



Global Banking & Markets
Retail Structuring & Structured
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United Kingdom

22 September 2011

European Securities and Markets Authority (ESMA)
103, rue de Grenelle
75007 Paris
France

Dear Madam,
Dear Sir,

Response to the Discussion Paper ESMA/2011/220: "ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS"

This paper is the response on behalf of the Structured Funds group of The Royal Bank of Scotland plc to your recent discussion paper entitled ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS.

The Royal Bank of Scotland plc manages over GBP 2.3 billion of assets (as of September 2011) in its Structured Funds business, including the RBS Market Access ETFs, closed-ended protected funds and various tailor-made funds for large institutions. The Royal Bank of Scotland Group has grown to become one of the largest financial services groups in the world. The Royal Bank of Scotland Group is now a truly global business, numbering over 170,000 people, working in more than 50 countries across five continents for 40 million customers.

We welcome the opportunity to contribute to this discussion paper. Please find below our detailed comments and answers.

Please note that other responses to this discussion paper may be submitted separately from other affiliates of The Royal Bank of Scotland Group.

Please do not hesitate to contact us should you wish to discuss any of our comments or answers.

Yours sincerely,

Danny Dolan
Managing Director, Structured Funds

General policy discussion

Introduction

ESMA considers that the current UCITS regulatory framework applicable to UCITS Exchange-Traded Funds ("ETFs") and Structured UCITS may not be sufficient to preserve financial stability, mitigate the risks associated with these types of funds and achieve an adequate level of investor protection.

This discussion paper issued by ESMA follows a series of reports and working papers focusing on potential issues arising from ETFs or structured funds that have been published over the past year by regulators, supervisory authorities and international bodies (including the Bank of England, FSA, Bank for International Settlements, Financial Stability Board, IMF). Similar concerns have also been raised in the financial press.

We share ESMA's view on the need to ensure full transparency and sufficient disclosure in relation to UCITS ETFs and structured UCITS. Such transparency should in our view include detailed information on the assets held by a fund, its investment policy and techniques used, the nature and quality of any collateral received (derivatives, stock lending and/or repo activity).

In this context, we agree with ESMA's observation on the discrepancy between UCITS regulations governing OTC derivatives and those governing stock lending, despite similar levels of counterparty risk, and would encourage ESMA to adopt similar UCITS guidelines for securities lending and repo activities as those that are currently in place for OTC derivatives.

We believe that some of the concerns expressed in this discussion paper reflect some confusion over certain aspects of UCITS ETFs and structured UCITS. We would also encourage caution with some of the proposed policy orientations, to avoid the risk of weakening the UCITS framework, or leading retail investors to invest in less regulated products.

"Retailisation" of complex products

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 believe it would be incorrect to classify synthetic ETFs or structured UCITS or all so-called "complex funds" as intrinsically unsuitable for retail investors. Many structured UCITS and so-called "complex funds" are actually specifically designed to meet the needs of retail investors.

It is very important to differentiate between "good complex" and "bad complex" funds in relation to retail investors. "Bad complex" in our view is the addition of complexity to justify higher fees or which increases the risk of the product. "Good complex" is where the use of derivatives reduces the risk and/or volatility of the product.

Blanket criticism of all structured UCITS and "complex" UCITS would seem to ignore the fact that the use of derivative instruments in structured UCITS may perfectly address the needs of retail investors. They enable the provision of beneficial features including inter alia, lower index replication costs, capital guarantee/protection, volatility control, rules-based strategies or predefined redemption amounts. Many "traditional" funds cannot achieve the levels of protection or predictability that are achieved by certain structured or complex funds.

The suitability of each UCITS fund for retail investors has recently been addressed in the implementation of UCITS IV. The level of disclosure has been recently reinforced. The implementation of the KIID is also viewed as a way to simplify the technical language in the documentation and give a partial guidance on the risk profile of the fund. Structured funds are subject to additional disclosures under the KIID.

In relation to ETFs, our view is that there is a lot of confusion regarding synthetic UCITS ETFs. There appears to be a widespread, and in our view flawed, perception that synthetic UCITS ETFs are by their nature more risky or less appropriate for retail investors than “traditional” physical UCITS ETFs.

It is important to note that the use of derivatives in synthetic UCITS ETFs must be disclosed in the documentation of the fund. Many providers, including RBS, now publish full details on their website. Further, the counterparty risk exposure is strictly limited under UCITS and the fund must implement a robust risk management process. Over the past year, the industry has moved successively towards full disclosure of the assets protecting the fund against a counterparty default, whether swap collateral or equity basket, and further reduction of counterparty risk, over and above UCITS requirements, through voluntary overcollateralisation.

By contrast, many physical UCITS ETFs use securities lending techniques, which also create counterparty exposure. However, such exposure tends to be far less prominently disclosed in certain jurisdictions. It may also not necessarily be captured in the risk management process of the UCITS. In addition, regulations on securities lending are currently far less strict than for OTC derivatives, particularly in relation to collateral, both in terms of quality and quantity. As a result, “traditional” physical funds can in many cases be less transparent or more risky or both, compared to synthetic funds.

Consequently, we do not think that retail investors should be prohibited from investing into synthetic ETFs or structured UCITS, simply because they make use of derivatives instruments. Instead, we would recommend increasing the levels of transparency and disclosure required for all fund types. Specifically, there should be prominent risk warnings required for more risky speculative or complex funds. More disclosure required for all counterparty exposures, who the counterparty is, how much exposure the fund has to it, and the quality and quantity of any collateral used to mitigate that exposure. We also believe strongly that the UCITS regulations on securities lending should be tightened up considerably, both in terms of disclosures and collateral rules, and that the allocation of securities lending revenue between the promoter and the fund should be made clear.

We think that creating sub-categories within the UCITS framework, by limiting the distribution of certain UCITS funds to retail investors, would create confusion among investors and that any benefits of such a measure would be outweighed by negative consequences. Isolating certain funds because they are more structured than others would effectively classify them as less appropriate than others although they share the same regulatory regime and the same UCITS brand. This would eventually weaken the whole UCITS brand and create more uncertainty for investors and regulators alike. Any regulatory limitations on the distribution of structured UCITS funds to retail investors could lead them to invest in less regulated or offshore products that are not necessarily designed for them, and that do not provide with the same levels of protection and transparency as a structured UCITS.

In our view, transparency and disclosure are the key elements to consider. Any retail investor should be able to assess whether an investment is appropriate or not when reading the documentation of the relevant fund. In addition, disclosure requirements regarding the appropriateness and suitability of an investment, the use of derivatives or the use of securities lending techniques, the level of counterparty exposure, and the types and quantity of collateral used, should all be reinforced.

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’?

We believe that structured UCITS are sometimes incorrectly classified as complex or, when they are more sophisticated, incorrectly regarded as being more risky than UCITS implementing plain vanilla or direct investment strategies.

Firstly, some structured funds are very simple in practice even if they may look “complex”. A fund replicating a financial index through an OTC derivative, and/or providing a capital guarantee, is likely to be considered a structured fund but is not necessarily complex.

The term “complex” is highly subjective and not easy to define, several different criteria can be used to define the complexity of a product.

There is also recurrent confusion between the complexity of a fund and its risk profile. Indeed, it is very important to note that "complexity" does not mean "more risky". As explained earlier, certain complex funds are less risky than funds implementing plain vanilla strategies. For example, a capital-protected UCITS is more protective and less risky for an investor than a UCITS investing directly in emerging market equities, which may be highly volatile and where liquidity may not necessarily be guaranteed.

Accordingly, we believe much more consideration should be given to the nature and purpose of any complexity in a fund's structure, and the resulting risk profile of the fund for investors, rather than a more simplistic analysis of whether a fund is "complex" or not. Mandatory and prominent risk warnings are more appropriate than restrictions or "bans" on certain UCITS funds, which could undermine confidence in the UCITS brand.

We may however consider that funds using "complex portfolio management techniques" (where the term "complex" should be defined precisely) should be subject to different disclosures helping to explain the product. In particular, examples and scenario analysis on the potential redemption amount in different circumstances, to ensure potential investors understand what factors can affect their redemption amount and by approximately how much.

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?

All UCITS in a particular jurisdiction are subject to the same rules.

The UCITS regulatory framework has been created to maintain a high level of investor protection, particularly for retail investors. It currently ensures a higher liquidity and transparency than other regulated products or funds on the market. It also imposes robust risk management processes.

Consequently, we do not consider that there are "inappropriate" UCITS. Creating a distinction between "retail-friendly funds" and "inappropriate or non-retail-friendly funds" could in our view undermine the overall highly protective UCITS label.

However, it is clear that certain UCITS are not designed for retail investors. They may be tailor-made for a particular type of investor, or indeed a single institutional investor.

We believe these funds should more prominently disclose which audience is targeted. Specifically, additional prominent language in bold on the first page of the risk warnings about which investor type a fund is intended for, together with equally prominent language highlighting any elevated levels of risk, where applicable, would be appropriate for such funds in our view.

We do not believe that restrictions on distribution are the answer to this issue. Indeed, UCITS ETFs designed for institutional investors for example could be bought quite easily on the market by any retail investor. Limitations on distribution would not necessarily solve the issue.

However, it is possible to set a minimum investment amount for the secondary market or, in the case of a non-ETF UCITS, a minimum subscription or holding amount. These can be good filters to prevent retail investors from investing in products not intended for them. Many fund providers including RBS already make use of these mechanisms for that specific purpose.

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

No, for the reasons outlined above.

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

On the issues of financial stability and systemic risk, it should be noted here that UCITS rules already provide some guidance on the collateral posted to synthetic ETFs and swap-based UCITS when they employ fully-funded swaps.

We believe however that securities lending and repo activities in UCITS are not necessarily subject to the same levels of regulation or disclosure in the various jurisdictions as is the case for OTC derivatives. We also believe that unlike swap collateral and "substitute baskets", where the securities used are now widely disclosed by providers, the securities used in collateralising such activities may still in some cases be of lesser quality and liquidity, which could contribute to systemic risk.

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.

It is interesting to note that certain jurisdictions already apply certain UCITS rules on OTC derivative collateral requirements or securities lending to their non-UCITS regulated funds.

We do not necessarily think that all the regulated funds should be subject to the same level of regulation as they are not necessarily addressed to the same audience, or the same investment needs. UCITS regulations are, correctly, designed with investor protection as the overriding priority.

Certain non-UCITS funds, which are explicitly open only to institutional or sophisticated investors, should not be subject to the same investment restrictions as UCITS, since their investors are by definition less in need of protection. They are indeed, in many cases, unwilling to bear the cost of certain UCITS protection measures or accept restrictions imposed by certain UCITS regulations, such as UCITS diversification requirements, leverage limits and counterparty exposure limits.

However, we would be supportive of a coordinated approach to adopt similar guidelines for other funds or products if they are sold to retail investors.

Regarding financial stability, other regulated funds do not benefit from the European passport, so they are still subject to a foreign fund registration process with the local regulators when it comes to cross-border distribution.

We think that a coordinated approach here would be a good idea as individual regulators may not apply the same measures to ensure financial stability in different ways (e.g. short selling restrictions to stabilize the markets have been implemented by various regulators at different times without significant coordination).

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.

A line should be clearly drawn between UCITS (ETF or not) and other products which are not UCITS, and in some cases, are not even funds.

There is insufficient clarity with certain less regulated types of products that may be "similar" in their economic profile, but are very different from a pure legal perspective and do not entail the same protections and disclosures.

Particular examples here are non-fund exchange-traded products, such as ETCs and ETNs. In many cases these are marketed as ETFs, or insufficiently differentiated from ETFs, which can result in investors not correctly understanding the nature of the product they are buying.

Any guidelines for these products should be clearly separated to avoid any further confusion. They should include reasonably prominent disclosures.

Exchange-Traded Funds

Title

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 with a global naming convention that would clearly identify UCITS ETFs. A clear line would be drawn between UCITS ETFs and other products, specifically (a) non-ETF UCITS, (b) non-UCITS ETFs and (c) non-fund ETPs.

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

No. We do not think that the identifier should distinguish ETFs on the basis of their investment policy. All replication methods are available under UCITS, so the delivery mechanism and investment policy should be disclosed in detail in the documentation but not in the identifier.

Synthetic ETFs are already subject to additional disclosures regarding the use of derivative instruments and the counterparty risk.

However, physical ETFs that use securities lending or repo techniques should be required to apply the same level of disclosure and should be subject to similar requirements regarding counterparty, eligible collateral or haircuts.

Differentiating between physical and synthetic ETFs in the fund identifier would in our view contribute to the misconception that synthetic funds are more risky than physical funds.

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

Yes. The identifier should appear in the KIID.

Index tracking issues

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

Most of the disclosures highlighted in relation to the tracking error are already required in certain jurisdictions (such as the counterparty risks for synthetic ETFs, risk warnings on the tracking error, dividend reinvestments).

Other methods of replication are currently not required to follow the same level of disclosure. For example, physical replication where there may be counterparty risks associated should be required to disclose these. The level of replication is also a factor that should be disclosed (full replication or sampling), and the resulting effect on tracking error.

Q12: Do you agree with the policy orientations identified by ESMA for index-tracking issues? If not, please give reasons.

We agree with ESMA that the prospectus for index-tracking UCITS ETFs should contain a clear, comprehensive description of the index to be tracked, the mechanism used to gain exposure to the index and the main risks linked to the investment policy, as is already the case in certain jurisdictions.

The index methodology may be described in detail, and some information may be provided regarding the index components. However certain index providers are reluctant to provide the full composition of indices without a full non-disclosure agreement in place. As a consequence, a full description of the components may be difficult to achieve.

We share the views of ESMA regarding the disclosure of the level of tracking error for transparency purposes. We also think that additional risk factors could be added to describe the issues that may affect the efficient tracking of the index, such as costs, illiquidity of certain small components, or dividend reinvestment. This should be limited to the description of the risks factors, since some aspects such as transaction costs are variable (relative to the number of trades).

Sampling policies or methodologies should also be disclosed for transparency purposes, as they impact the real composition of the portfolio.

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, but only if the format of the KIID allows it (constraints on the size of the document or use of plain language).

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

Synthetic ETFs – counterparty risk

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

It is not clear what the term "collateral" refers to as it is sometimes incorrectly used to designate two different portfolios. "Collateral" should only refer to the guarantee provided by the swap counterparty to the fund in the case of a funded swap as opposed to the "substitute basket" in which the fund may invest in the case of an un-funded swap.

We support most of the ESMA disclosures. Many of them, such as those relating to the type of collateral received, the identity of the counterparty or the counterparty risks, are already required in certain jurisdictions.

The analysis that UCITS ETFs may raise funding against illiquid portfolios is not necessarily true for synthetic funds, as either the direct holdings of the UCITS (un-funded swap) or the collateral received by the UCITS (funded swap) must be made of eligible liquid assets. This may, however, be a risk with non-UCITS ETFs.

It may also be a risk with physical UCITS funds which engage in securities lending, since the current UCITS rules on collateral for securities lending are not particularly stringent (except in certain jurisdictions). We would therefore recommend that these rules are brought into line with the UCITS rules on collateral for OTC derivatives, and also that disclosure of such collateral becomes mandatory (both for derivatives and securities lending) to eliminate such risk.

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.

Yes. We agree with ESMA that the quality, type and quantity of assets constituting the collateral are crucial. This is already the case in certain jurisdictions.

We share ESMA's views regarding the disclosure of collateral. Collateral composition should be disclosed as a best practice, as well as the level of collateralisation. Some promoters already voluntarily provide additional collateral above the 90% UCITS requirement.

We would further recommend a clear pan-European policy on haircuts to be applied on collateral, as they seem to differ in practice between providers and jurisdictions.

However, we do not believe the collateral should be required to match closely the relevant index.

Firstly, it may not be possible to achieve such correlation. For example, the index may be composed of assets which are not eligible as collateral (e.g. commodity futures).

Secondly, we believe such requirement could also be detrimental to investors. For example, the collateral posted should be highly liquid, whereas the relevant index could track less liquid equities (emerging markets indices).

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 that the same diversification requirements should apply. The purpose of the collateral is to provide a guarantee to the fund in case of default of the swap counterparty, and will in all likelihood be immediately liquidated by the fund should it ever take possession of it. Accordingly, it should not in our view be subject to the same diversification requirements as a long-term investment portfolio

However, we would propose to apply a conservative limit of 20% per issuer, i.e. at least 5 different issuers as is the case for cash deposits (or cash collateral in certain jurisdictions). This level would also match the diversification requirements for the index by applying the lower 20% limit.

Securities lending activities

Q19: Do you agree with ESMA's analysis of the issues raised by securities lending activities? If not, please give reasons.

Yes, we fully agree.

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

Yes, we support ESMA's policy orientations.

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.

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.

Yes, we support this proposal as explained earlier.

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?

Not necessarily, provided the regulations on collateral for securities lending (quality and quantity) are sufficiently robust.

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

Yes, please see below.

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

In addition to the policy orientations, we think that additional disclosures dealing with quality of the counterparty (same as for OTC derivatives) should be required, to enable potential investors to make an informed decision.

We also think that risk language should be required, highlighting potential conflicts of interests in relation to any split of fees/interests between the securities lending agent, the investment manager and the fund.

Actively-managed UCITS ETFs

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

Yes.

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

Leveraged UCITS ETFs

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

Not entirely.

Sophisticated funds must monitor their risk by using the VaR methodology. Under the current VaR parameters (1 month, 99% confidence interval, 20% limit), a sophisticated UCITS may exceed the 200% total exposure limit applied to non-sophisticated UCITS following the commitment approach.

We do not consider that leveraged UCITS ETFs are a potential source of financial instability. There are far more highly leveraged instruments available to investors, both institutional (e.g. futures) and retail (e.g. call/put warrants and turbos). In our experience, leveraged UCITS ETFs are primarily used for hedging purposes, rather than speculation.

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

Yes. Disclosure is essential for leveraged UCITS ETFs.

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

Yes. Leveraged short ETFs may mitigate the risks by applying a stop-loss mechanism to reduce the losses in the fund if the benchmark index climbs in value.

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

We would consider the use of such a mechanism, and detailed disclosure on it, essential.

Secondary markets investors

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

As a preliminary comment, UCITS ETFs do not necessarily test the appetite of investors via the market participants before launch. Many promoters launch ETFs without an initial offering period, and enter into arrangements with authorised participants without knowing the real level of secondary market investor demand for the fund.

We agree with ESMA's proposal to clearly outline in the ETF documentation the difference between the primary market and the secondary market. This difference should be highlighted in the various sections of the prospectus dealing with subscriptions/redemptions, cut-off times, and in particular when describing the rights and entitlements of the investors.

However, we believe that giving secondary market investors a direct right to redeem with the fund would not be manageable from a technical/practical perspective. The investors would have to be registered in the shareholders' register of the fund, for funds in the form of ICVCs/SICAVs and have to redeem via the registrar and transfer agent. This would effectively turn the UCITS ETFs into regular daily-dealing mutual funds, and remove the benefits to investors of the exchange listing. Specifically, the enhanced liquidity from multiple market makers, and the ability to trade intra-day, rather than just once-daily at NAV.

With respect to the last proposal, the price per share paid by the investor on the exchange is based on a bid-offer spread. The price will usually differ from the net asset value of the fund which is the essence of the exchange, as the book value will rarely match the quoted price on the exchange. Indeed, it is not possible to establish the exact book value at all times although the iNAV comes as close as possible. It is the role of the market maker to ensure that there is sufficient liquidity, and that the price does not differ excessively from the iNAV.

We do not think there should be any guideline in this respect as the bid-offer spread is not necessarily standard and varies according to different parameters such as volume of trades, AuM, transaction costs, overall liquidity of the market...etc. Time of the day is also a significant factor, when the trading hours for some or all of the index components do not match those of the ETF. Most fundamentally, the nature, composition, liquidity and volatility of the underlying index varies widely between ETFs (even those within the same sector or asset class), making any measure to standardise bid-offer spreads inadvisable. Exchange rules and ever-increasing competition between providers are the best safeguards of fair and competitive bid-offer spreads.

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

Yes.

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

As explained above, it is necessary to clearly differentiate the various types of products similar to UCITS ETFs, which are neither UCITS nor even funds. These raise the issue of investor information about risks.

We also would like to see precise guidelines in relation to the obligation to provide the KIID to the investors of a UCITS ETF, as there seem to be different interpretations and some practical constraints in this respect (secondary market investors deal with the exchange and not with the UCITS when transacting).

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?

No. As explained above.

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?

If market makers are no longer providing liquidity then the UCITS may not ensure a daily liquidity (or at least redemptions twice a month). If it is the case, it does not meet the UCITS liquidity requirements. The UCITS should then be liquidated in our view.

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?

See above question 33.

Structured UCITS

Total return swaps

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

We share the views of ESMA on most of the issues raised in the discussion paper regarding total return swaps.

However, we believe that an unfunded total return swap providing the swap counterparty with a delta one exposure to the underlying assets can be analysed as a pure delivery mechanism and should not be seen as an investment comprised in the UCITS's portfolio. Whilst being comprised of UCITS eligible assets, the UCITS portfolio should not necessarily have to comply with the usual UCITS diversification requirements. This analysis has already been approved by certain regulators.

Q40: Do you support the policy orientations identified by ESMA? If not, please give reasons.

Yes.

Regarding the control or level of discretion that the swap counterparty may have on the underlying portfolio or strategy, we fully agree with the analysis and proposals of ESMA. These structures are often referred to as "black box" strategies and contribute to opacity in the market.

We think that the policy should also be extended to any third party manager who manages the underlying strategy of the swap as it may differ from the swap counterparty.

The swap counterparty or the third party underlying strategy manager should be treated in the same way as the investment manager of the UCITS and be required to comply with UCITS investment restrictions.

Indeed, notwithstanding the fact that the UCITS does not necessarily face directly the manager of the underlying strategy (third party manager) and have a direct legal relationship, we cannot ignore that it has an economic exposure to the underlying strategy which must be taken into account. At all times the strategy should comply with UCITS investment restrictions and the level of discretion should be clearly disclosed.

In order to prevent any breach of the investment restrictions, we agree that it would be imperative to put in place an investment management delegation or a trading agreement which sets the investment restrictions and the responsibilities of the underlying strategy manager.

Certain regulators have already implemented this policy.

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

Yes, please see below.

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

When using unfunded total return swaps, we would suggest that the UCITS portfolio complies with a minimum diversification requirement of 20% per issuer.

Strategy Indices

Q43: Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.

We agree with ESMA regarding almost all of its policy orientations.

However, we would like to express our views regarding a small number of policy orientations.

With respect to the rebalancing frequency, we think that a daily or intra-day rebalancing would not only be problematic from a replication perspective, but also might be seen as contrary to the rules-based nature of the index when it comes to strategy indices. Indeed a more frequent rebalancing implies an active management or discretion in the index which is in our view not necessarily compatible.

With respect to publication, we have concerns about ESMA's view that the index provider of a proprietary index should disclose the full methodology of the index. For certain indices, this would not be feasible without breaching the intellectual property rights attached to the index. Several regulators accept the disclosure of a redacted version of the methodology or full publication via a secured website only accessible by existing investors. These indices may nonetheless comply with UCITS index regulations on diversification and be fully rules-based as required.

The replication requirement for an index should in our view mean that the index must be replicable, but should not mean that the index provider must fully explain how to achieve it in practice.

We believe that a redacted version of the methodology is sufficient, provided that it provides the necessary information to fully understand the mechanisms, techniques, composition and rules of the index. The vast majority of investors would have limited interest in replicating a complex algorithm.

If such guideline were to be adopted it may well lead to a significant portion of investors switching to offshore or non-regulated alternative funds.

It may also lead to certain strategies no longer being available to UCITS investors, and act as a barrier to innovation in UCITS funds. This is because providers would have no incentive to offer proprietary strategies which represent a significant intellectual capital in UCITS format, if they were forced to immediately disclose publicly the product of potentially length research and development, which their competitors could then copy.

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

No comments on FX rates. Several regulators take the view that an index of interest rates is by nature compliant with diversification requirements (due to the lack of issuer risk). In addition, it may be recalled that UCITS regulations do not provide for quantitative investment limitations in respect of currencies and interest rates.

Q45: Are there any other issues in relation to the use of [strategy indices] by UCITS that ESMA should consider?

No.

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

N/A