

Comments

on ESMA's policy orientations on guidelines for
UCITS exchange-traded funds and structured
UCITS

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Thank you for the opportunity to comment on the possible future form of regulation for ETFs and structured UCITS. We especially welcome the fact that ESMA has involved market participants prior to proposing possible guidelines or other regulatory measures and is soliciting their preliminary assessment of the policy under consideration. We are confident that an exchange of views at this early stage will prove highly advantageous and enable ESMA to base its decisions on appropriate information.

With respect to the aspects mentioned in paragraphs 6 and 7 – namely the implications for financial stability of “new” practices by ETFs – we would like to draw ESMA’s attention to our response to the FSB’s recent consultation, a copy of which we enclose for ease of reference.

Q1: Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.

We basically welcome efforts to ensure that rules are as consistent as possible across Europe. We also support ESMA’s approach of establishing a high degree of transparency with the aim of mitigating the risks associated with certain types of ETFs and structured UCITS. By contrast, we would generally reject such radical market intervention as a limitation, or even ban, on marketing certain ETFs and structured UCITS to retail investors. We would suggest permitting bans only in the event of actual and significant damage to investor interests on a scale which jeopardises the smooth functioning of the financial markets. Many products are only put together in the first place in response to a strong demand by retail clients to invest in the tracked markets. The objective cannot be to engage in “nannying” these clients by restricting their ability to make investment decisions.

On top of this, there may sometimes be legal or economic obstacles to full replication or sampling with the result that synthetic replication is unavoidable. But the benefit of being able to replicate additional markets in this way may also give rise to counterparty credit risk as a result of outsourcing the responsibility for performance, for instance, and make it necessary to execute different or additional transactions than is the case with full replication. These are further arguments for adequate transparency vis-à-vis clients.

ETF providers are therefore already concerned not just to comply with legal information requirements but to supply all clients with further data (e.g. by publishing the swap risk, details of collateral posted, etc. on the internet) so as to offer them an optimal basis for informed investment decisions. What is more, ETF providers guarantee full transparency at all times about the composition of their funds.

The UCITS Directive requires asset management firms to prepare key investor information documents (KIIDs) and make them available to clients. In addition to the prospectus, these documents provide clients with a succinct overview of aspects such as the fund's investment strategy, scenarios under various market conditions and possible associated costs.

Financial institutions marketing the funds also give their retail customers sufficient information and advice on which to base an informed investment decision. Future regulation should continue to be guided by the principle of the informed investor. Requirements should avoid imposing administrative burdens which merely generate additional costs without delivering investors any added value.

It should, moreover, be borne in mind that complex products do not necessarily involve more risk. Such products may include sophisticated mechanisms for the purpose of mitigating risk. The crucial point, in our view, is that investors are aware of the risks involved and have the opportunity to invest in products that best match their needs.

Q2: Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria could be used to determine which UCITS should be considered as 'complex'?

It is the task of the fund management to make professional investment decisions in the interests of their clients and thus reduce complexity from the client's perspective.

What is more, complex structures do not necessarily involve more risk. On the contrary, complex products can also be specifically designed as low-risk investments. A capital protection mechanism that might be considered complex may, for instance, actually reduce the risks involved. As a result, some complex UCITS may be less risky than a non-complex UCITS. We therefore take the view that UCITS which employ complex portfolio management techniques should be deemed *complex* for the purposes of the appropriateness test only. This should not, however, translate into restrictions on marketing these products to retail investors.

If ESMA nevertheless takes the view that a distinction must be made between complex and non-complex funds, this distinction should be based not on the formal complexity of a fund's structure but on the actual level of risk for the individual investor. Furthermore, the criteria for distinguishing between complex and non-complex need to be absolutely clear.

Q3: Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

We consider the current European approach, based on the concept of the informed investor, to be the right one.

Assessing the suitability of a complex UCITS for retail investors on a case-by-case basis is more appropriate than hard-and-fast restrictions on distribution. In our view, moreover, transparency is the key to enabling investors to take informed investment decisions and can be ensured by including corresponding information in the marketing documents, KIID and/or prospectus, for example. The combination of an appropriateness test and a high level of transparency is the best way to avoid retail clients investing in products that are unsuitable for their needs.

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

As long as potential investors have access to all the necessary information about a fund and the fund complies with the strict UCITS framework criteria, we see no reason to withhold the UCITS label.

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

No. We would draw attention to the documents published by the FSB and BIS on the issue of systemic risk and also to our enclosed response to the FSB consultation.

Q6: Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union?

If not, please give reasons.

We see no need for retail investor protection rules to be applied to non-UCITS funds which are specifically designed for, and may only be sold to, institutional investors. It is unnecessary, in our view, to apply UCITS rules to non-UCITS funds and to address retail investor protections concerns that are not covered by the Alternative Investment Fund Managers Directive. In any event, a non-UCITS fund should not be allowed to use the UCITS label even if there may be a partial fit with the UCITS regime. "UCITS-like" funds of this kind could have an adverse effect on the reputation of the UCITS label.

Q7: Do you agree that ESMA should also discuss the above-mentioned issues with a view to avoiding regulatory gaps that could harm European investors and markets?

If not, please give reasons.

In principle, we support measures underpinned by the concept of equal regulatory treatment. This presupposes, however, that such equal treatment is justified. ETFs and other UCITS products are designed quite differently from ETNs and the SPV-issued products ESMA mentions. They are therefore only comparable with ETFs to a limited extent and we see no compelling reason to subject them to the same requirements. This applies particularly if the products in question are not sold to retail investors.

Q8: Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.

Yes, we agree.

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

As ESMA itself points out, the borderline between physical and synthetic replication is a fluid one. We therefore think a hard-and-fast distinction would confuse rather than clarify. Instead, information in addition to the identifier should be made available to explain how the ETF functions.

Whether or not an ETF's investment decisions are actively managed could be indicated either in this additional information or in the identifier.

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

The essential point is that a KIID can be easily matched to its respective fund.

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

Q12: Do you agree with the policy orientations identified by ESMA for index-tracking issues?

If not, please give reasons.

Yes, we agree.

Q13: Do you think that the information to be disclosed in the prospectus in relation to index-tracking issues should also be in the Key Investor Information Document of UCITS ETFs?

Yes, we agree.

Q14: Are there any other index tracking issues that ESMA should consider?

No.

Q15: If yes, can you suggest possible actions or safeguards ESMA should adopt?

N/A

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

Q17: For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.

We believe that establishing transparency about the type of collateral posted is a more effective approach than imposing rules on what kind of collateral qualifies as eligible. Rules would unnecessarily limit flexibility with respect to collateral. In our view, the quality of assets used as collateral is appropriately and adequately ensured by CESR's Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

Q18: In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

We do not think it would make good sense to apply UCITS diversification rules "as is" to the collateral received in a swap transaction. The two sets of circumstances involved are not really comparable. Naturally, the assets used as collateral should be selected in such a way that they are fit for purpose. But since the collateral only has to be realised if the swap counterparty defaults, investors may be better protected by a type of diversification other than that required under the UCITS rules. Significant deviations from the UCITS diversification rules should be made transparent to the investor.

Q19: Do you agree with ESMA's analysis of the issues raised by securities lending activities?

If not, please give reasons.

Securities lending transactions create ETF-specific risk only to a limited extent (and irrespective of whether replication is full or synthetic). Securities lending is customary among actively managed funds as well, not just ETFs. Special requirements solely for ETFs would distort the level playing field in the UCITS regime. In addition, securities lending is subject to the stringent provisions of investment law. This ensures that only liquid securities can be used as collateral. If loaned securities cannot be returned on time, this collateral can be realised by the lender.

Furthermore, securities lending generates additional income for UCITS, thus increasing investors' returns. Rather than placing restrictions on securities lending activities, it would be preferable to establish transparency for investors about the types of securities lending transactions a fund may engage in.

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

We do not support the third policy orientation. The proposed disclosure of securities lending fees earned by UCITS ETFs is not part of the current UCITS regime and would thus place UCITS ETFs at a disadvantage compared to other UCITS and other index-tracking vehicles not covered by the UCITS regime.

Q21: Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced?

If yes, please specify.

No, we see no need for further safeguards.

Q22: Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral?

If not, please give reasons.

Q23: Do you consider that ESMA should set a limit on the amount of a UCITS portfolio which can be lent as part of securities lending transactions?

No, given the clear requirements imposed on securities lending activities to protect fund assets, we see no need for a quantitative limit.

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

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

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

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

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

No.

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

N/A

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

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

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

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

We would like to reply to questions 29 to 32 together since they are closely related to one another.

The German banks basically agree with ESMA's proposals. We would nevertheless like to point out that leveraged ETFs covered by the UCITS

Directive do not generate higher risks than do other funds falling within the directive's scope. The disclosure requirements concerning a fund's leverage should therefore be based on the standard level of disclosure required for other funds.

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

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

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

We would like to reply to questions 33 to 35 together since they are closely related to one another.

We basically support ESMA's thinking. It should be noted, however, that for example in the case of ETFs salient features can be inferred from their name.

Q36: In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

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

Secondary market investors should not have a right to direct redemption of ETF units by the issuer. The term "exchange-traded" makes it clear that units can only be bought and sold on an exchange. A right of this kind would make it extremely difficult to differentiate between ETF products and products that can be either returned to the asset management firm or sold on the stock exchange.

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

Units in UCITS are already frequently traded on the stock exchange. There is normally very little difference between the exchange-traded price and the redemption value set by the asset management firm. This demonstrates that there is no need for a special rule to prevent deviations.

Q39: Do you agree with ESMA's analysis of the issues raised by the use of total return swaps by UCITS?

If not, please give reasons

Yes, we agree.

Q40: Do you support the policy orientations identified by ESMA?

If not, please give reasons.

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

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

Q43: Do you agree with ESMA's policy orientations on strategy indices?

If not, please give reasons.

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

Interest rate indices such as EONIA are sufficiently diversified as they are averages of interest rates. Under the UCITS Directive, moreover, interest rates are eligible as underlyings.

Q45: Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

Q46: If yes, can you suggest possible actions or safeguards ESMA should adopt?

Enclosure

ZENTRALER KREDITAUSSCHUSS¹⁾

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Comments on the FSB note of 12 April 2011 on *Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs)*

Dear Sir, Madam,

We are pleased to take up the invitation in your press release of 12 April 2011 to comment on the note you published on Potential financial stability issues arising from recent trends in exchange-traded funds (ETFs).

• Evolution of the ETF sector in the recent past

We agree in principle with you when you say in this note that the growth of ETFs is due to their many benefits from the perspective of investors, e.g. low-cost diversification, high liquidity and tradability, easy access to different markets. As a result, ETFs have become a particularly attractive investment vehicle in recent years (but it should be kept in mind that one reason for these strong growth figures is the low base they came from and that in absolute terms assets under management by ETFs are around 5% of mutual funds). A further benefit in the eyes of investors is their easy-to-understand performance, which is closely linked to a usually well-known index. Besides the diversification ETFs inherently offer, another plus is that active management of the funds invested is not necessary, which keeps costs low.

¹⁾ The Zentraler Kreditausschuss (ZKA) is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Pfandbriefbanken (vdp)*, for the Pfandbrief banks. Collectively, they represent more than 2,200 banks.

- **Expansion of ETFs to different reference baskets/ ETFs using synthetic replication**

Driven mainly by investors' wishes, ETFs have branched out to other reference baskets or indices to which they are linked. At the same time, ETFs using synthetic replication, which track the performance of the benchmark by using suitable derivatives instead of full replication, have emerged. Such an ETF may be superior to a fully replicating one. The tracking error can, for example, be kept much lower with derivatives than is possible with full replication. In addition, costly adjustment of the investment portfolio to the index can be avoided or outsourced to a business partner whose business model or market position enables him to handle this more efficiently. These ETFs are, moreover, much freer in the choice of benchmarks, allowing participation in a performance that would not be attainable through replicating structures. Besides different asset classes, such ETFs may offer exposure to markets that are otherwise difficult to access as they can leverage the infrastructure capacities of the swap provider (e.g. specific emerging markets).

It is important to highlight that ETFs using synthetic replication are regulated by the same set of rules in Europe, namely the UCITS rules, as further described below (e.g. ETFs are established as funds separated from the assets of the asset management company with a custodian).

- **Potential risks of ETFs**

As regards the potential risks, it should be noted that these are risks which may arise not only from ETFs but also from classical investment funds.

It should also be noted that ETFs are subject to the stringent provisions of investment law. This means that potential conflicts of interest are mitigated in the set-up of European investment funds. For example, it is a misperception that a bank can be both swap provider for an ETF as well as manager of an ETF as in the European market asset management and banking activities are clearly separated. European investment funds adhere to this principle by outsourcing certain functions (such as e.g. custody, administration, etc.) to third parties. The national legislation implementing the UCITS III provisions specifies the form in which collateral, e.g. to cover swap liabilities, is to be posted. In addition, collateral is assigned a haircut in practice, resulting in over-collateralisation. The collateral is separated and bankruptcy-remote. The ETF's management company and the external depository monitor the quality and quantity of the collateral posted. If collateral is realised, this depository will safeguard the interests of shareholders, who are thus comprehensively protected.

Securities lending transactions create ETF-specific risk only to a limited extent (and irrespective of full replication or synthetic structures). The FSB itself points out that securities lending is customary among actively managed funds as well. Securities lending is also subject to the stringent provisions of investment law. This ensures that only liquid securities can be used as collateral. This collateral is realised if loaned securities cannot be redelivered in time.

The fact that many investors may return their investments at the same time, adversely affecting securities lending as well, is a general financial market phenomenon, so that liquidity squeezes and/or a drop in prices cannot be tied to a specific class of products.

A key promise of ETFs, also those whose underlyings are based on less liquid assets, is to provide constant, high liquidity for investors. This can often be achieved far better by synthetic structures. However, in stress phases investors may tend to first offload risky illiquid asset classes, which could make it difficult to keep the liquidity promise. Furthermore, ETFs using synthetic replication have the advantage that these risks can be transferred to an entity better endowed with expertise in such tasks, the reasons being that this entity regularly manages these kinds of risks or that it can reap economies of scale and scope because of additional or similar business.

• **Need to inform investors better instead of banning “harmful” innovation**

Not the FSB’s note, but the document published simultaneously by the Bank for International Settlements (BIS) “Market structures and systemic risks of exchange-traded funds”, compares the innovation in the ETF sector with the innovation in the securitisation markets which, in the US subprime housing market, was one of the causes of the financial crisis. While we agree in principle that mistakes like those made in the US subprime market must be avoided, we do not believe that braking innovation, which is, moreover, driven by customers’ wishes, is the right way to do so. Instead, (potential) investors should be enabled to make prudent investment decisions in line with their risk-bearing capacity. This can be achieved in two ways in particular – (a) by strengthening an understanding of financial mechanisms and (b) by providing the necessary information on the characteristics of financial instruments. The composition of many ETFs can already be viewed today on the internet. However, we agree with the FSB that there is still room for improvement on ETF transparency in some cases. ETF providers should (and often already do) inform investors about product composition and risk characteristics, as well as collateral baskets and arrangements for ETFs using synthetic

replication (positions in derivatives) and securities lending, to enable them to exercise due diligence.

Furthermore, we disagree with the position taken in the BIS paper that banks, as swap counterparties, co-mingle tracking-error risk with proprietary trading book risk and that replicating returns of broad market indices is not a core business of investment banking. Long before and independent of the nascence of ETFs using synthetic replication, (investment) banks accumulated expertise in these transactions.

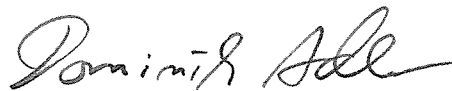
Yours sincerely,

On behalf of the Zentraler Kreditausschuss

Bundesverband deutscher Banken



Herbert Jütten



Dominik Adler