their constituents, should be clarified.

If the sub-index is itself an index according to the UCITS Directive and ESMA guidelines, the sub-index is itself properly diversified. The weight of the sub-index should therefore be allowed to be higher than 35%.

For example, we propose that it should be possible to have an index that would be made of 4 constituents, each of them for 15% of the index, plus a compliant sub-index for 40% of the index. As a constituent of the index, the sub-index can represent more than 35% of the index.

We do not see other specific issue.

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

ESMA guidelines should include a paragraph allowing indices that include other indices as constituents. It should simply mention that when an index includes as constituent another index (the "sub-index") and when the sub-index respect European regulations as an index, the exposure to such index can be higher than 35% of the index.