BVI · Bockenheimer Anlage 15 · D-60322 Frankfurt am Main

Bundesverband Investment
und Asset Management e.V.

Ms. Verena Ross
Executive Director
European Securities and Markets Authority ESMA
103, rue de Grenelle
75007 Paris

FRANCE

Contact:
Dr. Magdalena Kuper
Phone: +49.69/154090-263
Fax: +49.69/154090-163
magdalena.kuper@bvi.de

30 March 2012

Consultation Paper on the ESMA's Guidelines on ETFs and Other UCITS Issues

Dear Ms. Ross,

BVI[1] welcomes the opportunity to submit its views on the proposed regulatory guidelines for UCITS.

General remarks

As representative of the German investment fund industry with many established UCITS providers as members, BVI is highly committed to preserving and further enhancing the high quality of the UCITS brand. Indeed, we firmly believe that UCITS must continue to be the measure of all things for retail investors as regards product regulation, transparency and safety of assets. Therefore, we are glad to engage in discussions with

[1] BVI Bundesverband Investment and Asset Management represents the interests of the German investment fund and asset management industry. Its 82 members currently handle assets in excess of EUR 1.8 trillion in both investment funds and mandates. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. For more information, please visit www.bvi.de.

Director General:
Thomas Richter
Managing Director:
Rudolf Siebel

Bockenheimer Anlage 15
D-60322 Frankfurt am Main
Postfach 10 04 37
D-60004 Frankfurt am Main
Phone: +49.69.154090.0
Fax: +49.69.5971406
info@bvi.de
www.bvi.de

regulators as well as legislative bodies concerning elimination of any potential deficiencies in the UCITS framework.

In respect of the specificities of certain UCITS products or the applicable investment strategies, we concur with ESMA that enhanced transparency should be the measure of first choice for optimising investor protection. Hence, we support in general the proposed additional disclosure in the fund prospectus and regular reports. Nonetheless, ESMA should bear in mind that such supplementing information also entails administrative burden for UCITS providers as regards the necessary changes to fund documents and marketing materials. In order to keep these efforts at a reasonable level, we suggest limiting pre-sale disclosure to more generic items of information such as abstract product features, established policies and maximum level of payable fees. The specific implementation of these elements e.g. in terms of counterparties, obtained exposure or effective charges to the UCITS should be depicted in detail ex-post in the UCITS' annual report.

We are also open to discussing adequate adaptations of the substantive UCITS framework e.g. as regards the eligibility of certain investments which may not be fully appropriate for the retail market. Accordingly, we agree with ESMA that the UCITS rules should not allow for replication of indices encompassing active investment strategies which require intra-day rebalancing of index constituents. Such indices clearly cannot be deemed an adequate benchmark for a market and thus should be considered as not complying with the qualitative criteria for eligible indices. However, it is essential that the relevant guidelines be adequately calibrated in order to avoid prohibitive effects on the use by UCITS of broadly recognized traditional index products. For further details, please refer to our comments on **Q39** below.

In this context, it is essential that the impact of the forthcoming regulatory guidelines on already existing vehicles be minimised to the greatest possible extent in order not to jeopardize the anyway impaired investor confidence in the UCITS brand and the investment fund market in general. Therefore, it is necessary to allow for effective grandfathering of UCITS already present in the market. Especially, increases or decreases of the UCITS derivative exposure should not be treated as new investments and not prompt the necessity to unwind an entire fund in case the underlying to the transaction such as a customized strategy index becomes ineligible for UCITS investments in future.

Lastly, we would like to voice our concerns with regard to the ESMA's perception of the role of collateral in relation to the UCITS portfolio assets. The suggestions on possible alignment of collateral with the UCITS investment strategy or the envisaged extension of the UCITS diversification provisions to a combination of the portfolio assets and the collateral received seem to imply that the collateral is considered as an equivalent substitute for the assets lent out or, in case of total return swaps, for the claim resulting from the derivative transaction. As a rule, however, the applicable contractual agreements do not allow for direct transfer of collateral to the UCITS portfolio in case of default. Instead, the collateral is due to be liquidated and the proceeds used to purchase assets compliant with the UCITS investment strategy with any surplus being returned to the insolvency administrator. Therefore, the aspects of liquidity and issuer credit quality should be considered of utmost importance for the eligibility of collateral. Also, ESMA should bear in mind that the collateral diversification rules currently in place serve the purpose of reducing the counterparty risk, whereas the purpose of diversification in terms of portfolio assets is to limit the market risk of investments.

Against this background, we are convinced that any requirements on correlation with the portfolio composition or diversification in line with the UCITS investment provisions would rather reduce the UCITS managers' ability to obtain best quality collateral and hence run counter to the interests of UCITS investors. For further details, please refer to our responses to **Q19/20** and **Q37** below.

Specific comments

In light of the aforesaid, we would like to respond to the consultation questions as follows:

<u>Box 1: Index-tracking UCITS</u>

***Q1:** Do you agree with the proposed guidelines?*

We do not entirely agree with the proposed guidelines.

First of all, we deem it necessary to establish a definition of index-tracking UCITS which need to obey by the proposed standards. A clear and reliable definition is necessary in order to distinguish such index-tracking funds from other UCITS which also may invest in index derivatives. For this purpose, we could envisage the following phrasing:

"A UCITS qualifies as an index-tracking UCITS if, according to its fund rules or instruments of incorporation, the aim of its investment policy is to replicate the performance of a benchmark."

Moreover, we see no merit in requiring index-tracking UCITS to adopt an ex-ante policy in terms of tracking error, including determination of its target level. In the German practice, the quality of index-tracking UCITS following a full replication strategy is reliably expressed by the degree of duplication (German: Duplikationsgrad) which is laid down in the fund rules/instruments of incorporation and identifies the proportion of the UCITS portfolio which fully corresponds with the composition of the tracked index. In contrast, tracking error may be adequately assessed only ex-post when taking into account the implementation of this duplication strategy plus the results of EPM techniques and costs associated with the UCITS management. In addition, it should be borne in mind that tracking error cannot be a standalone criterion in assessing the quality of replication, because it accounts for both negative and positive deviations from the yield differential. Therefore, tracking error must be complemented by consideration of the total return difference between the index and the fund (so-called tracking difference[2]).

In consequence, we think that tracking error should be calculated ex-post and disclosed in the UCITS regular reports, whereas the ex-ante tracking policy should be determined by other metrics such as the degree of duplication stipulated in the fund documents.

However, should ESMA insist on disclosing ex-ante figures for tracking error, we would consider it more appropriate to disclose an anticipated percentage threshold for tracking error under normal market circumstances rather than its target level (e.g. "the tracking error for the fund should not in normal market conditions exceed x% per annum"). Accordingly, the ex-post reports on the size of tracking error envisaged in para. 2 should be complemented by due explanations in case the stipulated threshold has been breached.

---

[2] Cf. IOSCO Consultation Report on Principles for the Regulation of Exchange-Traded Funds published on 14 March 2012 which contains useful explanations on the concepts of Tracking Error and Tracking Difference in Box 3.

***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, we do not think that regulatory guidelines on calculation of tracking error would be helpful. Due to the diversity of existing approaches which are also prompted by diverging requirements from institutional investors, it would be very difficult to establish a harmonised methodology for such calculation.

Nonetheless, should ESMA require ex-ante evaluation of tracking error for disclosure purposes, further determinations should be provided with regard to the following:

- Applicable formula (constant or discreet calculation of yield differentials)
- Time horizon for observation of tracking error
- Time interval for calculation of return deviation (daily, weekly, monthly)
- Calculation of ETF performance
- Relevant benchmark (price index or performance index).

***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?*

It appears unclear what ESMA is actually aiming at with this question. A graphical depiction of the fund performance compared to its benchmark is already foreseen for KIID in Article 18 of COM Regulation 583/2010. Provided that the term “actual evolution” is equivalent with performance, we see no need for further regulatory measures in this regard.

Box 2: Index-tracking leveraged UCITS

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

We agree with the guidelines, but consider it necessary to provide a definition of “index-tracking leveraged UCITS” in order to unequivocally determine the scope of application.

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

We see no need for additional guidelines in this respect.

Box 3: Definition of UCITS ETFs and identifier

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)?*

In our opinion, the proposed definition of UCITS ETFs is still not precise enough in order to ensure that other UCITS subject to multilateral trading are not counted towards this category. In Germany, fund units are often traded in the so-called open market section of German stock exchanges ("Freiverkehr") without consent, or even knowledge, of the responsible management companies. This is possible because UCITS distribution partners can order large blocks of units and then pass them through to other distributors, including market makers, who make on own account the necessary arrangements for secondary trading. This situation pertains to many traditional UCITS offered for sale in the German market.

In order to cater for these market practices which cannot be effectively prevented by the UCITS managers, we suggest the following adaptation of the ETF definition:

"A UCITS exchange-traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradeable on at least one regulated market or multilateral trading facility (MTF) ***at the initiative or with the consent by the UCITS or its management company*** *with at least one market maker who takes action to ensure that the stock exchange value of its units or shares does not significantly vary from their net asset value."*

In this context, we also support further requests for modification of the ETF definition as brought forward by EFAMA which are meant to cater for specificities of fund trading in other Member States.

Furthermore, ESMA should keep in mind that the MiFIR proposal currently discussed in the course of legislative proceedings also contains a definition of ETFs for the purpose of pre- and post-trade transparency requirements. In view of the obvious differences between the two initiatives in terms of regulatory aim and scope, we believe that the MiFIR provisions should not refer specifically to ETFs, but encompass all units in open-ended investment funds traded on the capital markets in order to avoid confusion of regulatory terms. We would like to encourage ESMA to promote this approach in the context of the MiFIR debate.

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

We agree with the guidelines, but see the need for further clarification in relation to instances where the acronym "ETF" is already part of the management company's name. The question is whether the identifier should nevertheless be used in such cases (e.g. should "ETFlab DAX" be renamed in "ETFlab DAX ETF"?). ESMA should be also aware that there are companies active in the market which use the acronym "ETF" in their name, but offer ETPs other than investment funds.

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

No, we see no merit in distinguishing between physical and synthetic ETFs as part of the identifier. It is very difficult to establish at what extent of its use of derivatives an ETF should be classified as synthetic, given that some ETFs apply mixed replication strategies or even equip the fund manager with the discretion to select the appropriate technique for index tracking. Thus, it appears more pertinent to disclose the applicable replication strategy in the KIID and, in more detail, in the fund prospectus.

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

Yes, we think that this flexibility should be vested with ETF managers.

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?*

We do not see why there should be stricter requirements on the minimum number of market makers in case of affiliated entities. A market maker, affiliated or not, shall be equally under the obligation to ensure correlation between the bid and offer prices and the net asset value of ETF units.

Box 4: 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?*

Depending on the rules of a trading venue, the calculation of iNAV may be vested with different entities or is sometimes performed by the venue provider itself. Therefore, it appears inappropriate to require disclosure of details in terms of the calculation process in the fund prospectus. Instead, it should be permissible for ETFs to identify the service provider responsible for the iNAV calculation and, if applicable, to refer to other sources of information for further details. This statement should be supplemented by information on the frequency of the iNAV calculation.

Box 5: Secondary market investors

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

In principle, we think that both options proposed by ESMA represent valid redemption models under the UCITS Directive. Indeed, according to the definition of UCITS in Article 1 para. 2 (b), action taken to ensure correlation between the stock exchange value of fund units and the NAV shall be treated as equivalent to repurchases or redemptions out of the UCITS' assets. **In order to account for this flexibility enshrined by the UCITS Level 1 provisions, we strongly believe that both options presented in Box 5 should be available to ETF providers at their own choice.** The relevant procedure (secondary market trading vs. direct redemptions) and its implications in terms of costs should be clearly disclosed to investors in the KIID and the fund prospectus.

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.*

According to the proposed guidelines, UCITS ETFs shall also consider admitting direct repurchases of fund units by the ETF or its management companies in order to cater for possible disruptions of secondary trading. Under these circumstances, we see no need for further protection measures in this regard.

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.*

N/A

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?*

It is important to bear in mind that it is not an intrinsic element of UCITS to maintain a register of unit-holders. In Germany, like in a number of other Member States, UCITS issue fund units in the legal form of bearer instruments which are freely negotiable between any parties. Thus, the unit-holders of German UCITS are not subject to entries on any kind of register.

Box 6: 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 have several comments and reservations with regard to the proposed ESMA's guidelines on EPM techniques:

Paragraph 2: The required information on the UCITS' collateral policy in the ETF prospectus should not be too specific. Periodic updates and minor amendments of the policy should not in any case prompt the necessity to review the prospectus. Alternatively, it should be allowable to include in the prospectus a reference to an external source of information, e.g. the provider's website, where the relevant policy would be disclosed in more detail or to provide further information on the investor's request.

Paragraphs 3 and 4: We agree with the general rule that the fees accrued from EPM techniques should be returned to the UCITS. However, possible exceptions from this rule should be subject to practicable conditions. In particular, we object to the assumption implicit in para. 44 of the explanatory text that fee sharing arrangements are allowable only in relation to the securities lending agent.

In the German market practice, the securities lending agent is a third party who may be assigned with the daily operations of a fund's lending activities. Lending agent may be an affiliated entity of the UCITS manager, but never the manager itself. Management companies maintaining in-house resources for administering securities lending are not considered lending agents as they act in their own name and in their capacity as appointed investment managers of a fund.

Nevertheless, we are convinced that fee sharing shall also be admissible in relation to the UCITS management company and regardless of whether an external agent is involved in the lending activities. Currently, fees are usually being split between the management company and the fund, and the lending agent is being remunerated directly by the management company. This practice should remain legitimate, as there are fixed and variable costs associated with securities lending also at the level of the UCITS manager which include:

- Staff remuneration and infrastructure costs,
- Transaction costs of the loan transactions,
- Safekeeping and service fees for the underlying collateral,
- Development and maintenance costs due to regulatory requirements and client requests (e.g. monitoring of applicable counterparty limits or quality standards for collateral).

Moreover, it is essential that provisions on the allocation of revenues from securities lending in the UCITS fund rules/instruments of incorporation are recognized as adequate fee sharing arrangements for the purpose of the ESMA's guidelines.

Lastly, disclosure of fees arising from securities lending or other EPM techniques should be reasonably performed ex-post and not form part of the fund prospectus. Rather, the UCITS annual report should contain detailed information in this respect.

Paragraph 5: The proposed standard is entirely inacceptable for EPM transactions entered into for a fixed term. In particular, it runs counter against the key concept of repo agreements which always require repurchase of assets at a specific point of time. Subjecting repo transactions to a termination entitlement at any time would undermine the underlying business calculation and render such transactions extremely unattractive.

In our view, potential concerns in terms of liquidity or retrievability of fund assets should be rather tackled by defining maximum duration limits for EPM transactions or limiting the proportion of the UCITS' portfolio which can be at a given time subject to term trades.

Paragraph 6: We agree in principle that the collateral received in the context of EPM techniques should comply with the CESR's Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788, subsequently abbreviated as CESR's Guidelines). However, we understand that the qualitative criteria stipulated in Box 26 of CESR's Guidelines shall pertain only to collateral which is used in order to reduce the counterparty risk exposure and that other types of collateral which do not serve that purpose shall remain generally acceptable to UCITS. Moreover, para. 51 of the explanatory text dealing with the re-investment of cash collateral in non-risk-free assets should be deleted as such re-investment is already clearly prohibited in Box 26 para. 1 last bulletpoint of the CESR's Guidelines.

For further remarks on the quality of collateral, please refer to our answer to **Q17** below.

Paragraph 7: We reject the proposed extension of the UCITS diversification rules to a combination of the collateral and the portfolio assets not subject to the EPM techniques for reasons stipulated with reference to **Q20**.

Paragraph 9: While application of haircuts to the collateral is already an established market standard and commonly observed by UCITS managers, it appears not always practicable to assign fixed haircuts to each class of assets. Haircuts for collateral are usually subject to negotiations between the parties involved which take into account economic and risk aspects of the transaction. Therefore, we think that a haircut policy should not necessarily require stipulating fixed haircuts, but might be confined to defining criteria for agreeing on margins on a bilateral basis. In any case, taking into account margin requirements for exchange-traded derivatives which follow a different set-up (i.e. CCP set-up) appears not appropriate in this context.

***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.*

In general, we agree that extension of Box 26 of the CESR's Guidelines to EPM transactions will ensure good quality of collateral. However, the guideline on collateral diversification may sometimes lead to situations where a UCITS will be forced to accept collateral of lower quality in order to fulfill the diversification requirement. The prime example is collateral composed of German government bonds or other triple-A rated state securities which, albeit of best credit quality, would not be acceptable under Box 26.

It is our firm conviction that the primary purpose of collateral is to ensure secondary recourse in case of a counterparty's default, not to provide for a substitute of portfolio assets (cf. our arguments to **Q19 and 20**). Seen from this perspective, arrangements for superior credit quality of the collateral issuer should be put above the requirement for collateral diversification in order to adequately protect the interests of UCITS investors. Therefore, we request ESMA to review the principles laid down in Box 26 in terms of diversification for collateral in both EPM techniques and OTC derivative transactions.

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)?*

We see no merit in developing further guidelines in this respect. In our opinion, standards for re-investment of cash collateral should be equivalent for both EPM techniques and OTC derivatives. Indeed, the requirement for re-investment in risk-free assets only is already part of the CESR's Guidelines in Box 26 (cf. our comments on para. 6 of Box 6 above).

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.*

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?*

We disagree with the ideas to require a high correlation between the collateral and the composition of the UCITS portfolio as well as to apply the UCITS diversification rules to a combination of the collateral received and the portfolio assets not subject to EPM techniques.

These approaches seem to imply that the collateral received in the context of securities lending or repo transactions shall be a suitable substitute for the portfolio assets on loan and in the case of default, directly transferred to the UCITS portfolio. However, this runs counter to the current legal and economic set-up of EPM transactions. In the prevailing market practice, collateral is provided as means of secondary recourse with respect to the entitlement to retransfer of portfolio assets. In case of default, the collateral is being immediately liquidated and the proceeds used to acquire securities matching with the UCITS investment strategy. It is also customary for EPM transactions to agree on the UCITS manager's obligation to pass any surplus resulting from over-collateralisation of claims to the counterparty or its insolvency administrator.

In these circumstances, regulatory measures should in the first place aim to ensure that the collateral received by the UCITS is of good credit quality and sufficiently liquid in order to warrant the possibility of smooth disposal and adequate pricing. Correlation with the UCITS investments and sufficient diversification in line with the UCITS requirements, on the other hand, are not necessary in order to protect the interest of UCITS investors. On the contrary, in the instance of a UCITS ETF replicating an equity index, requirements for high correlation of collateral would even be detrimental to investors as such UCITS would be prevented from accepting triple-A rated government bonds in order to secure claims from EPM transactions. Moreover, the envisaged guidelines would result in major impediments to the appointment of a collateral manager who generally has no continuous overview over the composition of the UCITS portfolio and hence is not able to monitor compliance with the UCITS diversification rules.

Further, combining the fund assets and the collateral received by the UCITS for the purpose of the diversification test would contradict the principles of NAV calculation which is based on the total of the investment portfolio and assets on loan (where securities lending is used). It cannot be expected that the collateral held by the UCITS be considered part of the UCITS portfolio for this purpose. Hence, according to the ESMA's approach, UCITS would be required to run two parallel calculations: one for the standard NAV without collateral and then one including collateral but excluding assets on loan with no obvious benefit.

In this context, we also object to the allegation on the duties of depositaries in footnote 7 on page 20. It is already inconceivable why ESMA is referring only to UCITS ETFs when speaking about requirements for custody of collateral. More importantly, however, such requirements are just under discussion in the context of AIFMD, but have not been introduced yet for either AIF or UCITS depositaries. We expect the respective proposals being tabled in the context of the UCITS V reform and urge ESMA not to anticipate the results of this legislative debate. In the context of OTC derivative transactions, Box 26 of the CESR's Guidelines explicitly allows for collateral to be held with a third party custodian, not necessarily the depositary.

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?*
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.*

An indicative list of assets eligible as collateral would be an improvement, but it should be clearly highlighted as being only indicative, and not exhaustive. An exhaustive list would be inflexible in case of market changes and thus runs the risk of not adequately reflecting the market conditions in terms of liquidity at a given point of time.

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 disagree with the suggestion to account for the counterparty risk from EPM techniques in calculating the maximum counterparty limits for OTC derivative transactions under Art. 52 para. 1 of the UCITS Directive. In our opinion, it should be sufficient to include the counterparty risk created by securities lending and repo transactions in the calculation of the 20% limit for risk exposure to a single entity under Art. 52 para. 2, 2nd subparagraph, letter c. Such approach has been adopted by the German Investment Act which extends the cited provision of the UCITS Directive to all transactions undertaken with a single body (cf. § 60 para. 5 No. 3) and explicitly acknowledged in Box 27 para. 2 of the CESR's Guidelines. In order to avoid disruptions of contractual relationships with the established counterparties to the UCITS, we strongly advocate that this method of limit calculation be endorsed by ESMA.

Nonetheless, being aware of the impeding EMIR regime and the anticipated requirements for full collateralization of OTC derivative transactions with highly liquid instruments, we see a potential need to reconsider the UCITS counterparty risk limits in the near future. In particular, it might be helpful to provide for means to streamline the exchange of collateral between the counterparties to EPM and derivative transactions by facilitating a combined calculation of the counterparty risk exposure once the substantive rules on collateralization are in place. However, such regulatory steps would need to be accompanied by industry initiatives to ensure the development of a standardised master agreement with the possibility of netting in terms of crossing collateral obligations.

In this context, we would also like to raise ESMA's attention to the increasing uncertainties in the market with regard to the calculation of counterparty limits for centrally cleared OTC derivative transactions. UCITS and other market participants are already in the process of voluntary shifting to central clearing as a way to reduce their direct counterparty risk. However, the counterparty limits for OTC derivative transactions in Art. 52 para. 1 UCITS Directive have been designed for the bilateral world of OTC derivatives and do not reflect market structures applicable to central clearing. In particular, there is significant confusion relating to the question under which conditions adequate protection against the insolvency of the broker is achieved in order to disregard the margin exposure in calculating the OTC counterparty limits under Box 27 para. 1 of the CESR Guidelines. Hence, we would like to encourage ESMA to provide some clarification in this regard in the upcoming regulatory guidelines for UCITS.

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

We agree with this suggestion which already reflects the current market standard in Germany.

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?*

We strongly prefer quantitative limits in respect of EPM techniques being set at the counterparty level by capping the proportion of UCITS portfolio that can be lent to any single entity. Such approach accounts for the major risk associated with the lending activities which is the credit risk of counterparties to the transactions. For further details, please refer to our comments on **Q23** above.

In contrast, there is no reason for establishing a general limit at the UCITS portfolio level. Provided that there is a robust risk management process in place which accords with the applicable CESR Guidelines, such limit would be detrimental to the UCITS' ability to maximize returns for investors without further mitigating the counterparty risk.

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

It is very hard to quantify the proportion of asset which is typically subject to lending arrangements. It depends to a great extent on the relevant investment strategy, prevailing market conditions, dividend season, quality of assets and clients' demands. Roughly estimated, the proportion of UCITS assets on loan across the whole market lies probably between 5% and 15%. However, in selected cases assets lent out can amount to 50% or 60% of the UCITS portfolio depending on the interaction of factors mentioned above.

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, we do not see any merit in taking such further considerations into account. As requested in our reply to **Q25**, the limitation should take place in relation to individual counterparties.

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?*

In our view, the UCITS fund rules should include a general provision with regard to the intention to engage in EPM techniques, but the more specific information on associated risks and the collateral policy should only form part of the prospectus.

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, we don't think that prescribing the identification of EPM counterparties on a more frequent than yearly basis would provide added value to investors.

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.*

We do not see any valid basis for the assumption that the UCITS depositary is responsible for the valuation of collateral. Referring to our reservations with regard to the custody of collateral explained in our response to **Q19/20** above, it is not state-of-the-art under the UCITS Directive that the collateral is considered as falling under the depositary's custody obligation. In practice, valuation of collateral depends on the particularities of the secured receivables (e.g. whether the collateral is provided in the context of securities lending, OTC or exchange-traded derivative transactions) and is either regulated at national level or subject to contractual agreement with the relevant counterparty.

Furthermore, the UCITS Directive and the MiFID regime already provide for comprehensive sets of rules in terms of conflict of interests management which require appropriate steps in order to mitigate potential risks in all areas of business activities, including valuation of collateral.

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.*

It is unclear to us what ESMA has in mind when speaking about "automation of portfolio management".

Box 7: Total return swaps

Q32: *Do you agree with the proposed guidelines?*

We do not entirely agree with the proposed guidelines.

Paragraph 1 first sentence: We have significant objections to this suggestion. We understand that the proposed guideline requires that each the UCITS portfolio and the underlying to the swap to which the UCITS obtains exposure must in itself comply with the UCITS diversification rules. However, this approach completely disregards the fact that UCITS may conclude swap agreements only in relation to a fraction of the fund portfolio. So, if for example, a UCITS enters into five different swap agreements each of which ensures participation in a different basket of underlying assets with participation rates ranging from 10 to 20%, then it is entirely incomprehensible why each of these baskets in itself should be diversified in line with the UCITS Directive.

Therefore, we strongly advocate not considering the underlying baskets in separation, but allowing for delta adjustment of the relevant swap underlyings in the assessment of compliance with the UCITS diversification rules. Consequently, consideration should take place not at the level of each individual securities basket, but only and exclusively at the level of the entire UCITS portfolio. In this respect, a delta adjusted exposure needs to be calculated in order to adequately assess the actual impact of swap transactions on the fund performance. Taking the above example, if one of the swap contracts is rated at 20% and has an underlying basket composed of 10 stocks which are equally weighted, than the swap underlying as such would not be in line with Article 52 of the UCITS Directive. However, due to the agreed participation rate of 20%, the UCITS investors' exposure to each stock is only 2% which, in turn, fully observes the relevant diversification standards. Thus, the delta adjusted calculation of exposure ensures adherence to the UCITS diversification rules at the portfolio level and renders further requirements in relation to the swap underlying superfluous and inappropriate.

It should also be noted that such delta weighted calculation has been acknowledged by the CESR's Guidelines (cf. Box 2 and Box 27 para. 4 and 5).

Paragraph 1 second sentence and paragraph 2: We would like to reiterate our position that due to its purpose to provide secondary recourse in case of a counterparty's default, the collateral should not be treated as part of the fund portfolio and thus not be subject to the UCITS diversification rules in combination with other assets. For further arguments, please refer to our response to **Q19/20** above.

Paragraph 5: In our view, the requested information is too specific in order to be fully included in the UCITS prospectus. Especially, details of counterparties and types of collateral may change quite frequently due to market conditions or developments affecting the creditworthiness of involved entities. Furthermore, in practice UCITS may be launched and prospectus published at a stage where the fund manager is still in negotiations with various derivative counterparties. Consequently, it may occur that at the time of publication the names of the counterparties are not conclusively known.

Thus, in order to avoid frequent updates of the prospectus, we would suggest that only general criteria for choice of counterparties and determination of eligible collateral be disclosed to investors in the sales prospectus, with further details being provided in the annual report in accordance with paragraph 6 of Box 7.

Moreover, we agree with the requirements proposed in letters c and d of paragraph 5 as far as discretion over the composition or management of the UCITS portfolio is concerned. In practice, however, it is quite common to equip the counterparty with some discretionary power in relation to the swapped basket of securities, such as decisions on corporate actions, which might indirectly influence the UCITS performance. Such rudimentary discretion should not be treated as “any other discretionary decision in relation to the UCITS portfolio” as it appears inappropriate in these circumstances to consider the swap counterparty as an investment manager. We would appreciate a clarification from ESMA in this regard.

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.*

We do not perceive any significant enhancement in comparison to the CESR’s Guidelines as regards the quality of collateral. Indeed, as explained in our response to **Q17** above, we still see some room for improvement concerning the criteria for collateral laid down in Box 26 of the CESR Guidelines in order to ensure that UCITS manager are able to choose collateral which is of best quality in order to warrant the interests of UCITS investors.

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?*

No, we do not think that the requested information should also be included in the fund rules. It appears sufficient to ensure meaningful disclosure in the UCITS prospectus.

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?*
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.*

As highlighted in our answer to **Q21/22** above, we see some merit in developing an indicative list of assets eligible as collateral, but reject the notion of prescribing such assets in an exhaustive manner. An exhaustive list would be inflexible in case of market changes and thus runs the risk of not adequately reflecting the market conditions in terms of liquidity at a given point of time.

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?*

We decisively object to the proposal to apply the UCITS diversification rules to a combination of the collateral received and the investments made by the UCITS (it is not appropriate to speak about "assets not on loan" in the context of TRS transactions). As explained in relation to **Q19/20** above, we believe that ESMA assumes an incorrect function of the collateral which from the economic perspective shall serve as secondary means to satisfy the redemption requests and to ensure that the UCITS exposure is in line with the prospectus and the fund rules. In case of default, the collateral is being immediately liquidated and the proceeds used to acquire securities matching with the UCITS investment strategy. It is also customary to agree on the UCITS manager's obligation to pass any surplus resulting from over-collateralisation of claims to the counterparty or its insolvency administrator.

Therefore, the collateral as such cannot be treated as equivalent to the portfolio assets and subjected to the diversification test in combination with those. Moreover, the envisaged guidelines would result in major impediments to the appointment of a collateral manager who generally has no continuous overview over the composition of the UCITS portfolio and hence is not able to monitor compliance with the UCITS diversification rules.

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?*

As we have significant reservations in terms of the standards proposed in Box 7 and especially, regarding provisions on diversification of the swap underlying and the collateral received by the UCITS, we are not in favour of extending the envisaged guidelines to all OTC derivative transactions.

Box 8: Strategy indices

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

We understand that ESMA considers strategy indices based upon proprietary methodologies and requiring frequent rebalancing as non-eligible assets for UCITS. In these circumstances, it is of utmost importance to clearly define the term “strategy index” and to determine without any ambiguities whether the guidelines proposed in Box 8 apply solely to strategy indices or pertain also to other financial indices eligible for UCITS investments. In our opinion, the guidelines should be relevant for “strategy indices” only as especially the suggested disclosure standards in terms of calculation methodology and index performance might be difficult to fulfill by a number or broadly recognized market indices.

Paragraph 3: It is unclear to us whether paragraph 3 is meant to apply solely to commodity indices qualifying as strategy indices or to all forms of commodity indices. In any case, ESMA should bear in mind that it is very difficult to establish at which level of correlation future contracts shall be deemed to relate to sub-categories of the same commodity or to encompass different components. Additional regulatory guidance should be essential in this respect.

Paragraph 6: While agreeing that intra-day rebalancing may prevent investors from being able to replicate the index, we think that this conclusion is not necessarily justifiable in case of daily rebalancing. It is important to note that risk controls in an index, such as measurement and management of target volatility, are vital and daily rebalancing in such cases must be considered in the best interest of investors.

Paragraphs 13 and 14: We agree with the ESMA's view in paragraph 14 than any financial index should be subject to independent valuation. Under this condition, however, we are at a loss in terms of the "independent assessment of the underlying index" required as part of the swap valuation in paragraph 13. Does ESMA suggest that there should be another layer of valuation which is "independent" from the "independent valuation" of the index as such? We do not see the necessity for such duplication of control measures and therefore, are in favour of deleting paragraph 13.

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*?

The most obvious risk of conflicts of interest in case of affiliated firms relates to potentially inappropriate valuation of the index. This risk should be tackled by the requirement on independence proposed in paragraph 14. Given the extensive conflict of interest provisions in place under the UCITS Directive and MiFID, we see no need for further regulatory measures in this regard.

Box 9: Transitional provisions

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

We do not deem it appropriate to require immediate compliance with the guidelines for any new investments made by the UCITS or any collateral received as proposed in paragraph 2. The envisaged guidelines require implementation of several policies such as collateral policy, haircut policy, reinvestment policy or policy in relation to tracking error which need considerable time for preparation in order to become operational. In addition, depending on the content of the final guidelines, it might be necessary to renegotiate agreements with the securities lending agents and collateral managers in order to e.g. introduce veto clauses in terms of the acceptable collateral.

Therefore, we think that the guidelines should generally come into effect twelve months after their final publication. Additional time should be available in order to reflect the content of the new policies in the marketing materials and fund documents (12 months + X).

Moreover, it is crucial that adaptations (increases or decreases) of the notional value on a total return swap e.g. as a result of new subscriptions or redemptions of fund units do not qualify as "new investments" in the sense of paragraph 2. This interpretation is of particular relevance with regard to index swaps on strategy indices the eligibility criteria of which are subject to a material reassessment. Otherwise, the UCITS provider might be forced to wind up an authorised fund because its investment strategy would be suddenly considered ineligible. Such outcome appears highly detrimental in terms of investor confidence in the UCITS brand and its effective supervision by the authorities. Hence, we urge ESMA to clarify that increases or decreases of swap contracts concluded before the entry into force of the new guidelines may benefit from the grandfathering provision in paragraph 3.

With regard to para. 3 letter b, ESMA should bear in mind that fee-sharing agreements with third parties are often concluded as fixed-term contracts and renegotiated after the term expiry. It must be by any means avoided that such renegotiations have detrimental effects on the entitlement to retain fee components by a counterparty. Thus, ESMA should clarify that the requirement to engage in fee-sharing agreements before the entry into force of the envisaged guidelines is not meant as requiring prolongation of existing agreements for indefinite terms. Rather, it should be necessary and sufficient to ensure the existence of a valid contractual basis for fee payments at the respectively relevant point of time.

We hope that our views will help ESMA to pursue a balanced and viable approach when clarifying the regulatory requirements for UCITS. Please do not hesitate to contact us with any questions or comments relating to our reply.

Yours sincerely

Marcus Mecklenburg Dr. Magdalena Kuper