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FRANCE

Discussion paper „ESMA’s policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS” (ESMA/2011/220)

Dear Ms. Ross,

BVI¹ welcomes the opportunity to present its views on ESMA’s policy orientations in terms of possible regulatory guidelines for exchange-traded and structured UCITS.

Introductory remarks

We appreciate the efforts undertaken by ESMA in order to warrant adequate protection of retail investors and to uphold the quality of the UCITS brand. Therefore, we are committed to actively participating in the upcoming discussion on strengthening the regulatory framework for certain categories of UCITS.

¹ BVI Bundesverband Investment und Asset Management represents the interests of the German investment fund and asset management industry. Its 85 members manage currently assets close to EUR 1.8 trillion both in mutual funds and mandates. BVI’s ID number in the EU register of interest representatives is 96816064173-47. For more information, please visit www.bvi.de.

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However, it must be noted that many suggestions put forward in the discussion paper in relation to ETFs or structured UCITS might have much wider implications. From the legal perspective, ETF UCITS and structured UCITS are just UCITS pursuing investment strategies and applying techniques which are generally permissible under the UCITS Directive. Hence, the discussion on specific requirements for derivatives or securities lending initiated by ESMA must not be limited to ETFs, but should be led in the wider context, since any potential modification of the relevant UCITS provisions will inevitably affect all EU-harmonised investment funds.

On the other hand, we are very supportive of the notion presented by ESMA to extend the discussion on regulatory standards to other exchange-traded products. Indeed, such extension appears highly pertinent for both creating a level playing field in the exchange-traded product universe and ensuring appropriate investor protection. The latter could be achieved by applying equivalent standards of distribution to all comparable exchange-traded vehicles which is principally envisaged by the PRIIPs initiative, but also by submitting the non-UCITS ETPs to meaningful transparency standards and at least a minimum set of product-specific rules. We will elaborate on this concept in more detail in our answer to Q7 below.

As regards the formal proceedings, we think that the consultation period has been determined too short to allow for appropriate considerations of all the important questions raised in the discussion paper. ESMA should be aware of the industry being absorbed by evaluating its recommendations for the AIFMD implementing measures. This is even more astonishing as there is apparently no mandate and thus no clear deadline for ESMA's work on ETFs.

Specific comments

With regard to the questions for consultation raised by ESMA, we would like to remark the following:

Part II. General policy discussion

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.*

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”?*

We wonder on which basis ESMA reinitiates the discussion on classification of certain UCITS as complex or non-complex products, or other possible limitations of distribution at the current point of time. Clearly, distribution of UCITS as of other financial products is covered by MiFID provisions which are just in the process of a major review. The legislative proposal for modifications of the MiFID rules is expected to be published shortly by the Commission and should form the reference point for any debate on the future distribution framework for UCITS.

Nevertheless, we would like to reiterate our position concerning classification of UCITS for distribution purposes brought forward in the course of the preceding Commission consultation on the MiFID review:

There are still legitimate reasons for maintaining the general classification of UCITS as non-complex. The level of UCITS regulation exceeds any other regulatory framework in the financial sector. Even on the global basis, UCITS investments are subject to the highest standards on regulation and transparency providing in particular for appropriate risk diversification. The UCITS assets are strictly separated from the assets belonging to a management company and entrusted to a depositary for safe-keeping. The comprehensive information by UCITS providers as well as dense supervision at both product and manager level ensure that management of fund assets takes place in accordance with legal provisions and applicable fund rules. The Commission itself has recently admitted that the UCITS sector was “not one of the root causes of the financial crisis and the new regulatory framework for UCITS should place significant limits on the degree and nature of the risk that a UCITS might take on (...)”². This appraisal has to be borne in mind also in the context of the MiFID review.

In addition, all UCITS should comply with the criteria for non-complex instruments specified in Art. 38 of MiFID Implementing Directive. UCITS investments are very liquid (redemptions possible usually daily, but at least

² Cf. Working Document of the Commission Services “Consultation Paper on the UCITS Depositary Function and on the UCITS Managers’ Remuneration” dd. 14 December 2010 (MARKT/G4 D (2010) 950800), section 2.3. on page 26.



twice a month), do not involve any liability exceeding the acquisition cost, provide a very high level of transparency, are subject to stringent risk management rules and, above all, are designed to be well diversified. In particular, the recent introduction of the Key Investor Information Document (KIID) renders UCITS by far the most transparent financial instruments with a high potential for comprehensibility on the part of retail investors. The KIID provides investors with appropriate information about the essential characteristics of the UCITS concerned, so that the investor is reasonably able to understand the nature and risks of the investment product that is being offered to him and, consequently, to take investment decisions on an informed basis. Therefore, it appears contrary to the applicable legal requirements for KIID to consider management techniques of some UCITS difficult to understand for investors.

However, should abolishment of the UCITS general status as “non-complex” be envisaged notwithstanding these valid arguments, we deem it inappropriate to discuss the respective treatment of UCITS in isolation. Any changes in the classification of UCITS must be based upon general criteria applicable to all financial instruments subject to the “complexity test” under MiFID.

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?*

As explained above, we are not convinced that distribution of UCITS deserves specific regulatory attention as compared to marketing of other financial products. UCITS are indisputably the flagship of the European retail market with the highest standards of investor protection governing both product composition and transparency towards investors. It appears inconsistent to discuss limitations of distribution specifically for UCITS while disregarding more pertinent issues of potential misselling in other non-regulated vehicles.

Hence, any measures to be introduced in distribution terms under MiFID must apply on the basis of general criteria to all types of products displaying similar features for the purpose of assessing complexity or risk. Moreover, it should be noted that the current MiFID regime already requires distributors



to warn investors in case a product they wish to purchase does not meet the criteria of the appropriateness test³.

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

All products discussed by ESMA in the consultation at hand are fully compliant with the current UCITS regime. None of them should be deprived of the UCITS status just because they explore the possibilities of the UCITS Directive in terms of innovative investment strategies. If the regulators feel that the protection of retail investors is in some cases insufficient, the discussion should focus on ways and means of enhancing the relevant protection measures rather than banning certain products from the UCITS framework.

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

We are not aware of any issues relating to the systemic risk of UCITS. In fact, we have also been quite reluctant to the evaluation of the systemic relevance of ETFs presented by the Financial Stability Board earlier this year. Our respective comments can be found in the **attachment** to this reply.

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.*

We are not sure on what legal basis ESMA could apply any of the UCITS guidelines to other investment funds established or sold in the EU, since such funds would qualify as AIF under the AIFM Directive which lacks any product-specific regulation. However, from the material point of view, it might be desirable to extend the discussed transparency standards for UCITS ETFs to all exchange-traded funds listed within EU or even to all exchange-traded products available for sale to European retail investors (cf. our answer to Q7 below).

³ Cf. Art. 19 para. 5, 2nd subparagraph of MiFID.



Q7: *Do you agree that ESMA should also discuss the above-mentioned issues with a view to avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.*

BVI is very much in favour of widening the scope of the regulatory discussion in order to encompass other exchange-traded products such as notes issued by credit institutions or SPVs. As correctly depicted by ESMA, such products are not subject to any specific requirements concerning diversification, eligibility of assets, risk management or tailored transparency to investors. Therefore, on the production side they display a significantly lower level of investor protection as compared to UCITS ETFs.

The European PRIPs initiative currently in the pipeline aims at introducing a common standard for product-related disclosure based on the UCITS requirements for KIID for all “packaged retail investment products” sold to EU retail clients. As regards exchange-traded notes, PRIPs will probably to some extent remedy the existing shortcomings in terms of product information, even though not to the extent currently envisaged by ESMA in the consultation paper at hand. Given the obvious deficiencies in the area of product regulation and supervision as compared to UCITS or investment funds in general, it appears pertinent to give some thoughts to the idea of extending the transparency standards currently under discussion to all exchange-traded products (notes and commodities) available to EU retail investors.

In any case, the PRIPs initiative will not touch upon broader issues linked to the manufacturing of exchange-traded products. In this respect, however, the expected Commission’s proposal for MiFID review could provide an appropriate reference point by introducing certain organisational requirements for product launches by investment firms and banks. The consultation paper on MiFID review put forward some generic suggestions in this regard which were set i.e. to ensure product compatibility for target investors and to warrant proper management of product-related risks⁴. Depending on the final content of the Commission’s proposal, these deliberations could be refined and possibly strengthened for products considered as “complex” according to the relevant MiFID criteria.

⁴ Cf. Section 7.3.3 on page 68-69 of the public consultation on review of the Markets in Financial Instruments Directive (MiFID) dd. 8 December 2010.

Part III: Exchange Traded Funds

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.*

We agree with the suggestion to introduce the acronym “ETF” or the term “Exchange Traded Fund” as identifier for UCITS ETFs. Such identifier should form part of the fund name and be clearly disclosed in the fund rules, prospectus and marketing materials.

In our view, it is expedient to define UCITS ETFs which should be bound to use a common identifier. Such a definition should bear upon the fact that a distinct feature of UCITS ETFs is their listing on regulated markets within the EU, while excluding situations in which secondary trading of UCITS takes place on other trading platforms outside the regulated markets and is not prompted by a deliberate marketing decision on the part of the fund provider.

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

We believe that the identifier for UCITS ETFs should not distinguish between synthetically and physically replicating index funds. It is very difficult to establish at what extent of derivative use ETFs should be classified as synthetic, given the fact that some ETFs apply mixed replication strategies or even provide the fund manager with the discretion to select the appropriate technique for index tracking. In our view, the replication strategy should be clearly disclosed to investors in the KIID and fund prospectus, but not as part of the identifier.

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

Being an integral element of the fund’s name, the identifier must be used in the KIID for UCITS ETFs.

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



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

Ensuring adequate transparency should be a general concern to all UCITS. Therefore, we agree with ESMA's analysis of index-tracking issues, but would like to emphasize that the proposed enhancements of transparency should not apply solely to UCITS ETFs, but are relevant to all UCITS pursuing index-tracking investment strategies. Moreover, ESMA's stock-taking of the ETF market should duly account for the differences between funded and unfunded structures of swap-based ETFs⁵.

As regards ESMA's policy orientations, however, we have objections towards the suggestion requiring ETFs to define a maximum level of tracking error in the policy of index-tracking UCITS ETFs. Tracking error is determined by ex-post consideration of internal limit systems pertaining to the investment objectives of an ETF and thus cannot be limited itself *ex-ante*. Moreover, it must be noted that tracking error can also be positive due to yields achieved on securities lending transaction. In such case, maximum limits for tracking error might reduce the ETF investors' ability to benefit from such additional revenues. Also, accounting/booking practices can influence tracking error which will differ depending on whether e.g. the securities lending revenues are accrued on a daily basis or booked monthly at the time of their payment. In any event, it appears helpful to establish a common definition of the term "tracking error" for regulatory purposes.

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?*

In principle, we agree with including the key information on index-tracking issues in KIID for UCITS ETFs, provided that the regulatory guidance in this respect will duly account for the very limited space available in the KIID to facilitate such disclosure.

⁵ These structures are described in detail on page 5-7 of the BIS Working Paper No. 343 "Market structures and systemic risks of exchange-traded funds" dd. April 2011.



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?*

We do not perceive any further issues pertaining to index tracking by UCITS.

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

In general, we support ESMA's disclosure proposals relating to underlying exposure, counterparties and collateral, even though the requirement to specify the underlying exposure through derivatives in the annual report is quite extensive. However, ESMA should bear in mind that the logical consequence of these suggestions would be submitting all UCITS engaging in derivative transactions to the enhanced standards of disclosure.

As regards disclosure on counterparties, we understand that ESMA suggests to include in ETF prospectuses only generic information concerning the counterparty selection process, and to provide details on the identity of counterparties to derivative transactions in the annual report. We support this approach which should avoid overly frequent amendments of ETF prospectuses in case of changes to derivative contracts.

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.*

We do not see the necessity to discuss further enhancement of the UCITS provision for collateral to derivative transactions at this stage. The quality standards for collateral have been laid down in the CCSR Guidelines on Risk Measurement and the Calculation of Global Exposure for UCITS (CESR/10-788) which have been only recently implemented by the UCITS managers. In our opinion, these guidelines provide for a robust approach to risks related to collateral.

Especially, we reject any requirements for collateral to match more closely the relevant index as regards the type of assets. Collateral is being provided



in order to secure a claim and must not be confused with the fund portfolio. Also, we do not think that better correlation with the fund portfolio in terms of quality would necessarily bring benefits to investor protection. In case of ETFs tracking e.g. emerging market indices or the performance of specific innovative sectors, such measures would certainly deteriorate the collateral standards currently in place. Moreover, ESMA should bear in mind that the rules on EMIR might restrict collateral to highly liquid assets, thus excluding e.g. equities from being available for OTC derivative transactions with central counterparties.

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.*

The purpose of collateral is to shield investors from the credit risk of the counterparty to a derivative transaction, not to ensure risk diversification of the UCITS portfolio. Therefore, we see definitely no need for collateral to comply with the UCITS diversification rules. For collateral, the aspects of quality and liquidity are most important. Hence, we would even go further and question the reasonability of CESR Guidelines on Risk Measurement in terms of collateral diversification – currently, the guidelines exclude the acceptance of German government bonds as exclusive collateral to a derivative transaction, even though under credit rating aspects no higher-quality collateral exists.

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

We agree with ESMA's analysis but for para. 37 of the discussion paper. The systemic risk concerns raised by FSB are not justified as there are already provisions in place under the UCITS regime which prevent a market squeeze and protect investors in the event of increased redemptions (such as the right to suspend redemptions under Art. 84 para. 2 UCITS Directive). As regards ETFs, such risks are even lower as compared to other UCITS due to additional liquidity supply by market makers which significantly reduces the impact of unit trades on the fund portfolio and hence prevents large-scale recalls of on-loan securities. Please refer to our response to the FSB note provided in the attachment for further details.



Furthermore, we would ask ESMA to note that securities lending returns only contribute positively to the tracking difference. Hence, any concerns ESMA may have concerning tracking error should be set in the context of the long-term performance contribution of securities lending to the fund and the subsequent benefit to the end-investors. Moreover, as regards cash collateral, the fee for securities lending is generally expressed as part of the rebate rate. The borrower who pledges cash collateral expects a reference rate return (e.g. Libor) on the pledged amount.

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

We agree with ESMA's policy orientations on information to be included in ETF prospectuses in respect of securities lending. Transparency and disclosure to investors concerning whether and how ETF lends securities is extremely important and ESMA's proposed guidance in this area will serve to raise the level of transparency in terms of securities lending activities. In detail, however, whilst agreeing that the general collateral policy should be reflected in the fund prospectus, we believe that more specific information on collateral parameters, such as types of collateral, eligibility limits and levels of over-collateralisation, should be available on the provider's website or upon specific requests by investors as these elements might change quite frequently depending on market circumstances.

In this context, we would also like to point out that the enhanced transparency standards proposed by ESMA are relevant not only to ETFs, but should equally apply to all UCITS engaging in securities lending transactions. ESMA should be aware of this consequence when refining its regulatory approach to securities lending.

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.*

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.*

We support the suggestion to provide for EU-wide harmonised rules in terms of collateral for securities lending transactions. While it appears reasonable



to consider the criteria for collateral laid down in the CESR Guidelines on Risk Measurement as a starting point for such exercise, we are not entirely convinced that these measures are fully adequate to reduce counterparty risk immanent to securities lending transactions. In our view, a detailed analysis of the issue is necessary before introducing new standards for collateral at EU-level.

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?*

We definitely reject imposing any limits to the amount or proportion of a UCITS portfolio which can be subject to securities lending as suggested in Q23. Limits are neither necessary nor appropriate if securities lending transactions are adequately collateralized in accordance with the relevant standards currently in place. Moreover, ESMA should bear in mind that in case of synthetic ETFs the swap provider is also able to lend out the entire swap portfolio in order to generate additional revenues.

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

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

We cannot think of any other issues in relation to securities lending being of relevance for ESMA's stock-taking exercise.

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

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

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

We agree with ESMA's policy orientations but for the requirement to disclose the calculation mechanisms for the iNAV. Calculation of the indicative net asset value does not form part of the fund manager's duties, but is performed by external service providers. INAV is a purely theoretical number and not in any way correlated to the NAV of ETFs which is determined upon the market value of the fund assets in accordance with UCITS provisions. In



addition, iNAV is being provided for all ETFs, not only for those which are actively managed. Therefore, we do not conceive why ESMA proposes to specify the relevant calculation methods specifically for this ETF category.

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

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

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

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

We concur to ESMA's analysis and the suggested policy orientations relating to leveraged UCITS ETFs. However, the discussion paper remains ambiguous on the issue which UCITS ETFs should be deemed leveraged and in particular, whether leverage embedded in an index should be considered for this purpose. It would be helpful if ESMA could provide more clarification in this regard.

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

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

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

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?*

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

We definitely disagree with the provision of a warning to ETF investors as suggested in para. 45 of the discussion paper. In our opinion, such warning misrepresents the legal position of ETF investors under the UCITS Directive. According to Art. 84 para. 1 of the Level 1 Directive, ETFs, just like other UCITS, are obliged to grant their investors the right to redeem units directly with the fund or its management company. Such right of redemptions can be executed by ETF investors by intermediation through depository banks which hold the ETF units in client accounts.



Therefore, from our point of view, the alternative discussed in para. 46 is the only feasible way to conform to the valid UCITS framework. As stated above, we believe that already the current UCITS regime requires fund providers to ensure effectively enforceable redemption rights in terms of ETF units and that no further regulatory action is needed in this respect.

This should be without prejudice to the legitimate right of ETF managers to impose certain constraints to direct redemption requests by investors in the fund rules e.g. by applying redemption charges. Such charges are legitimate also under the UCITS Directive and, in the area of ETFs, generally deemed advisable in order to maintain exchange trading as the primary distribution channel. They are also in the interest of the remaining fund investors who might incur detriments due to the necessary sales of portfolio assets.

Q38: *How can ETFs which are UCITS ensure that the secondary market value of their units does not differ significantly from the net asset value per unit?*

It must be recognized that ETFs and their providers have in general no influence on the secondary market price of their units which is determined by independent market players and hence cannot ensure that no significant variations from the fund's NAV occur. However, ETFs operate in a market environment which allows for "fair value arbitrage" due to the redeemability of ETF units. Investors wishing to sell their units at the NAV price can do so by making use of their redemption rights towards the fund / management company, provided that they are prepared to accept charges on direct redemptions or other mechanisms which might reduce the amount of paid out capital. In this context, it should be noted that upfront or redemption charges are common practice among all UCITS and not specific to ETFs.

Part IV: Structured UCITS

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

With regard to ESMA's reservations in para. 54, it is worth recalling that total return swaps being derivative instruments under the Eligible Assets Directive permit limited engagement of UCITS in alternative investment techniques.



According to the current supervisory practice in Germany, the swap portfolio, while allowed to hold only UCITS eligible assets, may apply investment techniques and mechanisms which are not permitted for direct investments by UCITS. It is also clear, however, that UCITS entering into transactions for total return swaps must comply with the strict requirements of CESR Guidelines in order to measure the associated market and counterparty risk.

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

BVI agrees with the suggestions for enhanced transparency regarding transactions in total return swaps. However, we would like to stress that, in accordance with our remarks on Q16 above, only generic information on counterparties should be included in the prospectus with further details especially relating to the identity of counterparties being disclosed in the annual report.

We reject the notion to apply the diversification rules of the UCITS Directive to the swap underlying (which, in our understanding, represents the swap portfolio). Total return swaps are financial instruments in the sense of MiFID and should be treated as such for the purpose of measuring market risk. It is essential, but also sufficient, to adhere to the diversification rules with regard to the UCITS portfolio.

As regards the third paragraph of ESMA's policy orientations, we disagree with treating discretionary decisions relating to the underlying swap portfolio as delegation of portfolio management. The relevant swap agreements often provide at least limited discretion to the swap counterparty in "corporate event situations" (e.g. mergers). Thus, the swap provider should be allowed to retain some discretion over its product composition. After all, ESMA has certainly no intention to suggest assuming delegation of portfolio management in case of UCITS investments in equities where the management of an investee company is empowered to take strategic business decisions which might impact the market value of the company's shares.



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

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

We do not see any other issues in relation to the use of total return swaps which would require regulatory attention.

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

We disagree with ESMA's policy orientations on strategy indices for several reasons.

The most important issue is certainly the publication requirements relating to strategy indices proposed in para. 70-74. Strategy indices are based upon complex methodologies being the intellectual property of index providers for which index users usually pay considerable fees. It is not appropriate to require public disclosure of this proprietary information and we fear that hardly any index provider would be willing to obey by the extensive disclosure standards proposed by ESMA which would result in an effective ban for ETFs and other UCITS in terms of utilization of such indices. It must be also noted that the level of transparency required by ESMA would constitute a major problem for nearly all index providers, including those of traditional stock indices. Moreover, timely publication of comprehensive index data could result in enhanced front-running or prompt speculative trades against the index.

We also do not understand why the eligibility of an index should depend upon the (retail) investors' ability of replication as suggested in para. 69. Investors in actively managed UCITS are generally not able to acquire knowledge of the fund holdings on a daily basis. Hence, the decisive criterion should be the replication ability of a fund manager which is fully warranted also in case of daily rebalancing strategy indices. The rules for composition of strategy indices are predetermined in a static way and known to the fund manager who replicates the index.



Furthermore, we reject the suggested extension of eligibility criteria for hedge fund indices to all financial indices. These measures have been developed for a specific market sector and thus are not appropriate for the bulk of traditional financial indices. This concerns in particular the in-depth due diligence on index quality required in point 4 of para. 75.

As regards the issue of conflicts of interest raised in para. 77, we think that the general conflicts of interest rules applicable to UCITS managers provide sufficient mechanisms to deal with potentially conflicting interests of the swap counterparty or index provider. The suggested independent assessment of the swap valuation should also allow for control by internal business units provided the existence of Chinese walls or other segregation arrangements in relation to fund management.

Lastly, we wonder about the reference to commodity indices in para. 67, second bulletpoint. In our understanding, commodity indices usually track the performance of selected commodities without comprising any quantitative or trading component and hence cannot be considered strategy indices for the purpose of the discussion paper.

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

For interest rates or FX rates, it is very difficult to require diversification at the index level. It must be noted, however, that recognised rates such as EONIA are computed as a weighted average of a number of overnight unsecured lending transactions in the interbank market which means that the rates as such are already diversified. Secondly, no diversification rules in terms of the derivative underlying apply if a derivative linked directly to interest rates or FX rates is acquired for the UCITS portfolio. The reason is simply that such derivatives do not have underlying assets according to Art. 51 para. 3, 3rd subparagraph of the UCITS Directive. Therefore, investments in index derivatives linked to interest rates or FX rates should be submitted to the same treatment. This is without prejudice to the full applicability of the CESR Guidelines on Risk Measurement which should undoubtedly be warranted by UCITS tracking interest rate or FX rate indices.

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?*

In view of the extensive considerations presented in the discussion paper, we have no further suggestions for issues to be taken into regard in respect of strategy indices or total return swaps.

We trust that ESMA will take our suggestions into account when refining its views on the future regulatory guidance for ETFs and other types of UCITS, and remain at your disposal for any questions that may arise.

Yours sincerely

Marcus Mecklenburg

Dr. Magdalena Kuper

Encl. BVI's comments on the FSB Note on Potential Stability Issues Arising from Recent Trends in Exchange-Traded Funds dd. 16 May 2011



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FSB Note on Potential Stability Issues Arising from Recent Trends in Exchange-Traded Funds (ETFs)

Dear Sir or Madam

BVI¹ welcomes the opportunity to furnish comments on the recently published FSB note in relation to Exchange-Traded Funds. As the representative body of the German asset management industry, BVI comprises among its members major players in the ETF market in Germany including providers of both physically replicating as well as synthetic ETFs.

General remarks

We are glad about the perspective to engage in further discussions with the FSB pertaining to the recent developments in the ETF market and their possible implications for other market participants and the financial system as a whole. However, the note at hand suggests that there are some misperceptions on the part of FSB regarding the current market structure of ETFs. Hence, we would like to use this opportunity in order to provide more clarity with regard to the functioning of the European ETF market.

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¹ BVI Bundesverband Investment und Asset Management e.V. represents the interests of the German investment fund and asset management industry. Its 85 members manage currently assets of nearly EUR 1.8 trillion both in mutual funds and mandates. For more information, please visit www.bvi.de.

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Legal structure of European ETFs

By far the most ETFs launched in Germany are UCITS; this holds also true for the rest of Europe. As such, it must be borne in mind that ETFs are subject to the same comprehensive set of rules and must adhere to the same constraints as other UCITS. The UCITS Directive provides a robust regulatory framework for investment funds with strict rules applicable i.e. to risk management and measurement, quality of collateral in OTC derivative transactions and disclosure towards investors. These rules will be further enhanced with the entry into force of the UCITS IV reform by 1 July 2011.

As regards the structure of synthetic ETFs, the FSB paper apparently presumes that the ETF provider might be identical with the bank acting as swap counterparty. In the European market this situation can never possibly occur due to the overriding separation principle between banking and asset management activities. The ETF provider as the entity responsible for ETF management must be authorized as a UCITS management company whose license is limited to asset management, investment advice and some other ancillary services.² The provision of swaps, on the other hand, is clearly a banking domain and cannot be performed by a UCITS manager.

Under the UCITS Directive, the ETF provider has the sole legal responsibility for management of ETFs. The safe-keeping duty in terms of fund assets as well as important control tasks especially regarding valuation and observance of fund rules are entrusted with the depositary being a separate legal entity, usually a credit institution. In addition, many ETF providers delegate the performance of administrative tasks to a fund administrator providing an additional layer of control. The typical structure of German and Luxembourg ETFs as examples for the European market³ is shown in the **Annex** to our reply.

ETFs and other Exchange-Traded Products

We regret that the FSB note focuses exclusively on ETFs. This is especially unfortunate since the note itself quite clearly demonstrates that the

² Cf. Article 6 of Directive 2009/65/EC (UCITS Directive).

³ Luxembourg is a major centre of fund activities in Europe and place of foundation for many UCITS, including ETFs managed by German fund managers.

perceived drawbacks of ETFs may occur similarly or even more manifestly in other Exchange-Traded Products (ETPs) such as ETNs or ETVs (see Footnote 4 of the FSB Note). It is very important that a level playing field be maintained (or established, as the case may be) among financial products, and that regulatory arbitrage among ETFs, ETNs, ETCs and other product structures be avoided.

Regrettably, ETFs are often confused in the public domain and in the press with other ETPs, and more investor education is required to correct some of the misperceptions. The educational efforts on the part of both industry and regulators should be strengthened to make investors understand that only ETFs have certain features, and that in Europe they operate within the UCITS framework which provides the highest level of investor protection.

Systemic relevance of ETF activities

Albeit being a successful business model, ETFs still constitute only a small fraction of the entire fund market. By end of 2010 only 5.9% of global fund assets have been invested in ETFs.⁴ In Europe, only 2.6% of funds are launched as ETFs (3.5% of UCITS)⁵ and the high growth rates of the ETF market observed in the recent years are due to a low starting base.

In Europe synthetic ETFs represent 45% of the ETF market what in absolute numbers amounts to nearly USD 138 billion of assets under management⁶. Compared to the global fund volume, synthetic ETFs constitute a tiny fraction of 0.6%. On the other hand, the OTC swap market for equity-linked swaps reached the volume of USD 1,854 billion in 2010 according to BIS statistics.⁷ Thus, even assuming that all positions of synthetic ETFs are held in equity swaps, the proportion of ETF engagements in the global equity-linked swap market would be no more than 7.5%.

Eventually, new ETF types such as leveraged, inverse and leveraged-inverse ETFs amount only to a tiny proportion of the ETF universe, as highlighted by the FSB note.

⁴ Source: Blackrock Industry Review end Q1 2011, p. 50

⁵ Source: EFAMA and Blackrock statistics

⁶ Source: Deutsche Bank Research, Q1-11 ETP Market Review and Outlook, p. 24

⁷ BIS Triennial Central Bank Survey at end June 2010

On balance, it is quite clear that the ETF market cannot give rise to stability concerns in relation to the entire financial system due to its limited size. Some ETF market activities are also overestimated by the FSB note, thus providing a distorted picture of associated potential risk. This pertains in particular to the “potential impact of heavy ETF trading” to which we will revert in detail in our comments below.

Comments on the asserted risk implications of ETFs

Conflicts of interests in synthetic ETFs

The FSB assumes that banks can take up a “dual role as ETF provider and derivative counterparty”. This is clearly not the case for the European ETF industry. As already explained, the EU law system explicitly prohibits such mingling of functions, thus significantly mitigating the potential for conflicts of interests.

The risk of conflicts of interests resulting in improper valuation has also been overrated by FSB. In Germany, the valuation of fund assets is mostly performed by the depositary being a designated credit institution. ETF providers tend to appoint a depositary outside the respective financial group on the basis of its capacity to provide ETF specific services such as facilitating exchange trading of fund units. Consequently, in most cases the derivative counterparty to synthetic ETFs is different from the entity responsible for valuing the ETF swap positions and assessing the quality of collateral. In addition, many ETFs delegate the administrative tasks to a specialised fund administrator which entails the involvement of another third party in the asset valuation process.

Furthermore, it must be duly recognized that European ETFs like other UCITS are subject to tight rules on management of conflicts of interests under the UCITS Directive⁸. Equivalent provisions apply to the banking counterparties according to the Markets in Financial Instruments Directive (MiFID)⁹. These sets of rules require the implementation of comprehensive measures in order to resolve conflicts of interests pertaining also to other members of a financial group.

⁸ Cf. Articles 17-20 of Directive 2010/43/EC implementing the UCITS Directive.

⁹ Articles 21-23 of Directive 2006/73/EC implementing MiFID

Lastly, the counterparty limits applicable under the UCITS Directive reduce the possible risk exposure to a swap counterparty to 10% of ETF assets in case the counterparty is a credit institution with its registered office in an EU Member State and 5% of ETF assets in all other cases, and thus provide an additional mechanism of investor protection.

Level of transparency made available by ETF providers

The UCITS regime applicable to European ETFs requires publication of a full prospectus and a simplified prospectus for the fund (the latter to be replaced by the Key Investor Information Document, the KIID, under UCITS IV¹⁰). These documents contain detailed information on the investment strategy of a fund and the associated relevant risks. In addition, ETFs are obliged to publish annual and semi-annual reports on the fund holdings and investment activities.

In practice, ETF providers make much more frequent disclosures relating to collateral composition as well as portfolio holdings and counterparty exposures of ETFs. However, it should be noted that this enhanced transparency is provided on a voluntary basis.

Risks for market liquidity

The effect of maturity transformation perceived as critical by FSB is not a specificity of ETFs, but a common feature of all open-ended investment funds. In fact, provision of easily redeemable investment opportunities in less liquid market segments is one of the indisputable benefits of fund investments.

The redemptions “in kind” mentioned in the note are not a common standard for ETF trades. Nevertheless, it is important to recognize that market makers facilitating secondary trading in ETFs play a key role in alleviating potential liquidity pressures by netting the incoming buy and sell orders. This “liquidity buffer” provided by market makers is a distinct feature of ETFs as compared to traditional investment funds.

In the same vein, the role of market makers significantly limits the impact of ETF trades on liquidity and price formation of the referenced securities. By netting of orders market makers ensure that the volatility of ETF volume and

¹⁰To come into force by 1 July 2011 in Germany.

the corresponding trading activities are reduced to a minimum. Hence, it is incorrect to assume that a correlation necessarily exists between the trade volume at ETF level and the turnover of relevant index elements. In fact, “heavy ETF trading” objected by FSB might have only marginal effects for the referenced assets.

Risks associated with securities lending

Securities lending is an established practice across the asset management industry and provides significant benefits to both financial markets and fund investors. The FSB’s concerns relate to potential market squeeze in the underlying securities to be caused by securities lending in case ETFs recall significant volumes of securities to serve requests for redemptions of fund units. While we acknowledge that securities lending by investment funds facing enhanced redemptions (such as traditional mutual funds or hedge funds, not just ETFs) could result in recalled loans, no data has been provided by FSB to support a view that fund redemptions have ever prompted loan recalls of a size that has caused a market squeeze. Furthermore, ETFs engaging in securities lending typically lend low percentages of their overall portfolios. Significant redemptions would need to be placed before other-than-ordinary recalls were necessary. There is no evidence suggesting that securities lending by ETFs poses greater systemic risks than securities lending by other market participants. In addition, the small share of ETFs in the global investment fund market indicates that any impact in terms of market stability must be considered highly unlikely.

To sum up, we think that the most concerns brought forward in the FSB note can be allayed by the above explanations. Nonetheless, we would be happy to answer any questions and stand at FSB’s disposal to engage in further discussion on regulatory issues pertaining to ETFs.

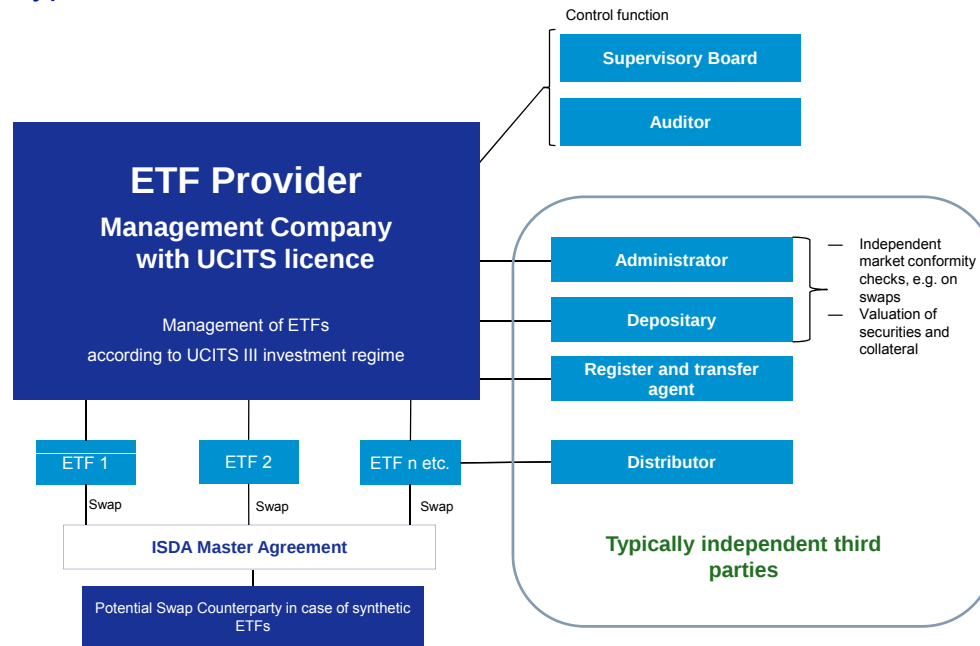
Yours sincerely

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Typical structure of German ETF



Typical Structure of Luxembourg ETF

