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CONSOmmATEURS
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ESMA's policy orientations on guidelines for UCITS ETFs and Structured UCITS

ESMA Discussion Paper

Contribution from the Belgian Consumers Association TEST-ACHATS

Test-Achats is the Belgian consumers association and makes up about 350 000 members. Test-Achats is a member of BEUC (Bureau européen des Unions des Consommateurs). It has been recognised by the Commission as an entity qualified to bring injunctions at Community level to protect consumer interests.

This document reflects Belgian consumers' association Test-Achats feedback on ESMA's consultation on its policy orientations on guidelines for UCITS Exchange-Traded Funds and Structures UCITS.

Test-Achats very much welcomes the present consultation and the intention of ESMA to adopt guidelines applicable to UCITS ETFs and structured UCITS.

Test-Achats is concerned by the evolution of the UCITS brand since the entry into force of the UCITS III directive. Until then, UCITS was without doubt an appropriate non-complex retail investment vehicle for the retail investor who could not, otherwise, invest in a diversified way. The increased complexity and risks – such as the counterparty risk – are detrimental to the UCITS brand and make it necessary to adopt additional measures regarding the disclosure and the distribution of those new UCITS. If no measures are taken, if the more complex UCITS are not identified and better regulated, it is the entire UCITS class who will be perceived as less transparent and more risky for the retail investor.

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.

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’?

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?

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

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

We agree with the fact that a common European approach is the best way to tackle the difficulties resulting from synthetic ETFs. Those products can be manufactured in one Member State, wrapped and distributed in another member state and listed in a third one. The international character of those ETFs makes any national initiative to improve retail investor protection inefficient.

Complex UCITS such as synthetic ETFs and structured UCITS should be considered as complex and carefully undergo the MiFID appropriateness test when made available to the retail investor. A specific warning should be inserted within the appropriateness test procedure when retail investors, unless sophisticated and experienced, are not supposed to understand the complexity or assess the risk of a financial instrument.

A minimum investment threshold (€50,000) should be stated for UCITS that are inappropriate for retail investors.

Complex UCITS should be clearly identified to avoid any confusion with non-complex UCITS and the KIID should mention that they are not recommended for non-sophisticated investors. Currently, there is no clear way consumers can identify riskier synthetic and leveraged/inverse ETFs. It is vital that this distinguishes between ‘synthetic’ and ‘physical’ ETFs and that this distinction is included in the fund name. Since January this year the Hong-Kong market put in place an asterisk as indicator for the synthetic ETFs¹. This is a good example of what can be done to distinguish complexity and other types of risky leveraged/short ETFs.

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.

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.

The guidelines to be adopted should be applicable to all substitutable investments products, such as unit linked insurance product, structured notes or non-UCITS funds established or sold within the EU. It is needed to avoid gaps in the regulation. The reasons that make the PRIIPs initiative necessary are also justifying a common approach for all substitutable products to the ETF or structured UCITS.

Some of the guidelines that could be adopted, like a greater care in the denomination of investment products that may not be misleading and should reflect risks, should be extended to the other investments than UCITS.

Some products, like poorly regulated and non-transparent SPVs are not suitable for retail investors, or directly or indirectly (when wrapped in other funds). A minimum investment threshold (€50,000) should be stated for those investment products.

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.

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

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

¹ New measures to raise investors’ awareness of synthetic ETFs, Press release
<http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=10PR134>

The retail investors have some knowledge of *physical tracking ETFs*. A lot of publicity has been made for those non-complex ETFs. It is essential that the synthetic or more complex ETF are clearly distinguished as we mentioned it above.

An identifier must be incorporated in the name of the ETF, the fund rules, prospectus and marketing material. As the complexity and increased risks are essential characters of the product, it must be explained in the KIID.

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.

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?

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

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

Yes, we agree with ESMA's analysis of index-tracking issues. Information should be disclosed in the prospectus and the Key Investor Information Document.

Regarding the policy orientations, the suggestion that the information should include a description of issues which will affect the index-tracking ETF's ability to fully replicate e.g. transaction costs, small illiquid components, dividend reinvestment etc. seems us too technical to be correctly assessed by the retail investor. In the KIID, it could be reflected by the mention that the index could be not perfectly replicated and that the tracking error could reach NN % of the index evolution.

Leveraged and inverse ETFs which rebalance daily and are not suitable for long-term holding. Their name should not mislead the investor in this regard. We also believe that they should also avoid the phrase 'tracker' in the name as this may give the impression to consumers that they are designed to track the index (by providing the inverse or a multiple of the return) over longer periods.

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.

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.

Test-Achats is particularly concerned by the counterparty risk and the conflict of interest when the ETF manager and the counterparty are member of the same financial group.

We agree that provisions on the quality and type of assets constituting the collateral should be further developed.

The UCITS diversifications rules should apply to the collateral.

A special attention should be given to the collaterals issued by the counterparty itself: a bond issued by the counterparty cannot compensate the risk of default of the counterparty itself. We are concerned that the collateral provided for some synthetic ETFs consists of a significant proportion of corporate bonds issued by other banks.⁴ It is likely that in the event of a default by the swap counterparty (likely to be a major bank) the price of corporate bonds issued by other banks is likely to be negatively affected.

If the quality of collateral is poor or if the correlation of the collaterals with the fund strategy is weak, the manager must ask for over-collateralisation. The suitability of the collaterals must be assessed during the entire ETF life. If conflict of interests between manager and counterparty are not avoided, the collateral should be of high quality and correlated with the ETF strategy.

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

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

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.

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.

Test-Achats agrees with the issues raised by ESMA.

Regarding the policy orientation, we generally agree. However, we consider that disclosure of the fact of securities lending and the existence of a risk is of little help for the retail investor who cannot assess that risk. The risk must be quantified to permit the retail investor to understand the implication of it.

If the lent securities exceed a threshold to be discussed, the physical character of the UCIT is vanishing and it must be considered as a complex UCITS.

We express the same concern about the collateral than in our answer to the questions 16 to 18.

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

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

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

Yes, we agree with the policy orientations identified by ESMA for actively managed UCITS.

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?

Inverse and leveraged ETFs are only likely to be suitable for a tiny minority of investors.

Test-Achats expresses his concerns about the misleading presentation of those leveraged ETFs in some newsletters sent by brokers to their clients or even in financial press.

The addition of a clear identifier in the ETF name will help increase the effectiveness of any warnings issued to retail investors about these products. All inverse and leveraged ETFs which rebalance daily and do not provide effective tracking over longer periods; their name should not mislead the investor. They should avoid the phrase 'tracker' in the name as this may give the impression to consumers that they are designed to track the index (by providing the inverse or a multiple of the return) over longer periods.

The disclosure of the impact of reverse leverage as proposed by ESMA could be too technical to be understood by retail investors. A special warning in the KIID and a careful appropriateness test with specific warning could help. A minimum investment threshold should be stated for the investments that are the most unsuitable for the retail investors

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?

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?

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?

KIID should be easily available for all ETFs available on a secondary market. Appropriateness test (or suitability test if there is an investment advice) should be carefully performed.

The fact that the price on a secondary market can be different than the iNAV is an important information that should be reflected in the KIID and by the broker before the order registration.

We are concerned that secondary market investors could suffer detriment if liquidity in the ETF market is absent when they need to trade their shares. At times of market stress there could be a significant divergence between the price of the ETF and the 'true value' of the index they track. We believe that ESMA should examine whether its proposal has the potential to increase liquidity in ETF markets at these times.

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

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?

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?

Test-Achats is concerned by the fact that structured products with principal protection are too often proposed as an alternative to deposits.

The lack of transparency of the structured products, especially the costs hidden in the structured part of the UCITS, combined with the fact that there generally is no comparison possible between

two structured products make them the ideal way for the industry to sell products with unreasonable costs.

We express our concerns about the part of the assets that must protect the principal at the end of the investment. It can be that without knowing it, the retail investor is too much exposed to the financial sector or the sovereign debt of countries facing difficulties. Information in the annual report won't help the retail investor, even if the information is detailed enough. The risk must be lowered.

In addition, a lot of our comments regarding the ETFs are applicable to structured UCITS (requirements for collateral, diversification, conflicts or interests, mention of the complex character in the name of the UCITS and the KIID etc.).

The Belgian supervisor FSMA is currently conducting a consultation on structured products. We will send ESMA our contribution to that consultation when drafted (at least by 15/10/2011).

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