German Banking Industry Committee

Die Deutsche Kreditwirtschaft

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Comment on 'ESMA's guidelines on ETFs and other UCITS issues'

12-03-30

Dear Sir or Madam,

Please find enclosed the German Banking Industry Committee's comment on 'ESMA's guidelines on ETFs and other UCITS issues'.

The German Banking Industry thanks the European Securities and Markets Authority (ESMA) for the invitation to comment on these guidelines. Generally, we subscribe to ESMA's view that ETFs and other structured UCITS feature an increasing degree of complexity and that investor protection and financial market stability stand to benefit from enhanced transparency.

More specifically, in terms of the current consultation, we particularly welcome ESMA's decision to refrain from any ETF specific regulation and that, *in lieu* of this, the scope of the guidelines shall cover (index-tracking) UCITs in their entirety. However, we do have certain reservations over the proposed preconditions with regard to securities as regards actively managed ETFs as well as individual requirements with regard to strategy indices.

Yours faithfully,
on behalf of the German Banking Industry Committee
National Association of German Cooperative Banks

by proxy

Gerhard Hofmann

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Comment

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Berlin, 12-03-30

*The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.*

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Comment on 'ESMA's guidelines on ETFs and other UCITS issues'

Preliminary remarks

First of all we would like to express our gratitude for the opportunity to respond to the guidelines to regulate ETFs and UCITS with relevant activities and similar investment strategies. We welcome ESMA's approach of including market participants' suggestions in its developing of such guidelines. Generally, we subscribe to ESMA's view that ETFs and other structured UCITS feature an increasing degree of complexity and that investor protection and financial market stability stand to benefit from enhanced transparency.

More specifically, in terms of the current consultation, we particularly welcome ESMA's decision to refrain from any ETF specific regulation and that, *in lieu* of this, the scope of the guidelines shall cover (index-tracking) UCITs in their entirety.

However, we do have certain reservations over the proposed preconditions with regard to securities as regards actively managed ETFs as well as individual requirements with regard to strategy indices.

We now turn to a detailed response to the questions.

I. Index-tracking UCITS

Q1: Do you agree with the proposed guidelines?

Yes, we do.

Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs.

No.

Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?

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II. Index-tracking leveraged UCITS

Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?

Yes, we do.

Q5: Do you believe that additional guidelines should be introduced requiring index-tracking leveraged UCITS to disclose the way the fund achieves leverage?

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III. UCITS Exchange-Traded Funds

Definition of UCITS ETFs and Title

Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?

Yes, we do.

Q7: Do you agree with the proposed guidelines in relation to the identifier?

No, we don't. We propose to use the identifier 'UCITS ETF' and not only 'ETF' in order to demonstrate it is a UCITS.

Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?

No, as both ways of 'rebuilding' the relevant index are common market practice and an identifier should be short and simple, it is not necessary to include the technique into the identifier. Nevertheless, the distinction can be made and should be made in the prospectus.

Q9: Do you think that the use of the words 'Exchange-Traded Fund' should be allowed as an alternative identifier for UCITS ETFs?

No, because there might be other forms of 'Exchange-Traded Funds' (i.e., no UCITs). If the term 'Exchange-Traded Funds' would be restricted to UCITS it would hardly be possible to name other forms of ETFs without creating confusion.

Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?

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Actively-managed UCITS ETFs

Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in the prospectus, the KIID or any marketing communications of the UCITS ETF?

We agree with the basic thrust of ESMA's thinking. It should nevertheless be borne in mind that there is yet no clear definition of 'actively managed' (and consequently no clear distinction between 'active' and 'non-active' management). This is doubtless because the borderline is fluid, making it virtually impossible to draw a hard-and-fast distinction. But without a clearcut definition, it will be very difficult to implement rules in this area.

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Secondary market investors

Q12: Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?

Secondary market investors should not have a right to direct redemption of ETF units by the issuer. The term 'exchange-traded' makes it clear that units can only be bought and sold on an exchange. A right of this kind would make it extremely difficult to differentiate between ETF products and products that can be either returned to the asset management firm or sold on the stock exchange. Therefore, we prefer Option no. 1.

Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.

No, we do not think so. Due to the market-making requirement (Option 1, 1) selling is a possibility which is constantly available.

Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.

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Q15: Can you provide further details on the relationship between the ETF's register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?

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IV. Efficient portfolio management techniques

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

We agree with the proposed measures to generally raise security and transparency in regard to EPM measures in Box 6.

In regard to para. 2 of Box 6 we do not agree to include a collateral policy, especially covering permitted types of collateral and the level of collateral required, into the prospectus of each UCITS. The level of collateralization depends on the economic soundness of the counterparty. If UCITS managers would be obliged to publish the level of collateralization it would also be required to mention the relevant counterparties by name. This would not only cause negative effects for the counterparties but also lead to the need of frequent updates of the prospectuses. As far as it should be required to disclose the type of

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collateral it should be considered that UCITS managers typically ask for very liquid collateral. Due to market developments the liquidity of a collateral might change. A collateral which is liquid today might by illiquid next month. Therefore, additional information about collateral in the prospectus has a very limited informational value for the investor. In terms of efficiency and costs a frequent update of the prospectus is not appropriate.

According to the German regulation of security loans transactions (§ 54 InvG, German Investment Code), managers of UCITS shall ensure a full collateralization if they lend out securities and shall ask for additional collateral when needed. Furthermore, managers have to consider specific restrictions on the type of collateral (e.g. shares are only eligible collateral if they are listed on an organized market and have not been issued by the borrower or an affiliate of the borrower). When the German legislator implemented the provisions for securities lending transactions, the first draft legislation included haircuts which were not market standard. Therefore, critic was raised that it might be impossible for UCITS to find a borrower. Since it was the idea of the legislator to implement an additional profit source for UCITS-investors without increasing the risk, the German legislator decided to consider existing market standards for securities loan transactions rather than over-regulating those. We believe that practical experience with the existing rules has proven that investors are well protected from any damages. Since the applicable legal rules are available for anybody, it should be sufficient to include a reference to these rules within the UCITS prospectus. Any further specification would lead to inefficient and cost intense updates of the prospectus as stated above.

The proposed fee arrangement (Box 6, para 3.) seems to be inadequate. If a management company engages in EPM techniques additional resources (specialists, IT systems, etc.) are required. Securities lending activities are not part of the regular portfolio strategy of a UCITS but an additional source of performance for the investor. Therefore the management company needs to be compensated for the additional costs that occur.

According to para. 5 of Box 6, a UCITS shall ensure that it is able at any time to recall any security that has been lent or terminate any securities lending or repo agreement into which it has entered. Currently it is possible for UCITS to enter into securities loan transactions with a duration of 30 days. Since it is possible to gain higher lending fees and due to the fact that transactions with a fixed lending period are limited to 15 percent of the UCITS' assets, ESMA should evaluate if the intended restriction is required in order to enhance investor protection. Even in cases of securities loan transactions with no expiration date, which can be terminated at any time by the UCITS, there might arise a situation where the borrower is unable to re-deliver the securities lent. In such cases the borrower is obligated to compensate any losses to the lender respectively the UCITS. Therefore, we do not see any reason for an amendment of the existing regulatory framework. There are no risks for the UCITS investor that are not already addressed by existing rules and market standards.

Concerning the UCITS diversification rules, we disagree with the proposal provided by ESMA (Box 6, para. 7). Naturally, the assets used as collateral should be selected in such a way that they are fit for purpose. But since the collateral only has to be realised if the swap counterparty defaults, investors may be better protected by a type of diversification other than that required under the UCITS rules. Besides, the investor is not facing any economic risk from the collateral received. In case the value of the collateral received decreases significantly the consequence would be a margin call and the borrowers obligation to provide further collateral. Significant deviations from the UCITS diversification rules may be made transparent to the investor.

Nevertheless, we welcome the proposal of ESMA, as far as it refers to the diversification of cash collateral.

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If no, please justify.

Yes.

Q18: Do you see merit in the development of further guidelines in respect of the reinvestment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?

The similar question of reinvestment of cash collateral received in regard to OTC-derivatives has been answered in the CESR guidelines on risk measurement and any further development is not necessary.

Q19: Would you be in favour of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio? Please explain your view.

No. The consideration of a high correlation between the collateral provided and the composition of the UCITS underlying portfolio is not required. The economic development of the collateral does not entail any risk for the investors. If the value of the collateral declines, additional collateral has to be posted.

Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

No. There is no link between the collateral provided and the composition of the UCITS underlying portfolio. It the value of the collateral declines, additional collateral has to be posted. Even in case of the default of the debtor, the collateral provided does not become part of the assets of the UCITS. In such a case the complete collateral received will be sold immediately.

Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Compliance with the restrictions given in the CESR guidelines on risk measurement should be sufficient.

Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.

No. See our answer to question no. 23.

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?

We support this rule as long as the counterparty risk can be mitigated by posting collateral as well.

If risks arising from EPM techniques and OTC-derivatives have to be cumulated when calculating the maximum exposure under Art. 52.1 of the UCITS Directive, such may be beneficial for UCITS since risk arising from securities loan transactions could be netted with those existing for the counterparty with respect to OTC-derivatives.

In order to allow UCITS an economically viable collateral management process, it should be expressely regulated that EPM techniques have not to be collateralized as far as UCITS are subject to OTC-derivative related counterclaims of the same counterparty the relevant EPM techniques are agreed with.

Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?

Yes.

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?

No, if the collateral rules are stringent and effective there is no need to limit said proportion.

Q26: What is the current market practice regarding the proportion of assets that are typically lent?

The current market practice of asset managers complies with the limits set out in § 54 of the German Investment Code.

Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

No. If a limit has to be chosen there should be a general requirement to avoid interpretation issues as well as complex assessments to determine the correct limit.

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?

Disclosing general information on the basic principles of the securities lending activities within the prospectus is sufficient. An additional disclosure within the fund rules is not necessary (see answer to Q16).

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

No.

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Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interests?
If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps.

Since the depositary, which is monitored by the appropriate parties, should comply with the valuation rules for UCITS, a conflict of interest should not be possible.

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

No. Even if the investment process for a portfolio is completely automated, the management company still has to and will ensure that the appropriate safeguards are in place, e.g. by specifying the requirements within the relevant contracts and reviewing the posted collateral on a regular basis. The same basically applies to conflicts of interest which, e.g. can be identified and mitigated before the affected relations start.

V. Total return swaps

Q32: Do you agree with the proposed guidelines?

We only agree partially. In our view ESMA should differentiate between the different possible application methods of Total Return Swaps (TRS).

In regard to the use of TRS for e.g. synthetical replication with the goal of creating an index-tracking fund, we agree with the proposed ESMA guidelines. Regarding the use of a Total Return Swaps for active fund management, e.g. in order to gain cost-efficient exposure to a diversified stock market, there are some particular points that need to be taken into account.

On the one hand the proposed transparency measures (most importantly Box 7, para. 5. a) would require a quite extensive description of the underlyings (possibly dozens or even hundreds of possible underlyings) and other information as proposed by ESMA. This would be overly cost-intense and overall impracticable. On the other hand one has to consider the diversification requirement for the TRS underlying which has to be diversified according to UCITS rules. This rule (Box 7, para. 1) may be prudent for index-tracking funds but does not take into account active fund management which may for example require a TRS on a commodity basket which, considering the overall diversified portfolio (according to UCITS rules), per se does not impose the kind of risk ESMA wants to address.

In conclusion we propose a differentiation in terms of TRS, limiting the proposed rules to UCITS funds that explicitly use TRS in order to replicate index returns, i.e. create index-tracking funds, and therefore leaving the possibility to use a TRS for active management purposes.

With regard to collateral issues raised within the proposal please refer to our answer to question 16, which pertains to a similar issue.

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Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return is of good quality? If not, please justify.

Yes.

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?

Please see our answer to question no. 32. Any additional disclosure should be published within the prospectus. Disclosure within the fund rules is not necessary.

Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Compliance with the restrictions given in the CESR guideline on risk measurement should be sufficient.

Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.

No, we do not see any merit in this.

Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

Please refer to our answer to Q20.

Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?

If ESMA decides to implement the abovementioned provisions for TRS in general (see answer to Q32) they should apply to all OTC-derivative transactions not only to TRS. Since the economic exposure of a TRS can also be achieved by various other derivative instruments there should be a harmonized approach. This would also avoid definition problems.

VI. Strategy indices

Q39: Do you consider the proposed guidelines on strategy indices appropriate? Please explain your view.

For the specific use of strategy indices as eligible indices the proposed guidelines seem appropriate, especially seen, for example, in combination with a TRS that ensures a delta-1 relation between the funds' NAV and index. Independent from the use as an eligible index however, it should still be possible to invest into a strategy index, even if it is not diversified according to the proposed guidelines, as long as the overall fund still complies with the UCITS diversification rules. It makes no difference whether a fund buys a diversified index with 25 % components and 4 % portfolio share each or 25 % different swaps on different single commodities with 4 % portfolio share respectively. The latter allows for active management of the single components, the diversified index allows only a fixed proportion between the components.

Besides that, please allow us some comments on the guidelines set out in box 8:

6. The rebalancing frequency should not prevent investors from being able to replicate the financial index. Indices which rebalance on an intra-day or daily basis do not satisfy this criterion.

In our view, this criterion is too narrow as it effectively limits the range of indices in which investors may participate. For example, in regard to portfolio diversification indices with intra-day balancing can contribute significant value as an additional asset class in investors' portfolios. Clients may request products that are linked to indices which rebalance more frequently as they appreciate those as investment opportunities that are otherwise not accessible to them.

Furthermore, indices which are oriented on shorter terms are also capable of representing their respective markets appropriately. For instance, FX indices can require intra-day rebalancing in order to capture FX market movements reliably. In this regard, the fact that intra-day rebalancing does not meet this requirement appears somehow random. Therefore, we suggest to delete it completely.

12. The UCITS must carry out appropriate documented due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark. The UCITS must also assess the availability of information on the index including whether there is a clear narrative description of the benchmark, whether there is an independent audit and the scope of such an audit, the frequency of index publication and whether this will affect the ability of the UCITS to calculate its NAV. The due diligence should also cover matters relating to the index components.

We agree that a standard due diligence on the quality of the index should become mandatory. As a result the overall quality of funds should increase.

13. UCITS must ensure that any valuation of the swap includes an independent assessment of the underlying index.

We understand that an independent assessment of the underlying index may enhance the quality of the valuation of the fund. However, it is yet unclear to us what independent assessment means or what the requirements are. The workload as well as costs and time spent on this assessment depend much on these requirements.

In our view, a feasible solution would be a plausibility check by the management company of the fund. In this way, additional costs could be limited.

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14. The financial index should be subject to independent valuation.

It remains unclear to us who may qualify as independent valuation agent. In our view, a third party valuation agent would genuinely go too far. Again, involving a third party would cause high costs while the added value compared with an affiliated valuation agent is questionable. In our view, the costs involved with an independent valuation of the financial index would cause the extinction of strategy indices. Therefore, this matter appears somewhat disproportionate.

The process of pricing the underlying index is of high importance and a key quality criterion. Besides, the valuation is a mandatory element in the due diligence on the quality of the index.

We suggest to mention in the fund prospectus if an independent valuation of the financial index will be carried out. Especially, it seems important to outline the relationship between the index sponsor and the valuation agent, whether they are external third parties or affiliated.

Q40: Do you think that further consideration should be given to potential risks of conflict of interests when the index provider is an affiliated firm of the management company?

In many cases, index sponsor, valuation agent and management company will be affiliated, and may even operate as different departments of the same legal entity. By law, these entities are obliged to implement appropriate control measures to prevent conflicts of interest. Regulation authorities are supervising these measures and ascertain that the entities comply with these requirements on an ongoing basis.

In the context of this control setup we suggest that a proper disclosure of the relationship between index sponsor, valuation agent and management company in the relevant fund prospectus is sufficient. By including this matter as an additional risk factor we consider the disclosure as an appropriate form of disclosure to investors that there may be potential risks of conflict of interest. Therefore, further consideration is not required from our point of view.

VII. Transitional provisions

Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.

Para. 3b) should be clarified. UCITS with an existing fee sharing agreement should be exempted. The regulatory scope of para. 3b) should only cover UCITS without such an agreement. The reason for this is, that the current fee sharing agreements are probably fixed-term contracts. Upon 'maturity' they are reviewed and probably signed with a new counterparty. The way, the paragraph is currently worded, these UCITS would also be affected.