

ESMA'S POLICY ORIENTATIONS ON GUIDELINES FOR UCITS EXCHANGE-TRADED FUNDS AND STRUCTURED UCITS

COMMENTS FROM FIDELITY WORLDWIDE INVESTMENT

Dear Sirs –

Fidelity Worldwide Investment is a global asset management business. We operate in fifteen countries in Europe and a further nine in India and the Far East. Our UK business is a substantial component of our overall business, we manage £24 bn in the UK for private investors, pension funds and insurance companies.

We would argue strongly for UCITS being split into complex and non-complex UCITS categories, with all complex UCITS falling within the remit of the Alternative Investment Fund Management Directive (AIFMD) going forward.

There are a number of reasons for this but the main reason is that the introduction of the investment and borrowing powers of UCITS 3 altered the Asian market for UCITS for the worse. Under UCITS 1 most Asian jurisdictions simply accepted a UCITS certification without much further examination as appropriate for marketing to their own retail investors. This automatic comfort fell away with the emergence of UCITS 3, at which point Asian regulators were forced to examine each fund *ab initio* to determine whether it was a UCITS 1 fund suitable for Asian retail distribution or a 'new' unsuitable UCITS 3 fund.

This in turn led to a general heightening suspicion of European asset managers and funds which was then further exacerbated by the Asian region's own experiences during the financial crisis with structured products with investment strategies very similar to those of UCITS 3.

In order to regain a valuable foothold in Asia – by repairing the UCITS brand – we would argue for a reversion to an updated UCITS 1 definition being considered non-complex with all other funds being considered complex or alternative.

As ever, we would be more than happy to discuss any of the opinions set out in this submission. Otherwise, we would kindly ask that you

Yours Sincerely

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SUMMARY

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European past and present / Asian future: the structure of this paper

The key to ensuring a successful future for UCITS in Asia relies on rectifying problems with the UCITS 'brand' in the present which in turn relies upon an accurate understanding of the development of the UCITS brand over the course of the recent past.

As one commentator has noted, time present and time past are both perhaps present in time future, and time future contained in time past.

This in turn begs three questions that this paper seeks to address:

- Why is an Asian future important for UCITS?
- What is the present state of UCITS in Europe? and
- How did UCITS get here over the course of the recent past?

We will actually treat these latter two questions in reverse and approach the present state of UCITS in Europe through the lens of the recent past.

This analysis will in turn drive a response to the key and conclusive question - what can we do in the present to safeguard the future of the UCITS brand in the hands of European and Asian investors alike?

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WHY IS AS AN ASIAN FUTURE IMPORTANT FOR UCITS?

EDHEC-RISK estimate that up to 40% of UCITS are sold *outside* Europe.¹ With US investors unable to invest into UCITS (despite the best efforts of US and EU regulators to find mutual recognition between UCITS and 40 Act funds for the best part of 20 years), Asia has emerged as a key target pool for EU investment. This is because UCITS have acted as a key delivery channel into Asia which is in turn because of the power of brand recognition around UCITS. We believe that India will follow suit in the near future

What is key to understand in this context is that the distribution of UCITS into Asia - and, we hope, India going forward – is driven almost entirely by 'brand recognition'.

Why is Asian investment important?

¹ EDHEC-Risk Institute, [Are Hedge Fund UCITS the Cure-All?](#)

Asian investment into EU UCITS is important on a number of levels. First, is the fact that Asian investment into UCITS is often investment into the European companies whose securities are bought by EU UCITS funds. Then there is the fact that Asian investment into EU UCITS translates into financial services jobs and tax revenues remaining within the EU – rather than flowing to the US where Asian investors could also go for asset management services, but also, oddly, back to Asia itself.

Finally, there is the simple fact that wealth has been flowing from the West to the East for some time – both in the form of macro-economic might and personal investible wealth. While hot spots such as Hong Kong, Singapore and Shanghai have been an epicentre for wealth generation for the past few years, the rate of growth is now rising fast. The number of millionaires in the Asia-Pacific region grew by 25 per cent last year, catching up with Europe for the first time, according to the latest annual World Wealth report from Merrill Lynch and Capgemini. Meanwhile, the combined wealth of Asia-Pacific's rich people rose by more than 30 per cent to \$9,700bn in 2009, surpassing the \$9,500bn held by Europe's richest people. Even more striking is the expectation that, by 2013, Asia will have more millionaires than the US.²

It is odd then, that private wealth managers are struggling to connect with Asian high-net worth individuals (HNWIs) in a region of such rich pickings. There are clearly competitive between private banks in play, as there are issues around rising costs, but there is also the fact that many banks are finding it hard to squeeze revenues out of Asian clients, who tend to be savvy first or second-generation entrepreneurs, used to making their own decisions. Many are unwilling to buy the banks' preferred model of discretionary portfolio management, where a manager invests the customers' money for an annual percentage fee.³ One obvious alternative route for such savvy investors is self-directed or even advised investment directly into investment products including UCITS.

Why is the UCITS brand important in Asia?

Brand is not just a sales device but an aid to investor protection. "Brands are a mark of standards of quality and reliability as powerful as any regulator's kitemark or stamp of approval."⁴ They can provide investors – but more importantly, regulators – with a sense of comfort that rules out the need for anything but the most cursory further due diligence on the grounds that the 'brand says it all. This is an especially powerful quality in a brand if consumers are geographically or culturally dispersed – as they are in the case of UCITS across the 27 European nation-states.

The key to the success of the UCITS brand in Asia is remarkably similar in Asia and Europe – it is the fact that the region is as geographically and culturally dispersed as the EU but does not possess a brand of its own to speak of equal standards of quality and reliability equally to all. In other words, the EU UCITS brand has developed as something of a proxy for an ASEAN equivalent.

Acceptance of UCITS varies across Asia, from full acceptance in Singapore to none in countries such as China, Indonesia and Australia. Taiwan is generally accepting Ucits except for products using derivatives, although registration can take a long time, while South Korea allows funds of funds that can wrap UCITS funds, but has introduced tax disincentives on foreign funds. In Japan the registration process for UCITS is slow and costly, while in Malaysia and Thailand regulators require UCITS to be wrapped within a locally registered fund. In Hong Kong, UCITS offers the regulators some comfort, but fund managers essentially have to reverse engineer Ucits funds in order to re-create them under Hong Kong rules..

Nonetheless, in all a total of 5,267 Ucits funds were distributed in Asia in 2009, of which 2,260 were distributed in Singapore and 1,209 in Hong Kong, and as one commentator notes this is largely because it is easier to sell Ucits funds in Asia than to sell Hong Kong or Singapore funds. Indeed, 91% of all funds in Hong Kong are foreign domiciled.

From one perspective, then, the high levels of European management of Asian investment money may be seen as something of a side-product of the Asian respect for the European UCITS brand – or, even more tenuously, as the side product of an Asian need for a proxy brand, *any* brand. In such a

² FT.com, '[Asia: Battle stations as centre of gravity shifts](#)'

³ FT.com, '[Private banks struggle in region of rich pickings](#)'

⁴ Steve Hilton, 'The Social Value of Brands – Brands and Consumer Protection'.

light, it is worrying to speculate how if the European UCITS brand begins to lose its valency then UCITS managers will begin to lose their relevance to Asian investors. They will be replaced by Asian investment managers whether or not the ASEAN regime develops an Asian UCITS in UCITS' stead.⁵

It is indeed interesting to note that some Asian fund managers are already domiciling funds in Europe that are otherwise managed, administered and distributed solely in Asia. This is solely to receive the seal of approval conferred by UCITS status – but in a move that bypasses the EU fund management industry entirely.

Why is the UCITS brand under threat in Asia?

The problem for UCITS – and ultimately for expendable European UCITS managers - is that the UCITS brands has become weaker in the minds of Asian regulators in the wake of the financial crisis. As the CEO of the Hong Kong Investment Fund Association put it:

“After the global financial crisis, especially because of Lehman mini-bonds, the market environment in Asia has become more politicised and the regulatory approach has generally tightened. Some quarters have expressed concerns regarding whether Ucits can do too much and whether it will become a back door for hedge funds.”⁶

By way of reaction, a number of Asian regulators have begun to put in place a variety of point-of-sale requirements designed to enable them to control the distribution of UCITS over whose product make-up they have less control.

The Hong Kong Monetary Authority (HKMA) and Securities and Futures Commission (SFC) have not only published guidance on what investors should know about ETFs, but have pro-actively placed controls around the issuance and promotion of structured products in general and around the disclosure and product due diligence and risk-rating of synthetic ETFs in particular.⁷

Indeed, in September of last year the HKMA and SFC introduced a Code of Conduct Requirement with respect to Derivative Products that placed two key new requirements on firms providing services to clients with respect to FDIs.

In the first place, firms are required to ‘know their clients and ensure the transaction is suitable for their client’ - a requirement similar to MiFID's own suitability / appropriateness requirements.

But firms are also now required to assure themselves that the client ‘understands the nature and risks of the FDI products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the product’ – an altogether stronger form of sophistication / means testing⁸.

And not just in Asia...

Asian regulators are not the only regulators to have become disenchanted with the UCITS brand in particular – and with more complex funds in general.

The Belgian Financial Services and Markets Authority (FSMA), Dutch Authority for the Financial Markets (AFM) and French Autorité des marchés financiers (AMF) have all also recently unilaterally imposed restrictions on the sale of complex UCITS and other fund products to retail investors.⁹ The FSA are also currently consulting on increased powers of product intervention that will apply equally to UCITS and other complex structured retail products and we have welcomed this proposal.¹⁰

⁵ FT.com, [‘UCITS funds fail in Asia passport role’](#)

⁶ FT.com, [‘UCITS funds fail in Asia passport role’](#)

⁷ HKMA.gov.hk, [‘What you should know about exchange traded funds \(ETFs\)’](#); HKMA.gov.uk, [‘Circular on SFC press release – legislative amendment on structured products to take effect’](#); HKMA.gov.hk, [‘Synthetic Exchange-Traded Funds \(ETFs\) and Related Products’](#)

⁸ HKMA.gov.hk, [‘Circular issued by the Securities and Futures Commission \(SFC\) regarding Code of Conduct Requirements with respect to Derivative Products.’](#)

⁹ FSMA, [‘FSMA demands suspension of retail distribution of complex structured products’](#); AFM, [‘Dutch Minister of Finance announces legislative proposal for AFM to supervise development process of financial products’](#); and FT.com, [‘France favours UCITS categories’](#)

¹⁰ FSA.gov.uk, [‘The FSA’s Discussion Paper DP11/1 is entitled ‘Product Intervention’](#)

In the meantime, we would strongly echo the sentiment of Edouard Vieillefond, managing director, regulation policy and international affairs at the AMF:

"I think it would be worse not to take into account the current reality of UCITS funds, and that one day there may be a real problem with the use of the execution-only regime for complex UCITS."

"In the future, the Ucits brand will not exist in Europe and beyond because it is considered as simple; it will exist because it is well regulated, well explained and is trusted in giving the right level of protection to investors."¹¹

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HOW DID UCITS GET HERE OVER THE COURSE OF THE RECENT PAST?

If the question is, as M. Vieillefond suggests, how does one take into account the current reality of UCITS funds, the answer is by understanding the mutation of the UCITS brand in the recent past.

We conceive of the current issue with the complexity of UCITS as having three key time horizons – then, now and next.

Then

- in 1984 UCITS 1 established a set of rules dictating the basic shape of a UCITS fund and granted all UCITS retail compliant funds 'passports' around Europe.
- In 2001 UCITS 3 altered the basic shape of UCITS by widening both set of eligible assets and the way in which UCITS managers could employ investment strategies.
- In 2007 the UCITS Eligible Assets Directive (EAD) clarified UCITS 3 powers and effectively set in place a dual regime for so-called non-sophisticated and sophisticated UCITS:
 - Non-sophisticated UCITS could invest only in traditional / simple financial instruments, use financial derivative instruments (FDI) solely for 'hedging' or 'efficient portfolio management' (EPM) and must c
 - calculate global exposure on a Commitment basis; and
 - Sophisticated UCITS could invest in more innovative instruments, including FDI 'for investment purposes' and would calculate global exposure on a value at risk (VaR) basis.

Now

- In 2011 UCITS are using new assets and new strategies not envisaged but not disallowed by UCITS 3 – or, to be more precise, not disallowed because never envisaged by UCITS 3.
- This has given rise to the current position in which a Directive gives automatic distribution rights to funds it never intentionally legislated for
- There would appear to be two key beneficiaries of the unforeseen liberties allowed by UCITS 3:
 - synthetic ETFs (*contra* the situation in the US where the 40 Act expressly confines compliance to physical investment only – whether full or optimised replication). This is the first focus of the current ESMA consultation; and
 - hedge-fund lite 'newcits' funds which are not covered in the ESMA consultation, but which have attracted considerable attention of late.

We are less familiar with the types of structured UCITS on which the second half of ESMA's consultation focuses – unless ESMA is equating 'newcits' and structured UCITS.

- We would also say that we have less problem with 'newcits' offered by traditional UCITS managers (as distinct from those that have appeared as UCITS 'versions' of hedge funds).

¹¹ FT.com, ['France favours UCITS categories'](#)

This is because we find the extension of ‘newcits’ out of traditional UCITS management a safer more organic development than the acquisition of the UCITS brand by hedge funds (for whom we perceive there is a degree of ‘novelty risk’ or ‘commitment risk’ – as set out below).

- Equally we are much more comfortable with physical ETFs (whether fully replicating or optimising) or with synthetic ETFs run by asset managers (as distinct from banks or the asset management arms of banks).

In terms of the former, we are comfortable that physical ETFs are little more than traditional mutual fund UCITS with the added dimension of exchange-traded distribution (although there is still complexity inherent in this mechanism – and thus cost to UCITS retail investors over and above those pertaining to non-exchange traded UCITS).

In terms of the latter, we think it is acceptable for ETF managers to offer synthetic ETFs as an extension of their physical range – that is, to reach an asset class or region that their physical investment cannot reach (for example, where the asset manager does not possess the requisite qualifying investor licence to make physical investments into a region). As a matter of good practice, we would suggest that ETF managers should only resort to synthetic management when the opportunities for physical investment at reasonable cost have been exhausted.

Next

- From 2013 onwards the wider distribution powers that UCITS 4 give to ManCos will exacerbate the problem of a Directive that gives automatic distribution rights to funds it never intentionally legislated for
- At the same time UCITS 4 replaces the concept of non-sophisticated / sophisticated UCITS and replaces them with four possible categories of UCITS:
 1. UCITS that use no FDIs;
 2. UCITS that use FDIs for hedging only – as narrowly defined in CESR/ESMA guidance;
 3. UCITS that use FDIs for hedging and meeting investment goals – and that operate their risk management via the Commitment approach; and
 4. UCITS that use FDIs for hedging and meeting investment goals – and that operate their risk management via the advanced risk measurement (VaR) approach
- In terms of the latter two categories, the question of whether a UCITS applies the Commitment or VaR approach is in turn driven by two factors:
 - whether the UCITS makes extensive use of FDIs (VaR) or ‘non-extensive’ use (Commitment); and
 - whether the UCITS makes use of complex / exotic FDIs (VaR) or non-complex / non-exotic FDIs (Commitment).

Why did we get her? The Rise of Synthetic ETFs

There are some quite clear reasons for the rise of synthetic ETF UCITS:

- For synthetic ETFs offered by the asset management arms of banks there is the self-interest of the bank wishing to act as counterparty to the asset management arm of the bank for the total return swap (TRS). This is the risk that the synthetic ETF creation process may be driven by a bank’s desire to find an “inexpensive funding source for illiquid securities” as well as to take other turns out of the ETF value-chain - such as ‘collateral sweating’.¹²
- The creation and management of synthetic ETFs is indeed a highly profitable business for banks (compared with the equivalent management of physical ETFs by asset managers)¹³ - as the

¹² FSB, ‘[Increase in complexity and opacity: synthetic ETFs](#)’; BIS, ‘[Motives for synthetic replication](#)’; FT.com ‘[Do banks see ETFs as inexpensive funding for illiquid Securities Part I & Part II](#)’

¹³ FT.com, ‘[Low-cost ETFs reap fat profits](#)’: providers of synthetic, derivatives-based ETFs, such as db-x trackers, Lyxor, Amundi, Comstage and Source, command profit margins of about 71bps of assets, according to a July Deutsche Bank report, compared

recent focus on the profitability of the Delta1 trading desks of banks in the wake of the UBS blow-up has confirmed.

Technically, as part of UBS's ETF desk – itself a subset of the Delta1 trading desk - Kweko Adoboli, the unfortunate UBS 'rogue trader', would have been tasked with providing liquidity for ETF clients – including UBS' own suite of ETFs – by standing as the total return swap (TRS) counterparty to synthetic ETFs. He would then have been responsible for hedging away the exposure that UBS had assumed in providing a fixed return to its clients.¹⁴

However, as one commentator has noted, although Delta1 and ETFs are purportedly client services where profits are generated from economies of scale in reality "they work only because banks believe they can use their secret sauce, algorithms and proprietary trading to be just a little cleverer than their clients to produce the same or better returns more cheaply. These activities are some of the most profitable equity derivatives lines in investment banking. Small wonder such desks are among the few to still be hiring."¹⁵

- Other synthetic ETFs seem custom-made to feed into institutional trading strategies – rather than (indeed often never with any considering for) – answering the needs of retail investors. There are quite widely held concerns that ETF providers are manufacturing arbitrage opportunities for hedge fund and other institutional clients that wish to take a position against a given index – in a rather foreboding post-shadowing of the 2007 Goldman Sachs Abacus scandal.¹⁶

What is immediately clear and concerning is the fact that none of these reasons have any regard – or even consideration – for the interests of the end retail UCITS investor:

- In the 'manufacturing arbitrage' business-model the 'arbitraging' ETF manager clearly fails to act in the best interest of all his clients. For one thing, there is the clear conflict between the handful of institutional UCITS investors 'in the know' and the vast majority of 'out of the know' investors, while, as with Goldman, there is also a possible conflict also between manager and 'out of the know' investors.¹⁷ It is indeed worth noting that the SEC is at this very moment working up legislation under the Dodd-Frank overhaul that seeks to ban companies from shorting securities they are also selling to any form of investor.¹⁸

But far more worrying is the fundamental problem inherent in the creation and use of a public fund to offer a private / bespoke exposure to one or a handful of 'in the know' investors. Not only is a UCITS designed for universal retail investment, but this is often all many UCITS retail investors understand about the brand.

- This is indeed the very problem that currently exists around inverse/leveraged and inverse leveraged ETFs. Institutional investors know that these are products designed as tools to enable them to take *intra-day* leveraged and short positions. Retail customers do not and erroneously invest in them over longer periods of time believing they are taking buy-and-hold leveraged or short positions, when these positions are in fact resetting at the end of each day.¹⁹ This problem is so acute amongst US investors of ETFs that FINRA recently issued a Notice on the topic..²⁰

to margins of 48bps for providers of physically backed ETFs and 12.5 basis point margins generated by the traditional mutual funds industry in western Europe in 2010, according to data from McKinsey

¹⁴ FT.com, '[Opportunities to hide in murky world of ETFs](#)'

¹⁵ FT.com, '[Delta skelter: the trouble with ETFs](#)'. See also FT.com, '[The curse of Delta one strikes UBS](#)': "Delta One can be considered the last domain of prop trading in the banking sector, where via market-making activities, traders can still get away with taking ample risks. As eFinancialCareers [reported](#) only this month, this is one of the few divisions in the banking community which is still hiring. It's also the division where SocGen's Jerome Kerviel used to work."

¹⁶ FT.com, '[Frankenstein's ETFs for hedge funds](#)': "We also have concerns that hedge funds and others may be approaching ETF sponsors to create even more nuanced indexes in a fashion eerily similar to the practices of mortgage-backed securities traders who asked for custom indexes around trading preferences that could more easily exploit certain securities." See also FT.com, '[Manufacturing arbitrage with ETFs](#)'

¹⁷ FT.com, '[Goldman hopes for SEC deal](#)'

¹⁸ FT.com, '[SEC rule aims to clean up securities market](#)'

¹⁹ FT.com, '[Something for the ETF lobby to chew on](#)': "ETFs do NOT always match the underlying in the way people expect. Because of daily rebalancing and compounding, you can own a leveraged long ETF and lose money over period when the

- In the ‘balance-sheet’ business model the retail UCITS customer takes a back-seat to the bank’s primary objective of putting lazy elements of its balance-sheet to work or firing up profits via its Delta1 trading desk (the so-called ‘bank problem’). It is indeed noteworthy that Delta1 business has been re-named ‘flow-prop’ business in recognition of its hybrid status between client service (‘flow’ from ETF managers) and self-interest (to its own proprietary book). Indeed, according to JPMorgan, ETFs are thought to be a prime opportunity for growth at many Delta One divisions. “Most players have high ambitions in Delta One products, ETF[s] in particular where volumes are expected to grow further by 20 per cent per annum”.²¹

And when the ETF flow comes from the asset management arm of the same banking group the hybrid nature of ‘flow prop’ trading comes full circle to mutate into a clear and present conflict between the group behind the UCITS ETF and TRS and the UCITS retail customer. In such a model, there is nothing to stop the group from creating the ETF from the Delta1 desk ‘backwards’ as it were – beginning with the most profitable or otherwise conducive ‘bet’ that the Delta1 desk would like to take and ending with the equivalent ETF that is finally made available to retail customers. Starkly put, the retail customer exists to fund the bank’s balance-sheet strategy and the more ETF units the retail investor buys, the more value in the chain that can be turned to profitable effect by the bank’s Delta1 trading desk. The Delta1 tail wags the UCITS dog – and never more so than in the current climate when banks are thirsty for sources of funding for their trading strategies. Oswald Gröbel, UBS chief executive, said only earlier this year that the bank needed to ratchet up its risk...

- This is indeed a second key difference between Europe and the US (alongside the 40 Act’s effective prohibition of synthetic ETFs), where the so-called Volckler rule enforces a separation between a banking group’s asset management business and its proprietary trading desks. Under the Volckler rule, in other words, a bank’s proprietary tail would never be allowed to wag the asset manager dog whose fiduciary obligation would thus remain intact while the bank would be compelled to fund its own bets with its own money.

The UBS case may well strengthen the Volckler-like reforms currently under consideration in the UK (via Sir John Vickers’ Independent Commission on Banking) but at the moment Vickers’ own proposals fall short of the functional separation inherent in the Volckler-rule and seek to rely instead on institutional separation via Chinese Walls. In the rest of Europe there are not even Vickers-like proposals on the table and so the bank problem remains..²²

Why did we get here? The Rise of ‘newcits’

Equally, there are some clear reasons for the incursion into the UCITS brand of hedge fund strategies – to generate ‘newcits’. To start with, is the fact that it is simply possible to ‘replicate’ hedge fund strategies within the UCITS 3 fund structure. Indeed, the following strategies are feasible:

- Long short equity
- Long short credit – liquid markets only
- Convertible arbitrage
- Global Macro

market goes up but during which there are some sharp falls. Equally, you can own an inverse ETF (which provides a short exposure) during a period when the market goes down but there are some sharp rallies and lose money. This actually occurred with some inverse ETFs in 2008. I would strongly suggest that people would not expect to be leveraged long and lose money if the market goes up or short and lose it when it goes down”

²⁰ FT.com, ‘[the ETF blow-up begins](#)’ and ‘[The ETF blowup continues](#)’

²¹ Ft.com, ‘[Q&A: Delta One](#)’: “Delta One sits in a unique position between trading for clients and so-called proprietary trading – or trading for a bank’s own account, which is also called prop-trading. Some have even described the business as “flow-prop,” referring to flow from clients and prop trading. According to JPMorgan banking analyst Kian Abouhossein, exchange traded funds (ETFs) are thought to be a prime opportunity for growth at many Delta One divisions. “Most players have high ambitions in Delta One products, ETF[s] in particular where volumes are expected to grow further by 20 per cent per annum,” he wrote in a global investment banking report from last year.

²² FT.com video, ‘[UBS case could hasten Vickers reforms](#)’

- Fixed income arbitrage – definitions of leverage need to be addressed
- Commodity index funds – there is no question of physical of derivatives on underlying commodities.
- CTA and Managed Futures
- Event Driven
- Funds of UCITS Funds
- Structured and guaranteed products
- ETFs

The following strategies are not recommended by proponents of ‘newcits’ as they fall foul of UCITS liquidity and valuation requirements: Less liquid credit strategies, distressed debt, mezzanine, private equity strategies, small and micro cap strategies.²³

EDHEC-RISK Institute’s 2010 survey *Are Hedge-Fund UCITS the Cure All?* lists a number of further reasons:

- Firstly, there is the perceived benefit of avoiding AIFMD – or as EDHEC-RISK has it, the strategy of side-stepping “an agenda out of control [that] will deter investment firms from making the investment to comply with the expected AIFMD requirements.”
- Then there is the ‘ready-made’ protection inherent in the UCITS brand for institutional investors seeking comfort in a world now more focused on counterparty risk after the Madoff affair and failure of Lehmans – especially with regard to asset security, liquidity and transparency. It is worth noting that this element is in turn, by and large, being driven by private wealth managers who would rather rely on the mere existence of an underlying UCITS structure than have to carry out corresponding due diligence on non-UCITS / traditional hedge funds.
- Also the benefit of distribution not only via the UCITS passport – both within the EU retail sphere but also into Asia and South America – but also via platforms that will more often than not insist on daily liquidity as a condition for inclusion;
- And finally, there is demand from institutional investors themselves as they become bound by quantitative restrictions ranging from their own internal policies (for example, for pension funds) to the external requirements of Solvency II.²⁴

As a July 2010 Hedgeweek Special Report has it:

Continued uncertainty regarding the provisions of the European Union’s Alternative Investment Fund Managers Directive, despite its formal finalisation on June 8, remains an important growth driver for the growth of Ucits funds offering alternative strategies. With the drafting of Level 2 measures to implement the directive in detail still months away at best, the lack of clarity is strengthening the appeal of Ucits to institutions as regulated vehicles.

*An increasing number of alternative managers are rolling out Ucits-compliant funds to complement their offshore offerings. They provide a clear, transparent way not only to attract investors across Europe through the regime’s passporting feature, but thanks to their recognition among global regulators managers can capitalise on the popularity of Ucits in regions such as East Asia, Latin America and the Middle East.*²⁵

Again, as far as UCITS retail investors are concerned the trend is similar to that of synthetic ETFs: it is hedge fund managers with institutional investors who have ‘moved into’ the UCITS brand for their

²³ Hedged.biz, [‘UCITS III for Hedge Fund Strategies: a brief guide’](#)

²⁴ EDHEC-Risk Institute, [Are Hedge Fund UCITS the Cure-All?](#) See also FundWeb, [‘Hedge fund industry players clash over use of UCITS III’](#)

²⁵ Hedgeweek Special Report, [Alternative UCITS 2011](#)

own convenience, rather than UCITS managers with retail investors who have extended their management into hedge-fund like strategies.

Of course, some UCITS managers have been offering more adventurous strategies for some time and these now also find themselves categorised as ‘newcits’ by the financial press. This makes it all the more important to distinguish more adventurous funds offered by traditional UCITS managers from the recent spate of hedge fund strategies parachuted into the UCITS brand in order to ‘take advantage’ of UCITS 3 or benefit from a perceived its ‘mid-life crisis’ rather than out of consideration of the needs of UCITS retail investors themselves.²⁶

Certainly in terms of experience and professionalism, these latter ‘newcits’ managers often lack the infrastructure of traditional UCITS managers – indeed many outsource the UCITS ‘elements’ of management in order to focus solely on running the hedge fund strategy, hence the rash of ‘how to...’ guides and third party agents offering to ‘run’ the UCITS wrapper while the hedge fund manager concentrates solely on running the investment strategy itself. This division of labour would not only seem to stretch a UCITS management company’s powers of delegation beyond the pale (to the extent that delegation is effectively reversed from portfolio manager to UCITS manager) but also injects costs into ‘newcits’ that is becoming increasingly problematic.²⁷

This seems to have given rise to something approaching a novelty, innovation or even commitment risk within UCITS.

It is not just that some of the *rationale* underpinning the recent creation of nearly 200 ‘newcits’ (according to PwC) sounds alarmingly short term – “*with the drafting of Level 2 measures to implement the directive in detail still months away at best...*”. It is also worrying that a number of ‘newcits’ are now closing, their managers having discovered that the structure does not after all fit the strategy they wish to manage – or more specifically, that ‘newcits’ cannot offer the same returns as the full-blown hedge fund versions they are replicating. In other words, the anticipated pay-off of ‘newcits’ offering additional security does not seem to be offsetting poorer investment returns.²⁸

While it is heartening to see ‘newcits’ exiting the UCITS space, such a *laissez faire* attitude towards running a UCITS in the first instance – here today gone tomorrow - is hardly good management practice and very far from a good experience from investors forced to divest their interest in a closing fund.

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WHAT IS THE PRESENT STATE OF UCITS IN EUROPE?

The development of the UCITS brand between its genesis in 1981 and 2011 has given rise to a number of new and, often unfamiliar, risks – as well as to new investment opportunities and strategies.

Market Risk

The FSB, IMF, BIS and ESMA have all pointed to market and systemic risk concerns inherent in the rise of complex UCITS and we agree that these are worthy of further regulatory scrutiny.

As capital market investors acting on behalf of the long-term savers who in turn invest in our funds, we are ever sensitive to the trading environment in which we operate. Changes to the trading environment can quickly lead to increased trading costs for the funds we manage (including opportunity costs) as well as to perverse market movements that we need to trade around.

We are closely tracking the MiFID review and genesis of the European Markets and Infrastructure Regulation (EMIR) for this reason. While we also share a number of the concerns currently mounting around the implications that ETFs in particular have for the wider trading environment.

²⁶ Deloitte, *NewCITS: taking advantage of UCITS III* appears to have been renamed [UCITS sophisticated funds – taking advantage of elaborate mechanisms](#) The Hedge Fund Journal, ‘[UCITS III Hedge Funds: ideally positioned to benefit from the UCITS ‘mid-life crisis’](#)”

²⁷ FT.com, ‘[Platforms ‘charge too much’ for Newcits’](#)’

²⁸ FT.com, ‘[Low Newcits take-up prompts rejig’](#)’

One cause for concern is the increasing use of ETFs by hedge fund managers for pursuing arbitrage strategies. On one level, there is the simple arbitrage opportunity available between the price of an index-tracking ETF and the value of the underlying components of its index – that is, the opportunity to arbitrage an ETF's tracking error.

But on quite another, there is the much more complex statistical arbitrage strategy that operates on a highly automated level and with increasing volumes of ETF units. Under a classic pairs trade strategy a hedge fund manager seeks to identify two financial instruments whose prices currently diverge but that in the long term are expected to be tied together by some common stochastic trend. By extension, an ETF statistical arbitrage strategy would see a manager taking, for example, the two US-listed ETFs that track the S&P 500 and betting on the fact that the prices of their units in the secondary market will diverge on an *intraday* basis while actually representing the same interest in the same underlying 500 securities.

According to one study, a theoretical who adopted a pairs trading strategy of selling (buying) the over (under) priced S&P 500 ETF in 2001 would by now have earned average annual profits of 6.7%. No wonder (as another commentator has estimated) more than 50% of the volume in the SPDR S&P 500 ETF can currently be ascribed to statistical arbitrage at the hands of hedge fund managers.²⁹

And there are two very telling reasons why ETFs lend themselves so readily to such arbitrage strategies over, say, futures or other financial instruments. The first is the presence of ETFs on computerised exchanges. The second is the fact that ETFs are - to use hedge fund *parlance* - populated by "uninformed money" – that is, the money of UCITS retail investors.³⁰

It is one thing that institutional investors are trading units in UCITS as programmatically as they do other listed securities and in such high volumes – already something never originally envisaged by mutual fund and UCITS legislators, but now one of the founding principles of ETFs. It is another that they are attracted to such units precisely because it enables them to bet against the less informed UCITS retail investors for whom UCITS have been designed in the first place.

But there is also the market risk posed by such ETF statistical arbitrage models. Although details are only now beginning to emerge, commentators have begun to question the role of such high frequency trading (HFT) ETF strategies in the so-called 'flash crash' of 2010. Indeed, the SEC have recently expanded their inquiry to include index arbitrage via ETFs and via leveraged ETFs in particular.³¹ There are also individual cases of algorithmic accidents – such as the Infinium Capital Management \$1.03m loss in August of this year – and in the 4 minutes before Nymex closed for the day.³²

It is also worth questioning whether HFT / ETF arbitrage strategies are responsible for the spiralling instances of settlement failures among ETFs. One commentator notes that as early as 2008 over 100 ETFs and ETNs were on the US Regulation SHO Threshold List (the US fail to deliver (FTD) list). These settlement failures affect some of the largest ETFs as well as the smallest. For example, the iShares Russell 2000 Index experienced over 30 trading days in the year 2007 in which over 10 million shares failed. These failures were for over \$1 billion worth of shares each day. Similarly, the original SPDR Trust experienced at least 10 trading days in 2007 with settlement failures of over a billion dollars per day.³³

And the discrepancy between instances of ETFs failing to deliver and other securities is on the increase. As another commentator has recently noted, statistically ETFs are amongst the most likely

²⁹ FT.com, '[How profitable is ETF arbitrage?](#)' and '[Statistical arbitrage and the big retail con-fusion](#)'

³⁰ FT.com, '[Statistical arbitrage and the big retail con-fusion](#)'. There are also emerging concerns about the way in which hedge funds may be using ETFs in commodity arbitrage strategies – FT.com, '[HFT in commodity ETFs](#)'

³¹ FT.com, '[SEC probes the role of ETFs in market turmoil](#)'

³² FT.com, '[High Frequency Trading and ETFs](#)': Infinium used an algorithm to execute a "lead/lag" strategy to exploit any miniscule arbitrage opportunities between United States Oil Fund, a well known ETF that tracks the price of oil, and West Texas Intermediate, the benchmark US crude oil future. On February 3 of this year with less than four minutes to go before Nymex closed floor trading for the day, Infinium turned on its new computer programme, which immediately started buying oil futures uncontrollably. The algorithm managed to place 4,612 buy orders before it was shut down five seconds later. The company then sent large offsetting sell orders but was left nursing a loss of \$1.03m.

³³ FT.com, '[What's the ETF settlement fail issue?](#)'

equities to fail to settle on time, with many securities notching up as much as 190 days (or more) of consecutive fails.³⁴ Is such a high FTD rate down to the high volumes of cancellation inherent in any arbitrage strategy, is ‘settlement failure’ itself becoming a new arbitrage strategy or is there some other structural reason in play – perhaps even something benign like the robust creation/redemption tracking mechanism built into ETF structures?

Whatever the reason, one effect is the destruction of one of the key functionalities of ETFs in the hands of UCITS retail investors (indeed, one that ETF investors pay for over and above what investors in non-exchange traded funds pay): inclusion on Regulation SHO Threshold list often makes it hard for investors, particularly retail investors, to engage in short sales.³⁵

The logic here is perfectly simple. In the same way that the European Commission is currently seeking to limit short-sales of European securities to those securities for which investors have an “agreement or arrangement” in place for delivery, the SEC very sensibly prohibits the short selling of any security for which there is a higher-than-average risk of settlement failure.

Thus the more ETFs are placed on the US FTD list, the fewer ETFs will be available to retail UCITS investors wishing to use them in pursuit of short strategies. Of course while we wait for short-selling regulation in Europe that has the same effect as the SEC’s Regulation SHO Threshold list, EU UCITS retail investors will simply run the risk of a settlement failure when undertaking a short-sale.

Systemic Risk

Although it is perhaps going a little too far to argue that ETFs have now replaced CDOs as the world’s ‘financial weapons of mass destruction’³⁶, the complicated link between the blow-up at UBS’ Delta1 trading desk and ETFs is worth dwelling on as an example of how the operations underpinning TRS-based UCITS such as synthetic ETFs and structured UCITS may pose a threat to the financial system as a whole..

As mentioned previously, as part of UBS’s ETF desk – itself a subset of the Delta1 trading desk – Mr. Adoboli, would have been tasked with providing liquidity for ETF clients – including UBS’ own suite of ETFs – by standing as the total return swap (TRS) counterparty to synthetic ETFs. He would then have been responsible for hedging away the exposure that UBS had assumed in providing a fixed return to its clients.³⁷

This sounds like a relatively simple service – indeed, like something approaching ‘indirect asset management’ whereby the bank manages a basket of assets that the UCITS manager cannot because of eligibility constraints in a simple act of eligibility transformation via TRS. What Mr. Adoboli’s losses of \$2.3bn remind us, however, is that the bank is actually free to honour its side of the TRS in whatever way it seems fit.

On the one hand the Delta1 desk might indeed set aside something approaching a ‘shadow portfolio’ and might even seek to hedge the exposure of this portfolio in the style of a traditional asset manager. But on the other, it might decide to take the risk onto its balance-sheet and leave its exposure to the ETF or its client unhedged. In reality, the position is somewhere in the middle:

The banks which provide ETFs often market the securities as offering ‘instant’ and liquid exposure to a wide variety of assets, many of which might otherwise be difficult for retail investors to gain exposure to. Delta One desks, meanwhile, play a vital role in providing that liquidity to ETFs and other products that promise to ‘match’ investors with synthetic exposures to underlying assets. In most cases the aim for the bank is to capture a spread, or difference, between the asking price and the selling price of the securities they are trading, so for example to buy at a lower price and sell at a higher price. That involves banks using their

³⁴ FT.com, [‘I spy \\$5.8bn of SPY settlement fails’](#): “Indeed, could it be that ETFs have a structural weakness that makes them easily used as a dumping ground for unsettled transactions in the industry? So, a little bit like the latest incarnation of Nick Leeson’s famous 88888 account. A good place to park stuff”

³⁵ FT.com, [‘What’s the ETF settlement fail issue?’](#)

³⁶ FT.com, [‘This \\$2bn mess has uncanny historical echoes’](#) and [‘Why ETFs give an uneasy sense of déjà vu’](#)

³⁷ FT.com, [‘Opportunities to hide in murky world of ETFs’](#)

own capital to fund the exposure until all the legs of the trade are closed out. In order to cover the risk, Delta One desks at banks will create hedges as cheaply as possible or match exposures internally by using the massive amounts of 'flow' from their other customers

As one commentator has noted “the role is to minimise the risk, but it’s not always the case that the hedge will work” – a comment that may appear something of an understatement once the full facts around the UBS blow-up are known.³⁸

It is equally worrying that the (reverse) consequences for synthetic ETFs of liquidity or credit-rating shocks at counterparty banks are also untested – a link that commentators are also now looking to investigate more thoroughly.³⁹

Opportunities for professional investors

We certainly share a number of concerns for the markets and financial system as a whole resulting from the rapid growth and complex institutional adoption of synthetic ETFs. However, there are some benefits for active portfolio managers that we also welcome – particular from the increasing number of ETFs.

For example, it would appear that passive tracker ETFs, with their large-scale non-discriminatory buying and selling passively on indices rather than actively on analysis, are now a major contributor to the increasing trend of stocks to move in lock-step with one another (so-called stock correlation). A recent paper from the National Bureau of Economic Research in the US has found that a simple inclusion of a stock in an index tends to significantly increase that stock’s co-movement with other stocks in that index.⁴⁰ Thus, with ETFs driving index-linked passive investment stock correlation is on the rise.

In other words, the correlation of value imposed on a herd of stocks by simple virtue of them being in a herd (index) tends to ‘distract’ the market from the underlying business fundamentals on which individual stocks ought to be valued - things such as the capital base, projected P&L, management style and strategy of the underlying company. This sort of analysis and understanding of a company’s fundamentals is the bread and butter of active investment managers who therefore stand to benefit from the mis-pricing that correlation forces on individual stocks.

We also welcome the flexibility that ETFs offer to institutional investors – for example, the ability to trade ETF units *intra*-day, as well as to take short and stopped-loss positions via ETFs – but would note that this flexibility comes at a cost and would question whether it is always in the best interest of retail investors to pay for such flexibility when ultimately pursuing a buy-and-hold strategy. For instance, non-exchange traded index-tracking funds will often do the same job as their exchange-traded equivalents without having to charge for exchange-traded functionality. There is also the spectre of failed settlement risk hanging over shorting strategies – as mentioned above.

There are indeed a range of strategic uses to which professional funds managers (including wealth managers) can put ETFs. For example, a portfolio manager will often have dual and conflicting obligations to maintain liquidity in a fund (to underpin subscription/redemption) at the same time as to keep a fund close to its benchmark (to deliver its stated investment objective). Faced with such a conflict, a portfolio manager can simply invest in an ETF that tracks the relevant benchmark at the same time as retaining the daily liquidity of a UCITS fund (via a so-called cash equitisation strategy). Although it is possible to pursue cash equitisation’ strategies within a UCITS funds via a futures trade – a common UCITS strategy making ‘non-extensive’ use of non-complex FDIs and therefore falling under the Commitment approach – the use of an ETF is often cheaper, easier to manage and thus less exposed to operational risk.

³⁸ Ft.com, ‘[Q&A: Delta One](#)’ See also ‘[Delta one: the special ops of equity trading](#)’: “The money is made just as much from taking a view with innovative hedges (the cheaper the better) as it is from margins and client fees. Although ask a Delta one initiate about the nature of his hedges (or lack of them in the case of Jerome Kerviel) and you’ll not be met with many forthcoming responses.... While they’re more than happy to talk about the products they’re providing to clients, it gets awkward when you start asking about the processes used for facilitating them or how optionality is deployed”

³⁹ Ignites Europe, ‘[Lyxor: we have no SocGen concerns](#)’ in which one commentator doubts that SocGen will sell of its ETF business to raise cash precisely “because it is a strategic asset for the equity derivatives desks of the investment bank.” QED.

⁴⁰ Stern School of Business, ‘[On the Economic Consequences of Index-linked Investing](#)’

Other ETF-based strategies employed by professional portfolio managers include sector strategies, divided strategies, portfolio completion strategies, index / active blending strategies, tax strategies and simple alpha strategies.⁴¹

However, notwithstanding some of the benefits of ETFs to active portfolio managers, ESMA's key question remains: what is the effect of the *retailisation* of complex UCITS? In other words, what are the risks to retail customers of complex UCITS – as distinct from those faced by professional investors, the markets or the financial system as a whole.

Risks to UCITS retail investors

To take first things first, it is fair to say that the *probability* of the retailisation of complex is 100%. As we note below, whatever the intended target audience a UCITS manager may have, the very idea of a category or type of UCITS investor is ultimately an anathema to UCITS. There are no categories of UCITS investors, only UCITS investors - for whom all UCITS products are by design equally suitable.

So what of impact?

The first – and perhaps fundamental risk – we conceive is that of a complex UCITS simply blowing-up. At base level mutual funds are quite simple, and well-regulated, investment vehicles. Their fundamental purpose is basically twofold: to pool money from many investors to buy and safely keep stocks, bonds, short-term money market instruments and / or other securities and assets; and then to issue shares / units back to investors that accurately reflect the interest that each investor has in the underlying assets. In order to fulfil its obligations, a fund will appoint a fund administrator to manage the trading, reconciliations, valuation and unit-pricing together with a board of directors or set of trustees to safeguard the assets and ensure compliance with laws, regulations and rules. It may also appoint an investment manager or adviser and a marketing / distribution company to promote and sell shares / units in the fund.

The fund has thus developed into a robust and secure pooled vehicle, to the extent that even if the fund manager should become insolvent, the fund itself, its assets and its shares / units reflecting its investors' interests would remain untouched. This has indeed been borne out in a number of just such management company wind-downs or buy-outs in the recent past.

It is fair to say that the concept of a fund is also a relatively simple concept to grasp and investors have been capable of understand the basic shape of the investment vehicles taking them to retirement, in the US at least, since the 1930s and 40s. Fund management is not rocket science (although portfolio management – the choice of which securities to put into a fund may be!)

For UCITS funds, such structural safeguards are not only further enshrined in regulation (e.g. around the role of depositaries and the quantity and quality of asset and share / unit valuation), but they are complemented by additional requirements around the duties of the UCITS management company and the adequacy of the risk measurement and management processes. Furthermore, the types of assets in which a UCITS may invest, and in what concentrations / with what risk diversification are also enshrined in law – with the depositary having as one of its key roles the duty to oversee the UCITS' compliance with these and the UCITS' own internal funds rules.

Not only are funds themselves easy to conceptualise, but UCITS funds are further designed to diversify investment risk as an addition control around the investment manager / adviser.

It is therefore alarming to read speculation about how an ETF UCITS – a *fund* not the *fund management company* – may fail. More worrying still is the question of *when* we can expect a newcits to undergo a Long Term Capital Management-style blow-up⁴² These are simply not questions that a UCITS retail investor should have to ask or risks that they should have to countenance.

A second set of concerns revolves around the risk of a UCITS retail investor making an investment into a UCITS that has not been designed for them – whether because it is a UCITS fund constructed with institutional investment alone in mind (perhaps even at the request of a single institutional investor),

⁴¹ For professional applications see iShares, [Utilizing ETFs in tactical, strategic and income strategies](#).

⁴² FT.com, [‘Can an ETF collapse?’](#); Ignites Europe, [‘UCITS III ‘blow up’ imminent: experts’](#)

or because a bank has driven the creation of an ETF for the good of its own balance-sheet or trading profits and not that of its end investors.

Again, it is important to remember that there are no categories of UCITS investors, only UCITS investors - for whom all UCITS products are by design equally suitable. Nor should any investor ever have to question whether a UCITS has been designed for their benefit or for the benefit of the fund manager offering it. The very concept of the bank tail wagging the UCITS dog cuts straight across the fundamental principles of a UCITS manager's fiduciary duty to act in the best interests of its investors.

A third set of concerns might be collected under the heading of 'dazzle' or 'sizzle' risk – the risk that investors might be drawn more to complex UCITS than to their non-complex equivalents because of the functionality or security complex UCITS are able to offer at headline level – in terms of 'absolute' returns or *intra-day* trading functionality. In other words, there is the risk that investors may buy on the basis of the sizzle and not the sausage, so to speak.

ETFs, for example, are often marketed on the basis that they offer the same trading flexibility as individual securities. While this functionality may indeed be useful for institutional investors seeking to make the *intra-day* tweaks to their portfolios mentioned above, it is clearly much less useful for a UCITS retail investor simply seeking to buy-and-hold index or sector exposure. A non-exchange-traded index-tracking fund would accomplish the same end – and at a fraction of the cost.

Equally, complex UCITS cannot always be relied on to reduce investment risk while maximising returns. As our own CEO has recently observed, "the industry has always tried to use financial engineering to produce equity-like returns but with cash levels of risk. Sometimes that's possible – but it's not possible anything near the amount of time consumers would like."⁴³

Finally, a fourth set of concerns revolves around the risk that a UCITS retail investor may simply lose sight of the nature of any given UCITS – whether this be of its management arrangements, investment strategy or even assets.

In terms of unforeseen investment exposures, it is now easy for UCITS retail investors to accidentally fall into a range of complex investment exposures not previously associated with UCITS – for example via a TRS that swaps non-eligible for eligible exposure.

A UCITS may now derive 100% of its investment returns from FDI rather than from the traditional act of physical asset management. This would appear to knock the investment manager / adviser out of the UCITS structure – or rather to transform him into a collateral or basket manager who simply stands counterparty to a third unseen entity that actually manages the investment return. This third party will often not even be an asset manager but a bank exposed to much deeper and more complicated balance-sheet liabilities.

To complicate matters further, the collateral basket with which the UCITS manager is left will quite often bear no relation to the investment return the UCITS retail investor is paying to receive – because this is what is promised 'on the tin'. In the worst case scenario of a counterparty failure then, the investor in a FTSE 100 ETF or structured UCITS may actually find they are left with an interest in a fund full of corporate or government bonds. They may also be disappointed to find that it is not the UCITS manager who has dictated the constitution of the collateral basket – but the counterparty – another abjuration UCITS manager's fiduciary duty to act in the best interests of its investors.

Finally, in terms of unanticipated parties to the UCITS' management process or even investment returns, there is a much wider web of counterparties for the UCITS retail investor to grasp. This counterparty may be the 'Authorised Participant' in a physical or synthetic ETF's market making process, the TRS counterparty of a synthetic ETF or structured UCITS, the counterparty to a physical ETF or other index-tracking UCITS' securities lending programme or a third party collateral agent tasked with managing the increased flow of collateral between all such parties. Whatever the web of involvement, there may now be many more parties involved in a UCITS than the UCITS manager, its administrator, its depositary and the directors or trustees of its assets.

⁴³ FT.com, ['Investor risk: labels and liabilities'](#)

It is this latter risk – the risk that UCITS retail investors may no longer understand ‘what is in the box’ - that we consider to be the chief risk in play with complex UCITS.

Expressed in a slightly different way – and taking the investor perspective that is crucial to this debate - this is the risk that the UCITS brand has lost the two key attributes of *any* brand in the hands of its consumers – its recognisability and its predictability. Or, to be more precise, it is the risk that the UCITS brand retains its recognisability to its consumers while acting in increasingly unpredictable ways for them. They thus assume it does its traditional job while it now does something quite radically different.

We would therefore reject the arguments of those who hold that complexity itself is not inherently risky –indeed that complexity that reduces the volatility of a fund or structured retail product’s payout should not count as complexity in the first instance.⁴⁴

Instead we would argue, firstly, that the volatility of the pay-out is far from the only risk dimension to a UCITS fund – especially in the current climate in which we have all learned that liquidity, counterparty and credit risks should weigh equally heavily on any investment decision. Secondly, we would argue that the level of complexity now built into UCITS in the service of (and thus excused by) the reduction of VaR outstrips the very benefit it is designed to deliver. In other words, complexity offers more risk to UCITS retail investors than the benefit of reduced VaR it returns to them.

For another, the idea that a UCITS should be allowed a type of benign complexity that it is somehow OK for the UCITS retail investor not to understand as long as it delivers, is to strike an attitude that is at once overly-paternalistic in its assumptions (akin to the political concept of benevolent dictatorship) and reductive in overlooking a key plank in investor protection – the investor’s own judgment. Not all UCITS retail investors are in need of rescue from themselves, and fewer will be the more they learn about the basic principles of management underpinning their investments.

Rather, we stand behind the belief that it is indeed time to debate the risk of complexity itself – as another commentator has recently argued:

Difficult to measure” risks include counterparty risk. The more complex the product, the more links in the chain of counterparties, so the greater chance one of them will fail.

Then, of course, there is the risk that the client, or the adviser, or both, has failed to grasp the core concept behind the product and thus failed to understand the risks. Even highly intelligent and sophisticated clients often mistakenly believe they are effectively being offered a “free lunch” [by a product offering equity-like returns for cash-like risks].

*The result of all this is that even highly intelligent people who have bought complex products often do not have a clue how they work*⁴⁵

We would contend that this lack of understanding is the key element of risk in a complex UCITS risk – it is its complexity risk.

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WHAT CAN WE DO IN THE PRESENT TO SAFEGUARD THE FUTURE OF THE UCITS BRAND?

Risk Mitigation – neither MiFID...

Of course, it is the UCITS Directive itself that encourages the UCITS manager to focus on the volatility of the pay-out as they key risk in the fund (for example, via UCITS 4’s Synthetic Risk Reward Indicator (SRRI)). This has one key side effect:. It means that the many other risks inherent in UCITS that are

⁴⁴ FT.com, [‘Don’t ban financial products for being complex’](#): “complex financial engineering techniques can be used either to increase or to decrease the risk exposure of investors; they are neither inherently “good” nor “bad”. Complexity does not correlate to riskiness – and one person’s risk is another’s acceptable opportunity. Products built to give significant downside protection can actually only be constructed using such techniques – so it would seem rather counter-intuitive for policymakers to make rules that “ban” products that are complex on the basis that they are automatically unsuitable”. See also, FT.com, [‘HSBC says regulators’ ETF concerns ignore other risks’](#)

⁴⁵ FT.com, [‘Time to debate the risk of complexity’](#)

not so easy to measure are pushed out to intermediaries to explain to UCITS retail investors. In other words, the mitigation of complexity risk is passed from UCITS fund managers to their MiFID distributors and intermediaries.

This would be fine if all MiFID intermediaries were up to the task – and were incentivized to play their role correctly. However the existence of the PRIIPS initiative at EU level, and of the RDR and other similar initiatives at individual member-state level suggests they are not.

Any regulatory strategy to shift the burden of mitigating complexity risk out from UCITS as a product Directive and into MiFID as a distribution directive, is further hampered by the more fundamental problem that not all complex UCITS are distributed via one of the three distribution channels that fall under the control of MiFID.

To take each in turn:

- Portfolio management – private wealth managers and stockbrokers who offer discretionary management to HNWI should not only find ETFs useful tools (for example, in implementing sector-exposure or core-satellite investment discretionary strategies) but, as professional investors, should have the sophistication / experience to understand the risks inherent in any synthetic ETFs, ‘newcits’ and other structured UCITS they consider appropriate for a portfolio. All discretionary management decisions must also be proven ‘appropriate’ to each client under MiFID.
- Investment advice – equally as professional investors, investment advisers should have the knowledge requisite to factor the ‘complexity risk’ of complex UCITS into the personal recommendation they make to their clients – all of which must be proven ‘suitable’ to each client under MiFID. However, the problems with this link in the intermediation chain are manifold and well-documented: the European advice market is rife with commission bias and poorly qualified advisers
- Execution – only – the appropriateness/suitability obligation falling on the provider of an execution-only service are thin compared with those of the fiduciary portfolio manager or investment adviser (largely because the investor will have approached the service provider for execution-only and not *vice versa*).

This said, platforms that offer execution-only services may be perceived to be offering at least some form of mitigating mediation service by the simple act of carrying due diligence on the products they make available for execution-only to UCITS retail investors. Fidelity’s own FundsNetwork, for example, plans to carry a small range of synthetic ETFs on which we as professional investors will carry out due diligence for the good of our retail investors.

The problem is that even as the most popular means of distributing UCITS to retail investors covered by MiFID, the ‘investment advice’ channel pales into insignificance next to the ‘sales’ channel thanks largely to the Continental bancassurance model – that is to say, banks in Benelux and France; banks and sparkasse in Germany; banks with asset management arms in Spain and insurance companies and banks in Italy.⁴⁶

As it does not constitute an investment activity under MiFID, the vastly more popular ‘sales’ channel is devoid of the fiduciary standards required of the portfolio management and investment advice channels – and even the ‘appropriateness’ standard of execution-only services. Indeed, for the vast majority, the conflicts of interest inherent in unregulated sales practice may actually lean towards a heavier distribution of complex UCITS with their higher built-in costs and eye-catching promises of cash-like security coupled with equity-like returns.

So although MiFID offers patches of mitigation from the risk of UCITS complexity via intermediation, MiFID itself has patchy application across the European distribution channels. It is clear that the risks inherent in complex UCITS cannot be mitigated by intermediation for the vast majority of European

⁴⁶ FSA.gov.uk, [‘Opening up European Markets for fund distribution: the impact of MiFID on UCITS distribution’](#)

UCITS retail savers – i.e. for all those other than HNWI or the higher-end mass affluent with the means to afford discretionary wealth management or investment advice.

Nor do we think limiting the distribution of complex UCITS via any of the three MiFID distribution channels a workable solution. As we noted in our response to the Commission’s consultation / review of MiFID we have two concerns with the Commission’s proposal to exclude complex UCITS from execution-only distribution:

- Our first concern is that the Commission proposal to ban execution-only services (Q90) would effectively remove one of the three key distribution channels open to retail consumers. This would not only deny consumers the basic right to access financial investments through a distribution service of their choice but also the right to invest at a cost they are willing to pay or, worse, can afford to pay.

At best, such railroading would be inappropriate for consumers seeking only to execute at their own (or some other adviser’s) discretion. At worst it may discourage or prohibit consumers from investing in even non-complex financial instruments altogether on the grounds of cost.

It would also almost certainly drive investors who cannot afford investment advice towards the very sales channel over which MiFID exercises no control.

- Our second concern is that the proposal would serve to close down a key emerging distribution channels to which retail consumers are increasingly turning – the direct retail online platform (“retail online platform”).⁴⁷ Elsewhere, in the consultation the Commission touches on the question of whether a retail online platform is capable of giving investment advice under the terms of the Directive. While we agree that this is theoretically possible (and would thus agree with the implicit proposal to modify the implementing directive accordingly), we are unaware of any retail online platforms that currently offer investment advice as MiFID means it – a bespoke ‘personal recommendation’. The complexity of matching a recommendation to the personal circumstances of each consumer is simply too high even for platforms operating on an algorithmic basis. The Commission proposal would thus rule retail online platforms out wholesale as viable distribution channels.

... Nor UCITS 4...

Unfortunately, we would also argue that it would be equally unwise to place reliance on the new UCITS Key Investment Information Document (KIID) document to provide the silver-bullet to the problem of mitigating the complexity risk inherent in complex UCITS – this time via product design.

For one thing, the UCITS KIID is as yet untested. For another experience and a whole raft of research continues to suggest that investor disclosure is often less than effective as a tool of investor protection – whether in the hands of a MiFID intermediary or an actual UCITS retail investor.

Then there is the problem of the UCITS retail investor never receiving the UCITS KIID in the first instance. For example, technically speaking there is no actual ‘point of sale’ between the UCITS manager of an ETF and the UCITS retail investor where the obligation to provide a KIID as a pre-contractual security mechanism could be made to stick. The ETF’s ‘Authorised Participant’ is the only investor that the UCITS has in terms of its obligation to provide a KIID, while all other investors – whether institutional or retail – are investors in the secondary market for units in the ETF that the Authorised Participant makes.

As a paper from the European Capital Markets Institute from as long ago as 2008 observes there are a number of gaps in the coverage offered jointly by UCITS and MiFID as far as the sales, distribution and even ‘advice’ around UCITS are concerned. Simply amending MiFID or hoping that the UCITS 4 KIID will serve to mitigate the complexity risk is simply not realistic..⁴⁸

⁴⁷ By a “retail online platform” in this context we mean an online platform accessed and used directly by a retail consumer – as opposed to a platform used by an IFA when advising a retail consumer face-to-face. This might be a fund supermarket or a wrap platform.

⁴⁸ ECMI Policy Brief, [‘Shedding Light on the UCITS-MiFID Nexus and Potential Impact of MiFID on the Asset Management Sector’](#). See Table 2 in particular.

... But brand management

To return to the key concern that we share with EU and Asian investors and regulators alike – the risk that the UCITS brand retains its recognisability to its consumers while acting in increasingly unpredictable ways for them – the question that remains is just how does one repair a brand so that it retains its power *and* safety – its recognisability *and* predictability?

Others have no doubt taken the opportunity of ESMA's consultation to argue for a renewed consolidation of the UCITS brand as a means of reinvigorating the brand. We would argue that the UCITS brand is best protected by taking precisely the opposite action - by splitting complex UCITS out of the UCITS brand leaving non-complex UCITS alone *as* UCITS.

For one thing, there is only so far a brand can stretch. "To determine whether and how a brand can be stretched requires a good understanding of current and potential customers, good judgment about future market trends, good information about all these things, and above all, inspiration."⁴⁹ Looking at the UCITS brand in this respect, it is clear there is a widening gulf between the needs of UCITS customers (UCITS investors' need to save and UCITS regulators' need to enable them to do so safely) and the future market trends for UCITS funds themselves (towards ever-more sophisticated forms of complexity).

And when a brand can stretch no further there are only two options left to its managers: let it snap or cut it into more operable pieces before it does so.

An odd analogy for this strategy would be Michael Eisner's splitting of the Disney brand a number of years into Eisner's tenure. Having (profitably) extended Disney's offerings into a range of areas outside their traditional comfort zone as providers of wholesome family entertainment (most notably a number of films with violent / sexual content) Eisner was concerned that he had placed the Disney brand in jeopardy with its audience. So he decided to hive the less-wholesome elements of the Disney output into a separate brand – Buena Vista. This left the Disney brand unpolluted and thus undiluted as a distribution tool for Eisner's key audience – families - while enabling Eisner to run his racier content nonetheless.

We would thus also argue for a retrenchment of the UCITS brand via the divestment of complex-UCITS altogether – a cleansing of the Augean stables. In one key respect, this brand divestment strategy would be even easier for UCITS as there is already an alternative vehicle / brand awaiting the complex UCITS hived out of the UCITS Directive – in the form of the AIFMD. This 'brand' also seems read-made to meet some of the key concerns that regulators have around complex-UCITS (as set out below)

* * * * *

POLICY OPTIONS

How to deliver a complex / non-complex split

In light of the problems with both MiFID and UCITS as mitigants of complexity risk – but moreover bearing in mind the need to address the problem of complex UCITS with a brand-manager's eye – we would recommend a more radical change to the UCITS Directive.

We would therefore advocate reverting UCITS investment powers to their UCITS 1 levels in conjunction with the Eligible Assets Directive.

This would have the effect of cleansing the UCITS brand and returning it to its recognised meaning in the hands of EU investors and Asian regulators alike.

Practically speaking, we actually think any movement back towards UCITS 1 (True-cits) would need to be delivered in two tranches:

- For funds seeking authorisation after a return to UCITS 1 complex UCITS would instead fall under the purview of AIFMD – a move that we believe has its own clear benefits (see below); while

⁴⁹ Anne Bahr Thompson, 'Brand Positioning and Brand Creation'.

- For funds already authorised as UCITS at switch-over, we would advocate ESMA introduce a complex / non-complex flagging regime within UCITS.

More proactively we would then go further to urge ESMA to consider inserting controls into UCITS that would have the same effect as those that would be available to national regulators of retail AIFs under AIFMD Article 41 (again, see below).

Conceptually speaking, a split between UCITS and the AIFMD would also put the AIFMD to use in some key areas of concern around complex UCITS:

- AIFMD would return ‘newcits’ seeking to escape AIFMD to the right Directive – and thus plug a regulatory arbitrage gap;
- AIFMD would have the right focus for many ‘newcits’ and synthetic ETFs that are designed for institutional investors and only take the UCITS retail wrapper as a matter of convenience
- Many AIFMD provisions are already modelled on UCITS so complex UCITS managers will not find the transition difficult (e.g. many UCITS managers will run dual UCITS/AIFM ManCos).
- Systemic / market concerns around ETFs and structured UCITS will be answered by AIFMD leverage caps, liquidity measures and reporting obligations to investors and competent authorities

Nation-states will nonetheless be free to re-permit retail distribution of complex UCITS via Article 41 of AIFMD – the crucial difference now being that they will be able to add in whatever conditions they deem appropriate (e.g. minimum subscription sizes, sophistication tests, distribution restrictions, marketing restrictions).

Not only do such retail alternative investment funds already exist in a number of jurisdictions (thanks in no small part to AIFMD’s own over-extensive scope), but there are also precisely the sorts of controls that French, Belgian and other regulators have already recently imposed on complex products. A product-level control (via AIFMD Article 41) would thus better suit the natural leaning of regulators than a distribution-level control (via MiFID).

Nation-state regulators would also have closer control over complex UCITS via product-level controls as distribution-level controls (via MiFID) would fall to distributors in other jurisdictions to deliver according to nationally implemented versions of MiFID. And our experience of MiFID implementation to date is not great.

Where to place a complex / non-complex split

In terms of where to place the complex / non-complex split within UCITS, we would urge ESMA to leverage the categorisation of UCITS funds that has now developed under UCITS 4 – and that in turn revolves around a UCITS’ use of financial derivative instruments (FDI). As noted at the outset, we conceive of four categories, as follows:

1. UCITS that use no FDIs;
2. UCITS that use FDIs for hedging only – as narrowly defined in CESR/ESMA guidance;
3. UCITS that use FDIs for hedging and meeting investment goals – and that operate their risk management via the Commitment approach; and
4. UCITS that use FDIs for hedging and meeting investment goals – and that operate their risk management via the advanced risk measurement (VaR) approach

In terms of the latter two categories, the question of whether a UCITS applies the Commitment or VaR approach is in turn driven by two factors:

- whether the UCITS makes extensive use of FDIs (VaR) or ‘non-extensive’ use (Commitment); and
- whether the UCITS makes use of complex / exotic FDIs (VaR) or non-complex / non-exotic FDIs (Commitment).

Within such a schema, we would advocate identifying as ‘complex’ all UCITS that fall within the fourth category above. These would be all UCITS that use FDIs for either hedging or meeting investment goals and that take a VaR approach to risk management because they either make extensive use of FDIs or use complex or exotic FDIs – or indeed both.

All other UCITS – that is, those in categories 1-3– should be considered non-complex UCITS.

ESMA might then also wish to consider layering additional conditions for triggering ‘complexity’ on categories 1-3 UCITS also - for example, if a non-complex UCITS operates a securities-lending programme. This might be done on a more *ad hoc* approach.

CONSULTATION RESPONSES

In answering we have sought merely to supplement our position more comprehensively set out above.

* * * * *

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.

While we share ESMA's concerns about the use of certain types of investment strategies in retail products we do so in the round – that is to say, across the whole spectrum of packaged retail investment products reflected in PRIIPS. We would therefore encourage ESMA to look at the issue in the round although not necessarily via PRIIPS which we believe would still fall short of adequate protection because of its focus on MiFID 'inducements' controls and UCITS 4 KIID as risk mitigants. We would certainly urge ESMA to move in conjunction with EBA and EIOPA on this issue.

Expressed the other way round, ESMA cannot justify imposing yet further constraints and disclosures on UCITS but not on other retail products.

Otherwise, we strongly agree with the imposition of limitations on the distribution of complex UCITS to UCITS retail investors. We would, however, expand this limitation out from those channels covered by MiFID to the 'fourth' distribution channel not covered by MiFID – that is, the 'sales' channel that predominates in Continental Europe.

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'?

Yes – we strongly agree that the greatest risk to investors in complex UCITS is complexity itself.

We therefore disagree with those who would seek to excuse complexity on the grounds that it reduces the volatility of a UCITS' payout (the Value at Risk apologists). We object that such apologists place too great an emphasis on the pay-out as the only risky element to a UCITS, and would propose instead that (in the current climate especially) a UCITS's collateral arrangements, stock lending exposures, conflicts of interest/governance structure concerns, redemption arrangements and other liquidity complexities rank equally with pay-out risk – if they don't actually outrank it.

We also object to the 'black box asset management' mentality implicit in the defence of internal complexity for a reduction in volatility's sake. Managers with this mind-set defend their denial of sight into the 'black box' that delivers investment returns on the grounds that there is no need for investors to understand *how* a fund operates as long as it operates in such a way that it delivers predictable returns. We contend that such a denial of understanding is overly-paternalistic even nannyish and that in the long run will lead to an even greater infantilisation of the investor base.

Fund management is not rocket science, and as long as UCITS remain simple investors can - indeed should - be encouraged to understand how they work – in the same way that US investors understand the principles and fundamental operations of 40 Act fund vehicles. The alternative is for retail investors to give up seeking to understand UCITS altogether and to hand this responsibility over to the very intermediaries or UCITS managers that are seeking to sell them complex UCITS in the first instance. We think this destroy a key plank in investor protection – the investor's own intelligence and judgment.

In terms of criteria, we would urge ESMA to leverage the categorisation of UCITS funds that has now developed under UCITS 4 – and that in turn revolves around a UCITS' use of financial derivative instruments (FDI). We conceive of four categories, as follows:

1. UCITS that use no FDIs;
2. UCITS that use FDIs for hedging only – as narrowly defined in CESR/ESMA guidance;
3. UCITS that use FDIs for hedging and meeting investment goals – and that operate their risk management via the Commitment approach; and

4. UCITS that use FDIs for hedging and meeting investment goals – and that operate their risk management via the advanced risk measurement (VaR) approach

In terms of the latter two categories, the question of whether a UCITS applies the Commitment or VaR approach is in turn driven two factors:

- whether the UCITS makes extensive use of FDIs (VaR) or ‘non-extensive’ use (Commitment); and
- whether the UCITS makes use of complex / exotic FDIs (VaR) or non-complex / non-exotic FDIs (Commitment).

Within such a schema, we would advocate identifying as ‘complex’ all UCITS that fall within the fourth category above. These would be all UCITS that use FDIs for either hedging or meeting investment goals and that take a VaR approach to risk management because they either make extensive use of FDIs or use complex or exotic FDIs – or indeed both.

All other UCITS – that is, those in categories 1-3 above – should be considered non-complex UCITS.

This said, ESMA might also wish to consider layering additional conditions for triggering ‘complexity’ on categories 1-3 UCITS also - for example, if a non-complex UCITS operates a securities-lending programme. This might be done on a more *ad hoc* approach.

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 think that neither distribution limitations (via MiFID) nor risk disclosure warnings (via MiFID or UCITS) are sufficient to tackle complexity risk.

In the case of the former, MiFID does not cover all UCITS distribution across Europe (indeed it omits the dominant ‘sales’ channel). And where it does cover UCITS distribution it does so to only patchy effect and with patchy national application.

In the case of the latter, UCITS does not cover disclosure to all UCITS investors (indeed it fails to capture investment in exchange-traded products such as ETFs). And where it does enable disclosure we – and we believe others – would still question the efficacy of simple investor disclosure as a risk mitigant *suis generis*.

In light of these problems – but moreover bearing in mind the need to address the problem of complex UCITS with a brand-manager’s eye – we would recommend a more radical change to the UCITS Directive. We would advocate reverting UCITS investment powers to their UCITS 1 levels in conjunction with the Eligible Assets Directive.

We believe that going forward this would mean that complex UCITS established today would instead fall under the purview of AIFMD – a move that we believe has its own clear benefits, not least in the area of market / systemic risk mitigation. Nation-states would then be free to control the retailisation of today’s complex UCITS much more closely via AIFMD Article 41. For instance, they could implement regimes that require minimum levels of subscription, sophistication or net liquid worth for investment retail AIFs. These requirements would then ‘travel with’ each retail AIF, so to speak, through the MiFID distribution channels – but also crucially through the non-MiFID sales channel.

As far as existing complex UCITS are concerned, we would advocate ESMA introduce a complex / non-complex flagging regime within UCITS at the very least. More proactively we would then go further to urge ESMA to consider inserting controls into UCITS that would have the same effect as those that would be available to national regulators of retail AIFs under AIFMD Article 41.

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

Yes – see our response to Question 2 above as well as to our more substantive response, the first part of which is effectively our market failure analysis for the UCITS label or brand.

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

We think that a number of industry commentators have a good grip on the market / systemic risk inherent in new and evolving types of complex UCITS. The IMF, FSB and BIS have certainly picked up a number of key concerns, but we could not comment on whether they have (or indeed) need the same level of understanding as industry commentators.

There are perhaps two international hot-spots that might bear a watching-brief. Framed as questions:

- What might be the implications of a European Volckler-like separation of investment banks from asset management arms within banking groups for bank-run synthetic ETF UCITS? We are perhaps closer to this question in the UK as a result of the Vicker's report
- By the same token, what might be the implications of the same European Volckler-like separation for 'newcits' if investment banks' proprietary and Delta1 desks are spun out to become standalone hedge funds? We are already seeing this in Europe (JPMorgan)

In the meantime, we would emphasise that most of the papers issued in the last recent months by different authorities fall into the trap of using the acronym "ETF" to cover all types of exchange-traded products (ETPs), including structured banking products and funds that are not UCITS. Great care needs to be taken when drawing on or drawing conclusions from those analyses as regards exchange-traded UCITS.

We would urge ESMA to retain an ongoing conversation with the EBA with regard to ETPs in particular, and with EBA and EIOPA with regard to complex PRIIPS more generally.

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 of avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.

Categorically, yes. See our responses to Questions 1 and 5 above.

Exchange Traded Funds

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?

The suggestion of establishing some form of mandatory identifier is well worth pursuing – although we would advocate that is extended to all complex UCITS, with complex ETF UCITS perhaps carrying an additional 'exchange-traded' flag or identifier.

It may also be worth exploring the application of flags or identifiers to indicate increased levels of complexity risk – e.g. via securities-lending programmes – for non-complex as well as complex UCITS.

Index tracking issues

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?

Setting aside our earlier comments about the efficacy of the UCITS 4 KIID as a risk mitigant, we would make only 2 observations:

The first is that ESMA should apply its policy orientations to all index-tracking UCITS and not just those that are exchange-traded.

The second is that we would support additional disclosures in the KIID and suggest that ESMA builds on the current KIID provisions for “structured” UCITS (i.e. that KIIDs for certain types of UCITS should be longer in order to enable additional disclosures to be made).

Otherwise, it is perhaps worth mentioning that FWI think of index-tracking UCITS as an interesting sub-category of UCITS for two reasons.

The first is that we think it is wrong to equate, as many people do, index-tracking funds with the idea of simple funds. Although the objective of tracking an index is indeed a simple one, this does not make a fund guaranteed to rise with the markets but also to fall with the markets a ‘simple’ one as far as ‘simple distribution’ or ‘simple advice’ is concerned. ‘Simple distribution’ has as its objective the delivery of the most suitable product to an end investor in as clean and easy way as possible. The objective of the ‘simple distribution’ of UCITS funds will thus often sit at complete odds with the ‘simple objective’ of an index tracking UCITS.

The second is that although many index-tracking UCITS will not constitute complex UCITS *per se*, it is index-tracking UCITS that appeal to hedge fund and other institutional managers seeking index arbitrage opportunities – not least because they have the added benefit of fuel-injecting the “uninformed money” of UCITS retail investors into the arbitrage opportunity. So, although index-tracking UCITS are not complex themselves, the uses to which institutional investors put them and thus their UCITS retail investors are.

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.

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.

Yes – we agree with ESMA’s policy orientations.

We believe that a number of the policy orientations identified by ESMA should already be a requirement – for instance, the disclosure of counterparty risks to UCITS investors. CESR’s Guidelines on Risk Measurement for UCITS states that collateral should be diversified (Box 26), and there are already quite stringent collateral requirements for UCITS, including UCITS ETFs. We have also ourselves noticed that some ETF managers have higher collateral control arrangements in place than others – for example, through the appointment of an independent third-party collateral agent.

The function of collateral is different to that of other assets and is there to provide security for investors. We agree, though, that it may be appropriate to review the collateral rules – for example, with a view to requiring that collateral more closely (in terms of quality and type) reflects the index being tracked.

Again, though, we question why such considerations should apply only to UCITS and not to other retail investment products that use collateral in a similar way.

Securities lending activities

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.

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?

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?

Yes – we support ESMA's policy orientations and agree in particular that the collateral received should comply with the criteria for OTC Derivatives in CESR's Guidelines.

Securities lending requirements should at least cover:-

- That the terms of any securities lending agreement is acceptable to the depositary
- That securities lending may only take place with approved counterparties (i.e. with persons authorised by regulators etc.)
- Collateral must be acceptable to the depositary
- The treatment of collateral (i.e. its form or type, value, transfer to depositary, use/ reinvestment etc.)

However, given the reduction to a UCITS TER that a well-managed securities lending programme would deliver, we do not believe that a cap on the amount of a UCITS portfolio that can be lent as part of securities lending arrangements is necessary.

Actively managed UCITS ETFs

Q26 Do you agree with ESMA 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 ESMA's proposed policy orientations.

We would note, however, that it is not part of a manager's duty to calculate the iNAV. The iNAV is a theoretical number which may not necessarily reflect the price of a trade.

Leveraged UCITS ETFs

Q29 Do you agree with ESMA 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 to leveraged UCITS ETFs that ESMA should consider?

Q3 If yes, can you suggest possible actions or safeguards ESMA should adopt?

Yes - we agree with ESMA's analysis of the issues raised by leverage. We would also refer you to comments made about leveraged ETFs in particular in our more substantive response.

Secondary market 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 ETF?

Q38 How can ETFs which are UCITS ensure that the stock exchange value of their units do not differ significantly from the net asset value per share?

It is a fundamental tenet of UCITS that all investors should be able to redeem directly at NAV. In any case, we agree that ESMA should clarify exactly what rights secondary market investors are entitled to as there appears to be confusion.

We also share ESMA's concerns about the uneven treatment of secondary market investors with regards the investor protection elements built into UCITS via the KIID disclosure. As we note above, we are concerned that UCITS does not cover disclosure to all UCITS investors (indeed it fails to capture investment in exchange-traded products such as ETFs). And where it does enable disclosure we – and we believe others – would still question the efficacy of simple investor disclosure as a risk mitigant *suis generis*.

There cannot be any guarantee that the stock exchange value of units will not differ significantly from the NAV. However, market activity will ensure that the market price of units does not move significantly from the iNAV. The NAV will only be correct at a specific point in time.

Total return swaps

Q39 Do you agree with ESMA 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?

We agree with ESMA's analysis of the issues raised and the policy orientations identified. However, we would argue that these requirements should apply to all UCITS funds and not only structured UCITS.

Strategy indices

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?

On the basis of the requirements set out in the various pieces of UCITS legislation on eligible, we find it difficult to understand how a "strategy index" (as described in the paper) fits easily within the legislative provisions or their intent.

We agree, though, with ESMA's policy orientations on strategy indices. We suggest a minimum number of components be used to determine whether an index of interest rates or FX rates complies with the diversification requirements.