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Deutsche Bank's response to ESMA's Discussion paper on ESMA's policy orientations on guidelines for UCITS ETFs and Structured UCITS

London, 22 September 2011

Dear Sir, Madam,

We appreciate the opportunity to comment on ESMA's discussion paper on guidelines for UCITS ETFs and Structured UCITS and support efforts to strengthen regulation underlying the ETF and structured UCITS industry. In general we welcome the proposed policy orientations and the emphasis on enhancing transparency. We specifically stress the importance of clear and understandable information for investors on these products.

We strongly support initiatives that address valid concerns in the funds markets and which lead to the implementation of common standards in the UCITS market, not just for ETFs but UCITS in general.

We caution against introducing limitations to the distribution of certain complex products to retail investors, specifically in the context of UCITS. Generally, "complexity" does not give a good indication of appropriateness for investors. After all, if a product embeds a derivative, in many cases it is intended to reduce risk for an investor. Also, one of the aims of the UCITS directive is to regulate funds that are suitable for the retail market.

Please find our responses to your questions below. We trust these are helpful.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'A. Procter', written over a horizontal line.

Andrew Procter
Global Head of Government and Regulatory Affairs



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.

We do not agree that it is necessary to explore further approaches to the marketing of synthetic ETFs and structured UCITS which go beyond the selling rules already in place in MiFID. In order to ensure consistency across all types of retail products (including notes, certificates and warrants, as well as funds), the obligations under MiFID should continue to be applied to the marketing of synthetic ETFs and structured UCITS.

Additionally, we note with concern that several member states are acting unilaterally in developing strict selling rules around structured products and UCITS. We strongly disagree with broad bans. They are not in the interests of retail clients as clients will no longer have access to products which – while suitable for retail clients – cannot be sold to them on the basis of indiscriminate requirements. Also, product bans do not address the underlying problem that causes products to be sold to clients that are not suitable for them. The existing - clear - selling rules in MiFID already provide protection which is meant to prevent the misselling of products to retail clients. If ESMA concludes that retail clients have been sold unsuitable products, then adherence to and enforcement of these rules should be evaluated.

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’?

We disagree with qualifying certain structured UCITS as complex. The UCITS directive in itself regulates investment funds through strict criteria and as such contains assurances that prevent the authorisation of UCITS that fail to meet such criteria. The marketing of UCITS is subject to the selling rules in MiFID. Assuming a sufficient level of enforcement, the appropriateness and suitability rules under MiFID sufficiently protect against misselling.

Notwithstanding the above, we note that the definitions of “complex” and “non-complex” do not take into account risk. A product with capital guarantee, for example, could be classified as “complex” where, in reality, a client has a much smaller chance of losing its investment than via, for example, an investment without a guarantee. In terms of determining complexity, the use of – for example - derivatives should not be a deciding factor.

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?

The ESMA paper discusses financial instruments and techniques (such as derivatives or securities lending) which can be used by all UCITS. They are useful and necessary for the entire investment fund industry and not “characteristics” of a fund that could be unsuitable for some investors.

We stress the importance of clear and understandable information about products – as intended in the Key Investor Information Document (KIID). Also, every product provider and distributor



should be responsible for identifying the target audience of a product and, subsequently, assessing the appropriateness of a product for a particular type of investor. This should be done via a robust new product approval process.

In order to avoid inappropriate UCITS being bought by retail investors, we would recommend:

1. the use of appropriate and clear risk factors and disclaimers in fund documentation and marketing material;
2. separation of marketing to institutional and retail investors - the provider and/or distributor can exclude certain products if not deemed appropriate for retail by restricting the marketing to institutions only; and
3. the use of separate websites for institutional and retail clients containing suitable warnings, disclaimers and appropriate offering documentation.

However, where advice is provided, it is the adviser that is responsible for ensuring that the recommended product is appropriate. Only the adviser has direct knowledge of the investor's characteristics and needs. Any sweeping limits to distribution will harm investor choice and may actually hinder investors.

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

No. Structural complexity does not automatically equate with greater product risk.

We also note that the nature of systemic risks means that it is difficult to identify them before they emerge. Hence we underline the importance of the monitoring and warning framework which the European Systemic Risk Board - working with national regulators and the three European Supervisory Authorities - put in place for the EU as a whole.

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

We do not see any other issues.

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.

Because of the robust regulation underlying them, UCITS are clearly recognisable by investors and are generally considered highly regulated products. While we agree that there is scope for improving rules around non-UCITS, we do not feel that it should be implied that non-UCITS can provide the same product assurances to investors as UCITS.



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.

We agree. In order to achieve more harmonisation, all products sold to European investors should be subject to the selling rules that currently apply to the financial instruments defined in MiFID. In this context we strongly support the Packaged Retail Investment Product initiative.

EXCHANGE TRADED FUNDS

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.

We agree that an identifier would provide clarity. The identifier should be clearly defined to avoid non-ETF products being included in the scope.

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

We do not agree. The most appropriate places for the distinction between synthetic and physical ETFs and actively managed ETFs are the prospectus and the KIID. It should be made clear to investors which strategy an ETF follows and an explanation of what this strategy means in practice should be given. This will provide greater transparency for investors and will result in better understanding.

We note that other UCITS funds which use derivatives as part of their investment policy are not required to distinguish between synthetic and physical. For the sake of clarity, we believe that it is important to ensure consistency across all UCITS in this respect.

A final, practical, consideration is that some physical ETFs allow for the use of derivatives. Any distinction in the identifier could create confusion. From a practical perspective the implementation of such a requirement would be extremely onerous for existing providers.

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

We agree. The KIID should be used to reflect crucial information on the ETF in a clear and understandable way.

INDEX TRACKING ISSUES

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

We agree, although we note with regard to paragraph 23 that tracking errors and tracking differences occur in all index tracking products.



We suggest that in the prospectus and KIID of both physical and synthetic replication ETFs clarity should be provided on the type of index being tracked by the ETF, i.e. whether they are based on Price Return or Total Return (including Net or Gross of any withholding taxes that may apply) and how dividends are reinvested.

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

It is inappropriate to include a maximum tracking error in the prospectus. A more appropriate place for the disclosure of the tracking difference and/or tracking error would be in the KIID, which is updated annually, so that investors can see what the actual tracking difference and/or tracking error has been. Also, a common definition of tracking difference and/or tracking error should be developed so that investors have clarity on what this comprises.

With regard to the provision of information to investors, investors should be made aware if a physical replication UCITS ETF is following a full replication model or a partial replication policy. However, we do not recommend detailed disclosure on the actual method followed, as these sampling policies are often proprietary.

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?

In principle we agree that key information should be reflected in the KIID. However, as the KIID has limited space and should therefore focus on the most important elements in a product, we do not feel that index tracking issues should be a standard part of the KIID. Rather, the product provider/distributor should be able to assess which risk factors are the most important for the investor to be made aware of at a certain time for a specific product.

Also, we believe that the performance chart in the KIID provides a good illustration of what the tracking error is for investors.

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

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

No, there are other issues.

SYNTHETIC ETFS – COUNTERPARTY RISK

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

Yes, but such provisions should apply to all UCITS using derivatives, not just synthetic ETFs. In fact, the ESMA proposals reflect common practice for the db X-trackers ETFs where there is daily disclosure on the website www.dbx-trackers.com.



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.

In general the CESR Guidelines on Risk Measurement for UCITS (box 26) address the quality of assets in a sufficient manner. In this context we note that the European Markets Infrastructure Regulation (EMIR) does not require collateral to mirror the underlying index or instrument. Rather, the EMIR requirements reflect the purpose of collateral: i.e. to ensure an equivalent level of cash can be obtained in case of counterparty default.

Finally, in our opinion any proposals should apply to all UCITS, not only to synthetic index-tracking ETFs.

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.

The objective of collateral is to cover counterparty risk. For this objective the quality of assets – as set out in the CESR guidelines - should be leading.

SECURITIES LENDING ACTIVITIES

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

We underline the importance of disclosure: The disclosure requirements for securities lending should be of the same standard as that for synthetic ETFs. Also, to ensure common standards, disclosure requirements should apply to all UCITS and not just UCITS ETFs.

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

We understand that the section on Securities Lending is intended to cover direct investment UCITS ETFs which engage in securities lending of fund portfolios. If this is the case, we agree with the policy orientations identified by ESMA.

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.

We agree that the disclosure for securities lending activities should match the collateral disclosure requirements for synthetic ETFs in order to create greater transparency for investors.

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.

We support this proposal.



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?

No, provided that there is appropriate disclosure (including in relation to collateral and counterparty risk).

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

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

No, we have no further suggestions.

ACTIVELY MANAGED UCITS ETFs

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

We generally agree. However, it is not necessary to disclose how the indicative net asset value is calculated. This calculation is not relevant for investors as they will buy at the offer price on exchange. There is no guarantee that this will be close to the indicative NAV, especially where markets for the underlying securities are closed. The exchange price has economic value and can be arbitrated by market participants. In contrast, the indicative net asset value is a theoretical value which cannot be corrected by market forces if incorrect. Also, the calculation of the indicative NAV is not part of a fund manager's duties and is typically performed by an external service provider.

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

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

No, we have no suggestions.

LEVERAGED UCITS ETFs

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

We agree with the analysis. We also recommend that leveraged and/or inverse UCITS ETFs use the word "Daily" or "Monthly" - as appropriate - in their identifier, as well as the level of leverage (e.g. "2X") in order to make it clear to investors which return is being tracked.

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

Yes.

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



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

No, we have no suggestions.

SECONDARY MARKET INVESTORS

We refer to the general comments in the EFAMA response which provides a detailed explanation on the nature of the primary and secondary market in trading ETFs.

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

We do not support the suggestion in paragraph 45 and refer to the EFAMA response on the issues covered in paragraph 45 and 46.

Paragraph 47 is unclear. The net asset value of a share is only correct at the moment it was calculated. The price the shares trade at on the exchange will not be the same as the NAV as it reflects the portfolio value at a different point in time and also depends to a large extent on the current level of the underlying market's volatility.

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

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

It is common market practice for ETFs to disclose liquidity risks for the secondary market in the prospectus. We suggest ESMA adopt this practice.

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?

Yes, under UCITS investors have the right to request direct redemption. However, in the first instance we would advise them to use the secondary market for this (see also our and EFAMA's response to Question 33).

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

Yes, this right should be used in very limited circumstances (see for example ISDA's definition of "disruptive events"), and, as we have set out above, investors should be encouraged to use the secondary market in normal circumstances.

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?

As an ETF cannot influence prices on an exchange, it cannot ensure that the exchange value of its units equal the net asset value per share. The net asset value of a share is only correct at the moment of calculation. The price the shares trade at on the exchange will not be the same as the NAV as it reflects the portfolio value at a different point in time and also depends to a large extent on the current level of the underlying market's volatility. However – as is set out in more detail in



EFAMA's response to this consultation – the NAV price is controlled via the ETF's primary market process.

We suggest that clear risk factors are inserted into the prospectus, which illustrate the risks of purchasing at ETF on the secondary market.

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.

We agree.

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

We generally agree. However, it is not clear what approvals for transactions would be required from counterparties.

Additionally, there would be much added value by adding the suggested disclosures to the prospectus on the type of collateral that may be received from counterparties as this is already required in the existing rules.

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

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

No, we have no suggestions.

STRATEGY INDICES

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

We disagree on some of ESMA's policy orientations and note that ESMA does not seem to give evidence to justify the necessity of extra rules or guidelines to increase investor protection for these products.

Paragraph 67: Commodity indices should not be required to comprise different commodities to be considered an eligible index. The UCITS directive sets out clear rules about the use of non-diversified indices (whether based on commodities or otherwise) to ensure that diversification criteria at the UCITS level are met.

Paragraph 69: The rebalancing frequency of an index should be reflective of the market which it is seeking to track. As markets have different frequencies we do not agree that indices which rebalance intra-day or daily are not eligible.

Paragraph 70 & 73: Proprietary methodologies are the basis on which investment managers compete and are therefore commercially sensitive. Therefore, we disagree that they should be



fully disclosed. As long as an investor understands how the index operates and into which assets it invests – via appropriate disclosures – the interests of the investor are sufficiently protected. In this context we also disagree with the statement that strategy indices involving undisclosed proprietary information should not be considered eligible financial indices.

Paragraph 72: While it is not entirely clear what is meant by “continually available”, we would disagree that a UCITS should be required to provide “live” index data such as composition and weighting. This would create an unlevel playing field between index based UCITS and non-index based UCITS, which only need to disclose their physical portfolios in semi-annual and annual reports. In addition, as implementing this disclosure requirement would be very costly, the benefit of such a requirement would be disproportionate to its cost.

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

From an economic perspective assessing whether an interest rate is “diversified” or not does not make sense. Diversification is not a pertinent measure of risk in respect of interest rates.

Rather, the appropriate test in respect of interest rates would be the “representativeness” of such rate (and therefore of any index built on that rate), which can be assessed by reference to the relative number of (market) participants whose transactions contribute to the periodical determination of the interest rate. In other words and as a matter of illustration, an interest rate would be considered representative of a domestic money market if – as is the case for the LIBOR or the EURIBOR for example – it is the result of the confrontation on an open market of (i) several diversified supplies/offers of liquidities in a given currency and for a certain term and (ii) several diversified demands for liquidities in the same currency and for the same term. The representativeness and hence the eligibility of any index built by periodically capitalising the performance of an interest rate should therefore be assessed pursuant to the same criterion.

The analysis set out above also applies to FX rates.

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

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

No, we have no suggestions.