INVERCO REPLY TO ESMA'S GUIDELINES ON ETFS AND OTHER UCITS ISSUES

GENERAL COMMENTS

INVERCO (Spanish Association of Collective Investment Schemes and Pension Funds) represents more than six thousands collective investment schemes and more than 1,300 pension funds, with assets under management over EUR 276 billion.

INVERCO thanks ESMA for its excellent work on UCITS and welcomes its sound commitment to work in close cooperation with the industry practitioners.

In general terms, INVERCO supports ESMA guidelines, except for certain aspects which are detailed in the answers to the questionnaire below. These answers have been issued under the two following premises.

The first one is the achievement of the higher degree of harmonization across Europe, also in operational issues, like the use of collateral or the calculation of tracking error, as an essential tool to foster the single market.

The second one is the recognition than an overload of information can be as much a problem to investors as a lack of information, and therefore, rules aimed to ensure more transparency to investors, although are always welcome, should be limited to relevant, concrete and easy-to-understand issues, avoiding those technical or complex aspects that should not be understood by the average investor.

I. Index-tracking UCITS

Q1: Do you agree with the proposed guidelines?

We agree with the proposed guidelines in general, except for the need of including details of the underlying components of the index in the prospectus and redirecting investors to a web site where the exact composition of the index is published. ESMA should take into account that, though those details are sometimes freely available, it is very likely that on other occasions the fund is to pay a license in order to be able to provide them. Acquiring and managing licenses might increase costs considerably.

From our point of view, the information about the index to be disclosed in the prospectus should just include a clear narrative description of what the index is trying to represent and, at the most, an indication on where the freely public information about the index is published (a link to a web site, etc.)

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.

In order to maximize harmonization on this issue, it would be convenient ESMA to provide guidelines on the formula to calculate tracking error (both for synthetic and for physical ETFs), as well as on the frequency for such calculation.

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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?

This question is not clear enough. Paragraph 2 in Box 1 already envisages the inclusion of this information on the yearly and half-yearly reports, so if the proposal means that information about evolution of the fund should be provided more frequently or through additional sources, the answer is negative, considering that information on yearly and half-yearly reports is deemed to be sufficient.

II. Index-tracking leveraged UCITS

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

Yes, except for the proposal included on paragraph 2 in Box 2, because we consider that information described on paragraphs a) to c) might be useful for those investors who are willing to acquire a deep knowledge on the UCITS, but it is too much technical for the average investor and not suitable for the goals of easily comprehension and brevity which inspired the replacement of the simplified prospectus by Key Investor Information Document.

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

Yes, but only if the provision of this information does not prevent the UCITS (or its management company) from putting in place these leverage techniques.

For this reason, we consider that such information should be provided a posteriori (by including in the periodical reports the way the fund has achieved leverage during the period the particular report is referred to), but not a priori (by an exhaustive enumeration in the prospectus or Key Investor Information Document of the techniques the UCITS may use to achieve leverage, which would rest flexibility to this activity).

III. UCITS Exchange Traded Funds

Definition of UCITS ETFs and Title

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

Yes.

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

Yes.

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

Taking into account the principles which inspired the replacement of simplified prospectus by the Key Investor Information Document, we consider that inclusion of certain references to concepts like synthetic or physical should be avoided because they are difficult to understand by the average investor.

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

Yes.

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 think that there should not be stricter requirements on the minimum number of market makers, even when one of them is an affiliated entity of the ETF promoter. In our opinion, one market-maker should be enough to assure liquidity, provided that adequate mechanisms for its replacement —when necessary— are established.

Moreover, the liquidity of the ETF shares is not affected when the market maker and the manager of the ETF belong to the same group. In addition, the own market where the shares will be admitted to negotiation usually regulates the minimum terms and conditions for a valid market maker agreement.

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?

In broad terms, we agree with the guidelines regarding actively-managed UCITS ETFs, although this kind of UCITS cannot be authorized under the Spanish regulation, which requires ETF be listed and track an index.

Secondary market investors

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

Option 1, but with the conditions explained in the next question.

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.

In our opinion, under paragraph 2 of option 1 in Box 5 there might be included two situations which are completely different and which require a different treatment.

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The first one is that whereby the market maker is no longer **willing** to act in that capacity. This situation implies a willfulness element which entitles the management company to adopt those legal actions against the market maker which may take place. Anyway, this event might be easily solved by replacing the market maker by another willing to fulfill its commitments.

The second one is that whereby the market maker is no longer **able** to act in that capacity. This situation implies an impossibility element, related to *force majeur*, which, in principle, could be due to one of the two following circumstances:

a) The volume of subscriptions or redemptions exceeds the market maker trading commitment.

b) The occurrence of exceptional market circumstances, like a temporary suspension of quotation of shares in the portfolio.

Event described in paragraph a) could be solved by searching new sources of liquidity, for example by negotiating with the market maker an increase in the volume of units to be bought or sold, or by reaching contractual arrangements with new market makers.

In the event described in paragraph b), the circumstances which prevent the market maker to provide liquidity would also prevent the Fund or the management company to redeem the ETF units from the Fund.

As a conclusion, redemption of ETF shares directly from the ETF would give rise to important practical problems, and therefore such direct redemptions should not be established, as far as they would not constitute an efficient tool to improve liquidity and would distort normal ETF operating.

In our opinion, there are better measures to this goal, some of them already mentioned (such as the replacement of non-compliant market makers or the agreement with new market makers, as well as the increase in the volume of units to be bought or sold by them). All these measures are already covered by the mention stated in first sentence of paragraph 2 of option 1 in Box 5 (*"A UCITS ETF or its management company should take appropriate action to replace the market maker if it is no longer able or willing to act in that capacity, and should ensure the protection of unitholders in the event of such a process of replacement or if the redemption in the secondary market is disrupted"*), so second sentence of this same part should be deleted (*"This may include making arrangements for investors who have acquired their units or shares on a secondary market to sell them directly back to the UCITS ETF or its management company"*).

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.

This possibility is not envisaged in the Spanish regulation, so there is not relevant information to provide.

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

Both ETF´s central register of unit-holders and sub-registers held by the rest of the participants in the holding chain are subject to Articles 13(7) and 13(8) of the MiFID and Article 16(1)(d) of the MiFID implementing Directive.

These articles require that credit institutions and investment firms *"must take the necessary steps to ensure that any client financial instruments deposited with a third party (…) are identifiable separately from the financial instruments belonging to the investment firm and from financial instruments belonging to that third party, by means of differently titled accounts on the books of the third party or other equivalent measures that achieve the same level of protection".*

This segregation rule is designed to safeguard client securities in case of insolvency of the account provider and to prevent the use by the account provider of client securities for own account.

IV. Efficient portfolio management techniques

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

We are in favour of the application of the same rules for all collaterals received by a UCITS, irrespective of the type of transaction being guaranteed (OTC derivatives, repos, securities lending). Additionally, we believe that the criteria already set out in Box 26 of the Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS included in the document CESR/10-788 (hereinafter, *"document CESR/10-788"*)— are valid and enough for these purposes.

In general we support the criteria set out in Box 6, except for what we detail below.

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

Yes.

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

In our opinion, we see merit in the definition of the basic reinvestment criteria (liquid assets, etc.), as well as a preliminary and non-exhaustive list of eligible assets in which collateral may be reinvested (for illustrative purposes only).

Besides we consider the reinvestment of collateral should not be limited to cash collateral.

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We would also support the reinvestment of non-cash collateral in repo or securities lending transactions provided that:

- these transactions are liquid (i.e. the UCITS is entitled to apply for the return of the reinvested collateral at any time at the UCITS' initiative);
- the UCITS have enough liquid assets which may be used at any time to acquire the collateral in case of the reinvestment transaction counterparty's default; and
- these transactions are taken into consideration in the determination of the global exposure.

The reinvestment of non-cash collateral should be referred not only to collateral received from repo or securities lending transactions —as it is already established in Box 9 of the CESR/10-788—, but also to collateral received from OTC derivatives transactions.

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.

We are strongly opposed to this proposal.

Firstly, it is not clear how a high correlation between the received collateral and the UCITS' underlying portfolio may benefit the UCITS (correlation which, in the case of cash collateral, is supposed to be referred to the assets in which the cash is reinvested).

If the motivation of this proposal is to avoid that, as a result of collateral received, the UCITS becomes exposed to other type of risks different than the one that is trying to be mitigated (counterparty risk), even under this assumption this proposal seems ineffective, because this goal would be better achieved by minimizing the correlation between the covered counterparty risk and the credit risk associated to the collateral itself. Besides the own UCITS' underlying portfolio is not required to include highly correlated assets, so there is no reason to require that correlation between the collateral (which may be considered as another asset of the UCITS' underlying portfolio) and the rest of the UCITS' underlying portfolio.

Secondly, this new requirement would imply that the UCITS and/or the investment manager should introduce certain control provisions in the collateral agreements which we understand (i) they are extremely difficult to articulate and monitor by the UCITS and/or the investment manager and (ii) the counterparties would not accept them, as such provisions would hamper counterparties' possibilities of delivering collateral.

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?

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We do not support that the collateral received by the UCITS must comply with the UCITS diversification rules because:

- On the one hand, non-cash collateral is not recognized in the balance sheet (they are off-balance assets), so it might be extremely difficult and costly from an operative point of view for the UCITS to monitor that the non-cash collateral, together with the UCITS portfolio, comply with the diversification rules. On the other hand, it should be coherent and reasonable to extend the application of the diversification rules to those assets in which cash collateral is reinvested —as these assets are accounted in the balance sheet—, as well as in relation to entities in which cash is deposited.
- This requirement would imply that the UCITS and/or the investment manager should introduce certain control provisions in the collateral agreements which we understand (i) they are extremely difficult to articulate and monitor by the UCITS and/or the investment manager and (ii) the counterparties would not accept them, as such provisions would hamper counterparties' possibilities of delivering collateral.
- In our opinion, it should be enough to require that any collateral posted must be sufficiently liquid (as established in Box 26 of the document CESR/10-788, i.e. so that it can be sold quickly and at a robust price that is close to pre-sale valuation) in order to adjust the composition of the UCITS' underlying portfolio to the UCITS diversification rules and to the UCITS' investment policy set out in the relevant prospectus at any time in case of counterparty's default (i.e. when the non-collateral is "definitively" owned by the UCITS and therefore is to be accounted in the balance sheet).

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?

Please, see answer to question 22.

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.

We see merit in the definition of the basic criteria that any asset must comply with in order to be considered as eligible collateral for UCITS (and we believe that the criteria already set out in Box 26 of the document CESR/10-788 are valid and enough), as well as a preliminary and non exhaustive list of eligible collateral (for illustrative purposes only).

Regarding those assets listed in paragraph 52 of the document, we would only add the bold and underlined words to point d.: *"Sovereign debt issued **<u>or guaranteed</u>** by an EU or OECD Member States".*

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transactions when calculating the maximum exposure under Article 52(1) of the UCITS Directive?

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Yes.

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

Yes.

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

Although in principle it would not be necessary to limit the proportion of the UCITS' portfolio that can be subject to securities lending activity, European domestic regulations already establish such limits. So, aiming at the maximum harmonization across Europe, it could result appropriate to set a threshold, which, in any case, should be high enough to allow securities lending activity to be fluently put into practice.

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

In Spain, securities lending activities are not still allowed, although there is a draft regulation. In case of being approved under its current wording, the threshold would be set to 75% of the UCITS' portfolio.

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)?

Not, at least regarding the proposed example (the use made by the counterparty of the lent securities). In our opinion, the use of the lent securities made by the counterparty does not affect the UCITS, above all considering that paragraph 5 of Box 6 already envisages that *"A UCITS should ensure that it is able at any time to recall any security that has been lent or terminate any securities lending or repo agreement into which it has entered OICVM"*.

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?

From our point of view, information about the collateral to be disclosed in the prospectus should not be extremely detailed and exhaustive. Including a mere provision stating that transactions may be collateralized in order to mitigate the counterparty risk in accordance with the current legislation and, if the case may be, describing those assets in which collateral may be reinvested, should be enough.

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. The provision of such information more frequently would be easily implemented, provided it is limited to periodical reports. But, in our opinion, and based on the recognition than an overload of information can be as much a problem to investors as a lack of information, we consider that the identification of EPM counterparties more frequently than

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once a year is not suitable for the goals of easily comprehension and brevity which inspired the replacement of the simplified prospectus by the Key Investor Information Document.

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

Valuation of the assets is one of the main duties of the management company, being the depositary in charge of overseeing the management company valuation systems. Therefore, risk of conflicts of interests would arise, if so, in case that the management company and the provider of collaterals were affiliated entities, but not when the provider of collaterals and the depositary are affiliated entities.

Notwithstanding, the management of that risk is already covered by the organizational requirements and rigorous procedures that the management company must adopt to the identification, management and disclosure of conflicts of interest, according to the Commission Directive 2006/73/EC, so it does not seem necessary to develop *"ad-hoc"* procedures when these conflicts of interest arise from the reception 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.

No.

<u>V. Total return swaps</u>

Q32: Do you agree with the proposed guidelines?

We agree with the proposed guidelines in general, except for what we state in our responses to the next questions and in the paragraph below.

We strongly disagree that structured UCITS must take into consideration the underlying of the OTC derivative transactions for the diversification limits. If this to be the case, most of the Structured UCITS might not be launched (i.e. those whose underlying is a basket of shares, as it is not feasible to launch a structured whose underlying consists of a basket of more that 3-5 shares).

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 are in favour of the application of the same rules for all collaterals received by a UCITS, irrespective of the type of transaction being guaranteed (OTC derivatives, repos, securities lending). No distinction should be made in case of TRS either.

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?

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No. Fund rules are a document quite static, unlike the information detailed in paragraph 5 of Box 7, which may be subject to frequent changes. As a consequence, the inclusion of this information in the Fund rules would oblige to modify them frequently, what recommends its disclosure only in the prospectus.

Q35: With regards to eligibility of assets to be used as collateral, do you have a reference 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?

Please, see answer to questions 21 and 22 above.

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.

Please, see answer to questions 21 and 22 above.

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

Please, see answer to question 20 above.

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?

We strongly support the application of the same rules for all collaterals received by a UCITS, irrespective of the type of transaction being guaranteed (OTC derivatives, repos, securities lending). No distinction should be made in case of TRS either.

Regarding the application of the diversification rules to collateral, please see our response to question 20 above.

VI. Strategy indices

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

Any initiative in order to strengthen and clarify the rules to be met by an index in order to be defined as a financial index, as well as to ensure compliance with them is welcome, especially taking into account the proliferation of strategy indices. We consider the proposed policy orientations are in the right direction.

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?

We consider that selection and use of indices is already covered by the organizational requirements and rigorous procedures that the management company must adopt to the

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identification, management and disclosure of conflicts of interest, according to the Commission Directive 2006/73/EC, so it does not seem necessary to develop "ad-hoc" procedures.

VII. Transitional provisions

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

Yes, provided that those periods whose duration is not defined (in particular, that included on paragraph 3.a): *"Uninvested cash collateral should comply with Box 6 paragraph 7 and Box 7 paragraph 2 no later than **X months** after these guidelines come into effect"*) result long enough to allow a smooth adaptation.

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