

Comments by

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on the Consultation Paper

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

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Introduction:

Union Investment very much welcomes the ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS dated 22 July 2011 and would like to thank ESMA for the opportunity to participate in this consultation.

In general we do not believe that UCITS ETFs nor structured UCITS should be singled out from other UCITS products. The UCITS framework provides extremely high standards for liquidity, fungibility and risk management but also limitations on the risk of losses for investors (i.e. investors in a UCITS may never lose more than the subscription amount). Furthermore the information provided to investors is adequately comprehensive. The UCITS regime has the merit of being a unified regime and it would not be appropriate to modify this.

Nevertheless we understand that ESMA considers some UCITS products are less comprehensible for retail investors in means of potential risk and return scenarios. From our point of view the decisive factor to address this problem is to enable the retail investor to make well informed investment decisions. With the introduction of the KIID regulators have taken a decisive step to help retail investors understand the investment objective and risk profile of a UCITS fund.

As the proposed ESMA policy orientations however suggest additional disclosure to such UCITS investors, we believe that this increase in transparency could be in line with the market best practice and we therefore welcome such proposals.

Retailisation of complex products

1. Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured¹ UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.

According to the EU-commission UCITS did not cause the financial crises. In its "*Consultation Paper on the UCITS Depositary Function and on the UCITS Manager's Remuneration*" dated 14 December 2010 the EU-commission states in Section 2 Subsection 2.3 that "*The UCITS asset management sector was not one of the root causes of the financial crisis, and the new regulatory framework for UCITS should place significant limits on the degree and nature of the risk that a UCITS might take on, ...*".

We do not believe that a distinction between "complex" and "non-complex" products within the UCITS-framework is an appropriate measure to help the retail investor making investment decisions complying with his personal investment and risk perspective.

¹ Below we define "structured UCITS" according to "CESR's guidelines on the methodology for the calculation of the synthetic risk and reward indicator in the Key Investor Information Document." complementing the commissions implementing regulations of the UCITS IV Directive (Directive 2009/65/EC). CESR the predecessor of ESMA states in Box 8 that "Structured funds" can be defined as "UCITS which provide investors, at certain predetermined dates, with algorithm based payoffs that are linked to the performance or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios shall be considered as structured funds."

Products within the UCITS framework are highly regulated, liquid, transparent, well diversified, underly strict risk management standards and limitations on the risk of losses for investors (i.e. investors in a UCITS may never lose more than the subscription amount). Products within the UCITS framework are in general designed to meet the specific retail investors risk/return profile. Last but not least the information provided to investors is adequately comprehensive.

Therefore ESMA should explore possible common approaches of marketing of ETFs² in general, not just for synthetic ETFs, in the light of better transparency for retail investors. The clear objective should be transparency and information for retail investors. We are not in favor of any extra rules changing or limiting the current UCITS investment guidelines. While doing so ESMA should also bear in mind potential interdependencies with the proposals to adjust the MiFID (Directive 2004/39/EC).

2. Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as ‘complex’? Which criteria could be used to determine which UCITS should be considered as ‘complex’?

We are deeply convinced that there are legitimate reasons for maintaining the general classification of UCITS as non-complex according to Article 19 para. 6 of the MiFID (Directive 2004/39/EC). The level of UCITS regulation exceeds any other regulatory framework in the financial sector. Even on the global basis UCITS investments are subject to the highest standards on regulation and transparency providing in particular for appropriate risk diversification. UCITS assets are strictly separated from the assets belonging to the management company and entrusted to a depositary for safe-keeping. The comprehensive information by UCITS providers as well as dense supervision at both product and manager level ensure that management of fund assets takes place in accordance with legal provisions and applicable fund rules.

In addition all UCITS should easily comply with the criteria for non-complex instruments specified in Article 38 of the MiFID-Implementing Directive (Directive 2006/73/EC). UCITS investments are very liquid (redemptions possible usually daily, but at least twice a month), do not involve any liability exceeding the acquisition cost, provide a very high level of transparency, are subject to stringent risk management rules and, above all, are designed to be well diversified. In particular, the recent introduction of the Key Investor Information Document (KIID) renders UCITS by far the most transparent financial instruments with a high potential for comprehensibility on the part of retail investors.

² We understand that ETFs are index trackers or actively managed investment funds traded on an exchange within an ETF-segment requiring market makers and the calculation of an iNAV. Investment funds which are also exchange-listed but that are not listed in a special ETF-segment and are not supported by market makers and do not publish iNAVs are no ETFs according to our understanding.

We believe that a classification based on portfolio management techniques is not appropriate for various reasons. Portfolio management techniques might be more advanced or rather less advanced. In most cases advanced portfolio management techniques are used to reduce risks and keep at an acceptable level for the investor (e.g. when derivatives are used for hedging). In that respect, advanced portfolio techniques even reduce the risk of an investment fund. However, less advanced portfolio techniques could also significantly increase the risk profile of a so called plain-vanilla investment fund or can be used to effectively increase the leverage of an investment fund.

Therefore, complexity is not equal to risk and a definition of “complexity” based on the use of certain investment instruments or management techniques would be misleading. Moreover it would not help the investor to choose a product on a well-informed basis that meets his investment goals and risk/return profile. We believe that an ultimate test is how a product behaves in various market conditions to reveal the different risk-dimensions for an investor. **Therefore we believe it is far more appropriate to consider the risk-profile of a product instead of creating a new sub-category of ‘complex’ funds.**

Having in mind that the retail investor should be enabled to take an informed investment decision before actually investing, accurate and transparent disclosures in the KIID, fund’s prospectus and any related marketing material explaining the risk profile of a fund (which could include risk explanation by showing different types of scenarios based on different market conditions) would be more effective in respect of investor protection. The KIID already provides investors with appropriate information about the objectives and investment policy as well as essential characteristics of the UCITS concerned, so that the investor is reasonably able to understand the nature and risks of the investment product that is being offered to him and, consequently, to take investment decisions on an informed basis.

3. Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

As the UCITS framework implies liquidity requirements, negotiability, high risk management standards but also limitations on the risk of losses for investors (i.e. investors in a UCITS may never lose more than the subscription amount), and the information provided to investors which is adequately comprehensive, we believe that there are no “inappropriate” UCITS.

UCITS are indisputably the flagship of the European retail market with the highest standards of investor protection governing both product composition and transparency towards investors. It must be stressed in this context that “UCITS” has become a worldwide recognized brand for retail investors, primarily thanks to its high level of investor protection.

Therefore transparency is the key matter. As stated above the UCITS rules are well defined and there should not be any UCITS inappropriate for retail investors. Any UCITS investment can be appropriate for retail investors depending on their own personal situation, investment goals and risk tolerance.

We understand that ESMA seeks to protect retail investors from investments in products he/she might not fully understand. Therefore we support any measures that increase transparency. **As argued above we do not think that it would be helpful to create sub-classes of UCITS investment funds.** Nevertheless the current transparency requirements include the appropriate description of the risks under different market conditions that are associated to a single product as given in the KIID.

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

All products discussed by ESMA in the paper at hand are fully compliant with the current UCITS regime. None of them should be deprived of the UCITS status just because they explore the legal possibilities of Directive 2009/65/EC in terms of innovative investment strategies. If the regulators however consider that the protection of retail investors is in some cases insufficient, the discussion should focus on means of enhancing the relevant transparency of the information disclosed to the retail investor prior of investing.

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

No. The Financial Stability Board addressed the relevant issues in April 2011.

6. Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union? If not, please give reasons.

By definition non-UCITS are not compliant with the UCITS rules. Anyway, rules on collateral requirements should possibly be applied on non-UCITS funds as well. From our point of view ESMA already addresses these matters in its level 2 consultation on the AIFMD as far as there is a legal basis for such measures.

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

Indeed, there should be a level-playing-field for the different investment products. Insurance products, home loan banking products (in Germany: "Bausparverträge"),

structured notes and others should be added to the mentioned ETNs and SPVs. Latest with the forthcoming work for the “PRIIPS”-regime there should be the same level of investor protection and transparency for all investment products.

8. Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.

Yes, we agree. Nevertheless there should be a clear definition of the term “ETF”. As suggested in answer to question no. 1, we propose the definition: “*ETFs are index trackers or actively managed investment funds that are traded at an exchange within an ETF-segment of the exchange that requires market makers and the calculation of an iNAV.*”

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

Yes.

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

Yes. For transparency reasons the identifier should also include information regarding the construction technique used in the portfolio (fully replicating or sampling ETF).

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

Basically yes. It is not always the case that the tracking error of a synthetic ETF is lower than the one of a physical replicating ETF. If trading and hedging costs of the investment bank are mirrored in the total return swap, the result is pretty much the same. Furthermore the collateral performance or the security lending process might have an impact on the tracking error. Technically the tracking error is also influenced if fund valuation processes differ from the index calculation rules (e.g. an equity index uses FX-rates at 5 p.m. while the fund’s NAV is calculated with FX-rates at 6 p.m).

An ETF should report a tracking error that is based on a NAV calculation that is identical to the index calculation rules.

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

Yes.

13. Do you think that the information to be disclosed in the prospectus in relation to index-tracking issues should also be in the Key Investor Information Document of UCITS ETFs?

Yes.

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

Yes.

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

As mentioned in our answer to question no. 11, valuation rules of indices and ETFs should be identical.

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

Yes, but there is one special case. If the collateral does physically replicate the index itself it should also be accepted, even if it is not compliant with the other rules (e.g. an ETF on an high yield bond index should also be allowed to accept collateral that tracks the index of the ETF). The high yield bonds do not fulfill the other requirements. But in the case that the collateral is needed in a default event the ETF would still track the index without any need to liquidate the collateral.

17. For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.

Yes, we see two viable solutions:

- a) The collateral matches the constituents of the swapped index/active portfolio or
 - b) It consists of liquid AAA rated government bonds or liquid AAA rated covered bonds
- in order to minimize the counterparty risk.

18. In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

No, the discussion should be focused towards a maximum standard of quality and liquidity of the securities held as collateral to minimize counterparty risks.

Securities lending activities

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

Yes. We welcome the intention to improve transparency for investors.

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

Yes.

21. Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced? If yes, please specify.

There are various rules for collateral received in the context of securities lending within the European Union. Most countries offer sufficient regulatory frameworks for any securities lending transactions. Contrary to a tightening of existing rules we support a harmonization of these rules within the EU to create transparent guidelines for securities lending activities independent from the domicile of the UCITS portfolio.

22. Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral? If not, please give reasons.

Although the purpose of a collateral is to minimize counterparty risks, the collateral criteria for OTC derivatives are not simply applicable for a securities lending collateral. A detailed analysis should be performed before creating rules for a collateral to secure the best result for the new framework.

23. Do you consider that ESMA should set a limit on the amount of a UCITS portfolio which can be lent as part of securities lending transactions?

No, if the collateral rules fulfill their goal there is no need to limit the amount of a UCITS portfolio which can be lent as part of securities lending transactions.

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

No.

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

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Actively managed UCITS ETFs

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

Yes.

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

No.

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

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Leveraged UCITS ETFs

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

Yes.

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

Yes.

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

No.

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

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Secondary market investors

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

In order to receive the status of a UCITS compliant vehicle, investors should have the right to redeem directly from the fund respectively the management company of the fund. The provision of appropriate minimum sizes and redemption fees must be possible to secure the quality of the product in the interest of the remaining investors of the fund.

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

Prospectus and marketing materials should be published on the internet pages of the fund management companies as well as the exchanges. Mostly this is already the case. Therefore retail investors should have access to all relevant information.

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

No.

36. In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

Yes, pls. refer to answer no. 33.

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

No, in fact it is difficult to measure whether a market maker does or does not provide liquidity. Increasing spreads can be a sign of missing liquidity, but it is difficult to specify at which level the “official” status of “Illiquidity” has to be declared. Therefore the redemption right should not be linked to market maker performance.

38. How can ETFs which are UCITS ensure that the stock exchange value of their units do not differ significantly from the net asset value per share?

Not at all. Market prices at the exchange are neither in the responsibility of the UCITS nor the exchange. It is the job of the investors to determine whether the price is fair or not. The calculation of an iNAV provides sufficient indication.

Total return swaps

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

We do partly not agree. UCITS diversification rule for the swapped portfolio are important, but are not a solution for all cases. As long as the UCITS' investment portfolio (including the swap) is in line with the 5%/10%/40%-UCITS rule under the terms of Art. 52 para. 2 Directive 2009/65/EC, a non-diversified portfolio as underlying for the swap should be acceptable. This kind of limit is also described and suggested for strategy indices.

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

Partly no, for details see our answer to question no. 39.

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

No.

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

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Strategy indices

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

By definition a strategy index follows a certain strategy which can be either quantitative or/and fundamental. Therefore it can not a benchmark of an overall market, e.g. the stock market. But a strategy can be benchmarked against a market index to measure its degree of success. Therefore we support the discussed proposals to increase transparency. Diversification is important, but in the case of a non-diversified index the 5%/10%/40% ensures diversification on the UCITS level.

As a result this rule should be added to the requirements of non-diversified indices. This rule should also apply to commodities indices, since 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 active management of the single components, the diversified index allows only a fixed proportion between the components.

We particular have concerns with the proposals in paragraph 69 in the discussion paper to connect the eligibility of an index to the (retail) investors' ability to replicate the index. Actively managed indices that follow a fundamental investment process cannot be replicated by external investors (in contrast to quantitative investment strategies). To offer a level playing field between quantitative and fundamental approaches the criterion of the investor's ability to replicate the index should not be implemented. The focus should rather be on an increased transparency for the investors.

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

As long as the swap is in line with the 5%/10%/40% rule the diversification criteria are met.

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

No.

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

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