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

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

FRANCE

Bundesverband Investment
und Asset Management e.V.

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

25 September 2012

ESMA Report and Consultation Paper concerning guidelines on ETFs and other UCITS issues

Dear Ms. Ross,

BVI[1] welcomes the opportunity to submit its views on reasonable conditions for fixed-terms repo and reverse repo transactions under the UCITS framework. In this context, we would also like to bring to ESMA's attention some issues pertaining to the already adopted guidelines which raise significant concerns with the German fund industry.

General remarks

While appreciating the public consultation process conducted by ESMA in respect of the guidelines earlier this year, we are taken aback by the considerable divergences between the consultation paper and the final

[1] BVI represents the interests of the German investment fund and asset management industry. Its 80 members currently handle assets of EUR 1.9 trillion in both investment funds and mandates. BVI enforces improvements for fund-investors and promotes equal treatment for all investors in the financial markets. BVI`s investor education programs support students and citizens in improving their financial knowledge. BVI`s members directly and indirectly manage the capital of 50 million private clients in 21 million households. BVI's ID number in the EU register of interest representatives is 96816064173-47. 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

provisions. For instance, treatment of proceeds from repo transactions as collateral for the purpose of applying the guidelines could not have been anticipated on the basis of the consulted text. Similarly, in the consultation paper the guidelines on indices were related specifically to strategy indices and no indication of a possible extension to all financial indices has been made.

In these circumstances, we think that the value of the consultation process which we highly appreciate in principle has been effectively diminished. Moreover, we do not understand that ESMA has decided to vote on the guidelines among its members by means of a written procedure which has been conducted with a very short deadline and in the middle of the summer break. Given that the guidelines govern several aspects of the UCITS framework which are of high importance in practice, we think that the chosen procedure has not provided for sufficiently thorough consideration of the provisions and indeed, must be considered the reason for a number of ambiguities and deficiencies in the adopted text.

Furthermore, it is stunning that ESMA has already drawn regulatory conclusions for UCITS in a number of areas in which the general political debate had not yet been concluded or even has not properly started. For instance, the UCITS VI consultation[2] aims to scrutinize the currently used techniques of efficient portfolio management with the prospect of introducing Level 1 provisions to the UCITS Directive. The FSB report on securities lending and repos which is supposed to contain recommendations on international regulatory standards for the same issues is also still due for adoption[3]. As regards financial indices, the EU Commission has just launched a broad consultation concerning the need for enhanced transparency and regulation of index providers[4].

[2] Consultation Document “Undertakings for Collective Investment in Transferable Securities (UCITS): Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investment” published by the EU Commission on 26 July 2012.

[3] In its Interim Report on Securities Lending and Repos dated April 2012, the FSB indicated that its Task Force on Shadow Banking will develop policy recommendations, where necessary, by the end of 2012.

[4] Consultation Document on the Regulation of Indices: A Possible Framework for the Regulation of the Production and Use of Indices serving as Benchmarks in Financial and Other Contracts, dated 5 September 2012.

Against this background, it appears not acceptable that ESMA anticipates the outcomes of these partly controversially led debates solely for UCITS which are consequently put at competitive disadvantages compared to other products and market participants. Obviously, this procedure also entails the risk that structures and processes to be set up in accordance with the guidelines will need to be revised shortly due to already foreseeable changes to the superseding EU law.

Specific comments on the consultation paper (Annex IV)

In relation to the questions for consultation raised by ESMA, we would like to provide the following comments:

Q1: *What is the average percentage of assets of UCITS that are subject to repurchase and reverse repurchase agreements? For the purpose of this question, please have regard to arrangements covered by the provisions of Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive. In addition, please provide input on the following elements:*
i) the extent to which assets under such arrangements are not recallable at any time at the initiative of the UCITS, *ii) the maximum and average maturity of repo and reverse arrangements into which UCITS currently enter. Please provide a breakdown of the maturities with reference to the proportion of the assets of the UCITS.*

As a starting point, we would like to take this opportunity to depict the economic rationale and legal implications of repo and reverse repo arrangements in UCITS:

- Broadly speaking, repo arrangements serve the purpose of delivering liquidity to the fund in exchange for securities combined with a commitment to buy back the securities at a specified price and generally at a designated point of time. Even though economically UCITS investors remain invested in the securities subject to repo contracts, from the legal point of view a full transfer of ownership takes place. This means that securities submitted to repo transactions are no longer perceived as portfolio assets and not

considered for the purpose of calculating investment limits[5]. Consequently, cash proceeds from repos have never been treated as collateral and UCITS have been generally deemed entitled to reuse such cash for any legitimate purpose, be it investment, collateralisation of other transactions or satisfaction of redemption requests by investors. Typically, repos are used to bridge liquidity gaps in UCITS in a cheaper way than unsecured bank credits.

- In contrast, reverse repo transactions are treated as secured investments for a pre-defined term. In the course of reverse repos, a UCITS invests cash at a counterparty and in exchange receives securities which are included in the calculation of portfolio limits. Also in this case, the securities obtained are not classified as collateral. Rather, value movements in respect of these securities are subject to collateralisation if agreed by the counterparties in order to mitigate the risk of decrease in value. Reverse repos can be concluded for a short term (up to one week) or longer and should not be subject to any limitations as they offer a secured alterative to time deposits.

In terms of market practice, the use of repo and reverse repo transactions is fragmented. Large asset managers with a sophisticated approach to asset management use repo and reverse repo arrangements quite frequently in German UCITS. Repos/reverse repos are utilized in order to facilitate liquidity management (especially to avoid liquidity shortfalls) and as safe investments. They were also considered a possible tool to supply liquidity for fulfilling collateral requirements under EMIR, especially in light of the expected obligation to provide the variation margin to a CCP in cash. However, due to the restrictions on re-investment of cash collateral agreed upon by ESMA, this avenue will be blocked in future.

With reference to the sub-question ii), the German Investment Act generally prohibits repo and reverse repo transactions with a maximum maturity of more than twelve months[6].

[5] For Germany, cf. § 57 last sentence InvG which requires securities obtained through reverse repo arrangements to be included in the limit calculation process. Upon reversion, securities disposed of by way of repos should not be considered part of the investment portfolio for the duration of the respective arrangement.

[6] Cf. § 57 third sentence of the German Investment Act (Investmentgesetz – InvG).

Q2: *Do you agree with the proposed guidelines for the treatment of repo and reverse repo agreements? If not, please justify your position.*

We do not fully agree with the proposed guidelines. First of all, we are at a loss as to what is meant by "recalling the full amount of cash on an accrued basis" in paragraph 2(b)(i). Does the term "on an accrued basis" refer to any profits made from cash reinvestment until the termination date? Or does it just mean that the cash subject to reverse repo transaction must be recallable in whole immediately after termination? In any case, we think that ESMA can reasonably expect the recallability of assets to be conducted at the valuation price as valid at the date of termination. In order to avoid confusion in the market, the wording of the proposed guidelines should be clarified in this respect.

We have also some reservations with regard to the requirements proposed in paragraph 3. In our view, it makes no sense to require an appropriate balance between short-term and medium term arrangements in general. For instance, if a UCITS engages only in short-term arrangements, it should not be forced to conclude some repos also for the medium term. Also under letter (b), the diversification of counterparties should depend on the size of repo transactions in relation to the fund portfolio. In case a UCITS concludes fixed-term repos only in relation of a small fraction of its assets, no diversification at the counterparty level appears necessary.

Q3: *What are your views on the appropriate percentage of assets of the UCITS that could be subject to repurchase and reverse repurchase agreements on terms that do not allow the assets to be recalled by the UCITS at any time and that would not compromise the ability of the UCITS to execute redemption requests?*

In our opinion, no regulatory limits on fixed-terms repo and reverse repo agreements should be set. In case of liquidity supply through repos, the trades should be mainly fixed-term in order to avoid daily refunding risk for UCITS. As regards reverse repos representing cash investments from a fund's perspective, it should be up to the portfolio management to define and properly manage the maturities of transactions.

Furthermore, ESMA should bear in mind that arrangements on terms allowing the assets to be recalled at any time are not accepted as liquidity

lines on defined terms by banking authorities (such as FSA) and are therefore economically unattractive. Should banks be not able to use e.g. liquidity from reverse repos for term credit lines, the rates must be expected to be comparable to overnight repos.

As we believe that repo and reverse repo transactions are efficient and low-cost instruments for mitigating risk because they provide access to secured funding respectively secured investments, the notion of restricting UCITS' ability to engage in fixed-term arrangements represents a serious drawback to risk reduction through EPM techniques and might scare off risk-averse investors.

Should ESMA nonetheless decide to impose a limit on fixed-term repo or reverse repo arrangements, we think that a restriction to 30% of fund assets might be feasible in the market practice. In no event should the allowable percentage of assets which may be subject to fixed-term transactions be set lower than 10%. At this level, no diversification duties in terms of the counterparties as envisaged in paragraph 3(b) should apply.

Q4: *Do you consider that UCITS should be prohibited from entering into repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time? If not, please indicate possible mitigating measures that could be envisaged in order to permit UCITS to use repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time.*

According to the ESMA guidelines presented in Annex III, proceeds from repo and reverse repo transactions are subject to high quality standards meant to reduce counterparty risk. Moreover, UCITS are required to conduct regular liquidity stress tests in order to assess the liquidity risk of collateral amounting to at least 30% of the fund assets. In these circumstances, we do not see any reason for generally prohibiting UCITS from entering into repo and reverse repo arrangements on fixed terms.

Q5: *Do you think that there should be a minimum number of counterparties of arrangements under which the assets are not recallable at any time? If yes, what should be the minimum number? To answer this question, you are invited to take into account your response to question 2 above.*

A general instruction on a minimum number of counterparties independent from the volume of fixed-term arrangements could conflict with the best execution rules in Articles 25 and 26 of Directive 2010/43/EU. Thus, at least up to the level of 10% of the fund assets, there should be no requirement as to the minimum number of counterparties. Should ESMA reject imposing a threshold for fixed-term repos or set it at a higher level, we recommend not requiring a minimum number of counterparties, but rather imposing relative counterparty limits for fixed-term repo trades. In this vein, it could be laid down that fixed-term repo transactions with one single counterparty cannot account for more than 10% of the fund assets.

Major concerns in terms of the final guidelines (Annex III)

We have identified a number of issues in the final guidelines presented in Annex III which are either ambiguous or create major problems in terms of their practical implementation. The key concerns affecting the initial compliance process are presented below. There are several further open questions which, in our view, should be clarified by ESMA in order to avoid legal uncertainties and to prevent potential regulatory arbitrage. We will take the liberty of alerting ESMA in this regard at a later stage.

I. Scope of application (para. 33 and section XIII)

Some elements of the guidelines which determine their practical implications are not at all clear:

1. According to **paragraph 33**, the guidelines for financial derivative instruments apply to total return swaps (TRS) or “other financial derivative instruments with similar characteristics”. There is no further clarification as to which other types of swaps or even other derivative contracts might be considered as having “similar characteristics” to TRS. In our opinion, a set of characteristics should be defined for such similar derivative instruments. In this respect, we suggest applying the following cumulative criteria in order to capture all derivates emulating the effect of TRS:

    - "Total Return", i.e. all revenues derived from the underlying are included in the payoff (e.g. for equities dividends as well as price changes),

- existence of two legs (payer and receiver) where at least one of them is based on one or several financial indices or a portfolio/basket of at least two securities,
- OTC trading.

2. In **section XIII**, the guidelines refer to financial indices in general instead of strategy indices discussed in the preceding consultation. Moreover, it is entirely equivocal whether section XIII is addressed specifically at index-tracking UCITS (which are referred to in paragraph 45) or applies to all types of UCITS investments in financial indices. The latter interpretation would encompass also fractional engagements of actively managed UCITS via derivatives on indices (such as index futures) and subject those funds to the very demanding requirements on index monitoring and transparency which, in our view, make at best sense for genuine index-trackers.

II. Substantive concerns

BVI has some major concerns in terms of substance of the ESMA guidelines:

1. **Treatment of TRS counterparty as portfolio manager (para. 36):** While agreeing with the guideline in paragraph 36 in principle, we deem it not acceptable to assume delegation of portfolio management in case of minor discretion powers remaining with the counterparty. For instance, decisions on corporate actions in relation to the swapped basket of securities should be assignable to the counterparty being the owner of the relevant assets.

2. **Liquidity of collateral (para. 40(a)):** According to the liquidity criteria enforced by ESMA, most EU government bonds might be considered non-liquid and hence become not eligible as collateral. Government bonds are usually listed on an exchange, but the trading takes place bilaterally meaning that no transparent pricing and execution close to pre-sale valuation can be ensured. We assume, however, that this is an unintended consequence and that UCITS should remain able to accept EU government bonds as collateral.

3. **Collateral diversification (para. 40(e)):** ESMA imposes an issuer limit of 20% on the basket of collateral held by a UCITS. Assuming that EU government bonds should remain eligible for collateral, this means that the issuer limit for collateral is much stricter than the limit applicable to the UCITS portfolio under Article 52(3) of the UCITS Directive. This appears inexplicable given the purpose of collateral to ensure liquid and reliable means of recourse in case of counterparty's default.

4. **Treatment of cash from repo transactions (para. 39 and 40(j)):** We understand that ESMA is determined to prohibit re-use of cash acquired through repo transactions. However, we would like to stress once again that by blocking the re-use of repo proceeds, ESMA makes it very difficult for UCITS to participate in the central clearing of OTC derivatives under EMIR. In these circumstances, UCITS might be forced to engage in collateral upgrade transactions involving additional fees and potentially creating further counterparty risks. Another possibility would be to avoid as far as possible central clearing by concluding non-standardised OTC derivatives which are cleared in a bilateral manner. This solution, however, would counteract the G20 objective of extending the central clearing of derivatives and raise insolvency risks which could be avoided in the CCP model.

5. **Requirements for financial indices (para. 49 to 58):** There are different layers of difficulties in relation to these guidelines:

   - We understand that the guidelines shall apply to all financial indices at least in the case of index-tracking UCITS referred to in paragraph 45. However, the transparency expectations in terms of the calculation methodology and composition of indices specified in para. 52 and 53 will not be met even by many traditional and recognized index products. In many cases, index providers charge fees for obtaining information on index calculation and/or index constituents. This pertains e.g. to indices offered by MSCI. In addition, it is entirely unclear whether para. 54 can be fulfilled if decisions on selection and rebalancing of index constituents are taken by an index committee on the basis of a fundamental assessment (like e.g. in case of Dow Jones Industrial Average). This leads potentially to

a situation where several, possibly hundreds, of European index-tracking UCITS might be forced into major changes regarding their investment strategy.

- Should the guidelines be also relevant to actively managed UCITS involving fractional exposures to indices through derivative transactions, then **we fear that the due diligence standards imposed by ESMA might have prohibitive effects on active UCITS' investments in that regard**. Moreover, we think that disclosure of the rebalancing strategy and its effects on the costs provided for in paragraph 50 is incommensurate for UCITS achieving only a small part of their performance by index investments.

- Overall, we have grave reservations against the approach adopted by ESMA with regard to financial indices. In its quest to inhibit replication of hedge fund like stategies in UCITS ESMA has severely tightened the standards applicable to all financial indices, thus placing severe burden also upon traditional UCITS managers. Due to the extensive transparency standards anticipated in financial indices, UCITS managers are now in the disagreeable position of being forced to exert economical pressure upon index providers in order to retain the ability to use their products for investment purposes. Given the fact that the political debate on regulation of indices and transparency standards to be incumbent directly upon index providers has just commenced, we deem it highly inappropriate to anticipate the results of potential future regulatory measures solely for UCITS representing a rather small group of index users. In our opinion, application of the ESMA guidelines to broad market indices should be postponed until an agreement on regulatory standards applicable to index providers has been reached.

III. Transitional provisions

1. **Immediate application to new funds (para. 60):** It is nearly impossible to apply the guidelines to new funds immediately after their entry into force which must be expected for early 2013. The new standards for collateral and for monitoring of financial indices require several months of intense preparation in order to renegotiate

contractual arrangements and to set up the necessary internal procedures. BVI members are already considering either quickening or postponing new product launches in order to avoid collision with the date of the ESMA guidelines coming into force.

2. **Adaptation of fund documents (para. 66(a)):** It is not appropriate to demand adaptation of the relevant documents such as fund prospectus or KIID in line with the ESMA guidelines on the first occasion of a revision due for entirely different reasons. It appears disproportionate to expect e.g. information on the new collateral policy in line with paragraph 44 to be provided by UCITS potentially a few weeks after the entry into force of the ESMA guidelines. This outcome would also run counter to the transitional provision in paragraph 62 which allows additional 12 months for the alignment of collateral with the new standards imposed by ESMA.

We trust that ESMA will take our comments into account in order to further clarify and improve the regulatory framework for UCITS management. We would be happy to continue our dialogue with ESMA with the goal of introducing standards which ensure both rigorousness of supervision and competitiveness of UCITS in the financial market.

Yours sincerely

Marcus Mecklenburg

Dr. Magdalena Kuper