

RESPONSE

Discussion Paper - ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

BlackRock is one of the world's preeminent asset management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world.¹ As of 31 March 2011, BlackRock's assets under management totalled €2.58 trillion across equity, fixed income, cash management, alternative investment and multi-asset and advisory strategies including the iShares® exchange traded funds ("ETFs"). iShares has over €430bn invested in 474 funds which represent 43.0% of the world's total ETF assets under management² and puts it in a leading position in Europe and globally. BlackRock and iShares are considered to be pioneers in the ETF and index fund management businesses. Unlike many ETF sponsors, BlackRock and iShares approach ETFs from the perspective of an asset manager and fiduciary.

ETFs have revolutionised the investment landscape in Europe and globally, allowing retail and institutional investors alike to harness the diversification benefits of buying an entire index in a single fund. A range of different exchange traded structures have emerged since the inception of ETFs, in order to meet client demand for less conventional exposures and asset classes.

Transparency remains at the heart of the iShares philosophy. We believe we act in the end-investors' best interest when they know how their investments are constructed and how they are performing on a daily basis. Therefore, BlackRock welcomes the opportunity to respond to ESMA's policy orientations on guidelines for UCITS ETF and structured UCITS. By way of extension of our fiduciary mandate to our clients, we stand ready to provide expertise and insights from our experience to the supervisory community to further develop the regulatory environment surrounding UCITS ETF and structured UCITS products in the future.

Executive Summary

As a fiduciary to our clients, we approach this issue from the perspective of the end-investor. The "complexity" inherent in the construction of a product that is designed to meet specific needs of end-investors must not be confused with risk. "Product complexity" is not and ought not to be synonymous with "outcome complexity." Rather, seemingly complex structural features can often act to mitigate risk. *Ex-facie* complex investment techniques may be used to deliver straightforward and low risk investment strategies.

We therefore oppose the "complex" designation for UCITS because it would not, in our view, improve investment outcomes for Europe's end-investors, such as long-term savers and pensioners. Rather it would lead to confusion whilst undermining the

¹ Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals. BlackRock represents the interests of its clients by acting in every case as a fiduciary. It is from this perspective that we engage on all matters of public policy. BlackRock supports regulatory reform globally where it increases transparency, protects investors, facilitates responsible growth of capital markets and, based on thorough cost-benefit analyses, preserves consumer choice. In addition to our investment management business, through BlackRock Solutions®, the firm offers risk management, strategic advisory and enterprise investment system services to a broad base of clients with portfolios totalling more than €6.73 trillion.

² Data as at end H1 2011.

hitherto pan-European success story that is the highly regulated and therefore globally recognised UCITS label.

Specifically as regards ESMA's focus on ETFs, the requirement to have clear and consistent investor documentation (including appropriate risk disclosures) would be the most constructive step ESMA could take to avoid "inappropriate" UCITS being bought by retail investors. Investors would benefit if such documentation helped distinguish between highly regulated ETFs on the one hand and other instruments traded on exchanges such as Exchange Traded Commodities (ETCs) and Exchange Traded Notes (ETNs) and other listed non-fund instruments.

BlackRock supports a drive towards greater transparency for end-investors in relation to the underlying exposure, counterparties and the collateral taken by providers of synthetic ETFs to ensure consistency and ease of comparability across competing ETF product ranges. End-investors may also benefit where there are multiple parties making markets for an ETF, given that competitive market making tends to reduce trading costs and enhance liquidity.

Our focus on consistent disclosure and transparency to end-investors extends to securities lending practices. Securities lending returns significant benefit to the funds which employ it and therefore to the end-investors that have chosen to invest in those particular funds.

Finally, as regards ESMA's policy orientation for structured UCITS, we are in general agreement with much of what ESMA has set out and would again advocate that end-investors would be best served where there is consistent disclosure and transparency so investors fully understand the product in which they are investing.

Detailed Remarks

II. General policy discussion

1. 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.

The UCITS framework is a very successful pan-European distribution framework for retail funds. The UCITS wrapper represents a high degree of quality and consistency among investors. It is for this reason that UCITS funds are increasingly popular in markets other than Europe, such as Asia and Latin America.

A fundamental split in the UCITS brand to distinguish between "complex" and "non-complex" UCITS funds would stymie the popularity of UCITS in Europe as it would in other non-European markets. However, we do not believe it is the intention of policy makers to put a brake on the further consolidation and growth and this tried and trusted pan-European success story for the fund management industry.

We feel strongly that the "complexity" inherent in the construction of a product that is designed to meet specific needs of investors must not be confused with risk. In short, "product complexity" is not and ought not to be synonymous with "outcome complexity" (as "outcome complexity" relates to the resulting exposure) or the crystallising of un- or ill-explained risk to investors. Rather, the complexity of a fund can often act to mitigate risk as part of the

structuring regime of the prudent product provider. *Ex-facie* complex investment techniques may be used to deliver straightforward and low risk investment strategies. Arguably, with recent acute market volatility, holding single equity stocks presents greater short-term risk to end-investors than more diversified structuring and holdings.

Therefore, it is extremely difficult to appropriately define the concept of “complexity” in a way which achieves ESMA’s objectives. **The addition of complexity, as outlined by EMSA, is likely to lead to potential regulatory arbitrage wholly inconsistent with the harmonisation principles which underpin the UCITS framework.**

We also see a risk that certain providers may turn to non-UCITS products, such as notes and other instruments not structured as regulated funds. Such products are likely to avoid the same degree of regulatory scrutiny as UCITS products. A major unintended consequence of dividing UCITS into complex and non-complex categories could, therefore, be that retail investors are directed away from UCITS products (which are highly regulated) to the competing lightly regulated suite of non-UCITS investment products. In our view, this is entirely inconsistent with ESMA’s stated policy objectives.

We believe that Europe’s end-investors would be better served if ESMA were to also focus on non-fund products and access by retail investors to such non-fund products.

For example, exchange-traded notes and commodities products are not generally subject to regulation or on-going supervision of their investment exposure and how that investment exposure is delivered to end-investors. These products are, however, readily accessible to retail investors by virtue of their exchange listings. As such, there is a strong case for change in this area. Consideration must also be given to designating non-UCITS structures as complex and non-complex and the appropriate limits on their distribution should logically apply. This point is further developed in response to question 7, below.

2. Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as ‘complex’? Which criteria could be used to determine which UCITS should be considered as ‘complex’?

We oppose the “complex” designation for UCITS because it would not, in our view, improve investment outcomes for Europe’s end-investors, such as long-term savers and pensioners. The specific rationale is highlighted in the answer above.

However, if ESMA remains persuaded of the need to sub-divide UCITS into complex and non-complex categories, we would then suggest that **a distinction needs to be drawn between: (i) complexity designed to mitigate risk and deliver a straightforward outcome to investors (even where *ex facie* complex investment techniques are used); and (ii) complexity that might deliver unforeseen and unpalatable outcomes.** Examples of the second category of complexity might include:

- funds which pursue investment objectives that require consistent use of leverage (such as ETFs that seek to achieve returns that are a multiple of an index return)
- funds which pursue investment objectives that require use derivatives that must be rebalanced daily to maintain a targeted exposure (such as ETFs that seek to achieve returns that are the daily inverse of an index return); and
- funds that use swaps or other derivatives as a fundamental structural component in a manner that creates a high degree of concentrated credit exposure (such as single counterparty swap-based ETFs),

where retail investors might have difficulties in understanding their risk profiles.

3. 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?

The requirement to have clear and consistent investor documentation (including appropriate risk disclosures) would be the most fundamentally important step ESMA could take to avoid “inappropriate” UCITS being bought by retail investors.

Echoing the points raised earlier in this response, focussing on UCITS funds alone (which form only part of the investment universe contemplated in this paper) does not fully address the problem regulators are attempting to solve. This is because competing, or substitute, investment products, whether they are insurance, bank or asset management products, are part of the same landscape from an investor’s perspective. As such, these products must also be brought into scope.

Accordingly, BlackRock strongly supports the European Commission’s Packaged Retail Investment Products (PRIIPs) initiative and urges that the proposal for it to be wide in scope and brought forward without further delay.

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

No. Investors need access to funds that allow them to pursue a variety of investment strategies and appropriately diversify exposures to reduce overall portfolio volatility. Provided more sophisticated strategies are risk-controlled and explained through detailed and meaningful risk disclosures presented in plain language, then the end-investor should be allowed access to “higher complexity” funds within the regulated UCITS framework. If the UCITS funds were not permitted to use the strategies discussed in this paper, investors could instead seek to obtain exposures that can only be delivered by “complex” products by investing in unregulated alternative which would offer less investor protection and potentially lead to unintended consequences to markets.

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

Subject to appropriate risk disclosures and product descriptions being made available to investors, we believe that funds pursuing investment objectives that use derivatives which must be rebalanced daily to maintain a targeted exposure should be permitted under UCITS. An example of this might be ETFs that seek to achieve returns which are the daily multiple or inverse of an index return. That said, we are mindful that the daily rebalancing process used by these funds may increase market volatility (as well as providing a risk profile that may be difficult for investors to understand). In view of this, we encourage ESMA to consider, as part of its consultation, the effect certain fund structures (such as those set out in this example) may have on secondary market activity.

6. 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.

Please see previous comments in relation to question one.

7. 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.

A range of different exchange traded structures have been developed since the inception of ETFs, in order to meet client demand for less conventional exposures and asset classes. This has increased the choices available to investors. Under UCITS regulations, certain exposures such as single physical commodities or futures-based commodity indices cannot be replicated within a UCITS compliant vehicle.

The non-fund structures that are used in such cases include Exchange Traded Commodities (ETCs) and Exchange Traded Notes (ETNs), both of which are structured as debt securities and therefore contain counterparty risk. The distinction between an ETC and an ETN is broadly that the ETC is normally backed by physical commodity holdings while an ETN is backed primarily by the credit of the issuer and may or may not be collateralised. It is important to note though that in this less regulated segment the terminology relating to non-fund structures is generally poorly defined and in some cases used inconsistently or inaccurately.

As these instruments trade and settle in a manner that resembles ETFs they have in the past been equated with ETFs. This overlooks a crucial factor – neither the risk appropriateness of the investment exposure nor the rigour and security of the mechanism to deliver that exposure are regulated. **It is therefore critical that investors be able to clearly distinguish between highly regulated ETFs on the one hand and other instruments traded on exchanges such as ETNs, ETCs and other listed non-fund instruments.** The latter may carry significantly higher risk investment exposures with limited investor protection.

This similarity in trading and settlement can lead to confusion if an investor in an ETN erroneously assumes that the protections of a fund implicitly apply due to the “Exchange Traded” label.

A renewed focus on systemic risk and the sovereign debt crisis has brought attention to the potential risks presented by the exchange traded sector, notably with regard to counterparty risk. A spate of recent warnings from international bodies such as the International Monetary Fund (IMF), Financial Stability Board (FSB) and Bank for International Settlements (BIS) has intensified the need for investors to carry out proper due diligence before investing in any exchange traded vehicle.

There is a clear need for correct – and revised – classification of the various investments available. Therefore, we would welcome the opportunity to discuss with ESMA in greater detail possible solutions to these important issues of classification.

III. Exchange-Traded Funds

I. Title

8. 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.
9. Do you think that the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs?
10. Do you think that the identifier should also be used in the Key Investor Information Document of UCITS ETFs?

Yes. **We agree that all funds which hold themselves out as being UCITS ETFs should use an “ETF” identifier which identifies them as a regulated exchange-traded fund.** Furthermore, it would be appropriate in our view for the ETF-identifier to clearly identify whether it is a synthetic or physical ETF, which can easily be established through the

principal investment policy of the fund. This labelling could appear in the product name itself, and should certainly be specified in the prospectus, marketing material and KIID. This would provide end-investors information in a clear and consistent format so that they can easily discriminate between competing types of product offerings (particularly between regulated and unregulated product ranges).

II. Index Tracking Issues

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

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

13. 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?

14. Are there any other index tracking issues that ESMA should consider?

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

By way of first principles it must be noted that **tracking error technically is measured as the standard deviation of the tracking difference** (the under/over performance of the fund vs. the index), generally on a daily basis expressed as an annualised number, and is a measure of the volatility of the tracking or "performance difference". It does not, however, equate to longer-term tracking or "performance difference" (which is the difference between a portfolio's actual return and its benchmark return over a specified time period). The structure that has the greatest daily variation in tracking or performance difference will result in greater tracking error but not necessarily in the greatest long-term performance difference.³

In response to the questions, we agree that the prospectus for any index-tracking UCITS ETF should include a clear and comprehensive description of the index to be tracked, and the mechanism used to gain exposure to the index. We think that the current UCITS IV Directive already requires a description of the index to be tracked and the mechanism used to gain exposure to the index to be disclosed in the investment objective and policy section of the KIID as we would consider such information to be part of the key features of any index tracking UCITS ETF. **In the case of synthetic ETFs it would furthermore be appropriate to disclose to the spread of the swap⁴ in the prospectus** as this information forms an integral and important part of the "clear and comprehensive description" of the mechanism to gain exposure to an index, which would inform end-investors and guide their investment decisions accordingly.

We also agree that it is appropriate to disclose certain information concerning the tracking error of an ETF, but this should not prescribe a maximum permissible level. Certain types of indices may naturally lend themselves to wider greater tracking errors due to

³ In synthetic ETFs the swap counterparty may guarantee the index return but charge a variable swap fee (reflecting the costs of hedging the swap guarantee) which is a source of consistently negative tracking difference vs. the benchmark. For example, a synthetic ETF that charges a large but constant swap spread (e.g. 50bps per month) would result in lower daily tracking error than a physical replicating ETF that experiences small performance deviations (typically in the range of 5-15 bps on an annualized basis each day, but with positive as well as negative deviations so that the daily differences do not consistently compound). The swap-based product in this case would have lower "tracking error" but experience greater long-term performance difference from the index return than the physical product and ultimately deliver lower performance for the investor.

⁴ The spread of the swap reflects the costs of constructing a portfolio that hedges the swap guarantee to the swap counterparty. It is part of the cost charged to the end investor for management of a product that seeks to deliver the fund's stated objective, and is therefore analogous to the management fee charged by the advisor of a physical fund.

the nature of the index methodology. Many indexes are constructed in a manner that is not possible to replicate perfectly when trading the underlying investments, either due to regulatory constraints or the impossibility of buying or selling certain constituents of the index at the precise times and values used to determine the index's return. Investors in funds that benchmark the returns of difficult-to-replicate indices frequently are willing to accept wider performance gaps in order to gain exposure to such indices. Because different investors may wish to measure tracking error in different ways in order to suit their investment needs, BlackRock's view is that any decision to adopt a standard measurement of tracking error needs to be very carefully considered. This should meaningfully weigh up the real benefit to investors against the potential for creating confusion or for misleading investors. Therefore, given the individuality of each index, it would be extremely difficult to impose a single tracking error limit across all index tracking funds without introducing complex definitional issues and potentially causing an inadvertent impediment to investor choice.

If ESMA prefers to have one single tracking error calculation methodology for consistency, then it is important that any rules introduced in this area be applied on a level playing field across all index tracking funds regardless of whether they track using synthetic or physical means in order to produce a result that is meaningful and consistent for investors. As physical funds and synthetic funds have different revenue streams and cost elements, the most meaningful measurement would be for any methodology to reflect the total cost of owning the shares to the investor. Such a measurement would enable investors to compare the actual costs borne by the fund (and, by extension, investors) across different types of index trackers on a "like for like" basis.

A distinction first needs to be drawn between the investment objectives of: (i) investors in passive index tracking funds; and (ii) investors in actively-managed funds which reference an index (for convenience, we shall refer to them as 'active index funds' in this note). Investors in passive index tracking funds are looking for performance which tracks the performance of a standard benchmark index **as closely as possible**, whereas investors in active index funds are looking for **outperformance** of the benchmark index versus standard benchmark indices. In order to recognise this distinction, it makes sense to have a different tracking error methodology for passive index tracking funds vs. active index funds. This will ensure that investors receive information which is meaningful and relevant to their respective investment objectives. Conversely, the tracking error methodology for a passive index tracking fund should calculate the difference in performance between the fund and its index. The tracking error methodology for an active index fund should reflect whether the tracking error is a result of the fund outperforming the index (positive from the end-investor's perspective) or the fund underperforming the index (negative from the end-investor's perspective).

In this way, we can see that the investment policy and strategy of the fund should determine whether a fund is a passive or an active index fund - not whether the tracking error of that fund exceeds a particular limit, as suggested by certain industry participants.

We agree that appropriate risk disclosures on issues affecting an index tracking ETFs ability to fully replicate the index should be disclosed. For physical-based ETFs, the risk factors are more readily apparent e.g. transaction costs, dividend distribution vs. reinvestment etc. For synthetic-based ETFs, some of the factors which cause tracking error in physical-based funds (such as tax charges and transaction costs) will be picked up in the cost of the hedge for a swap provider and charged back to the fund in the swap spread or reflected in the returns payable by the swap provider to the fund (but not necessarily disclosed as such to the end-investors). In order to create a level playing field in terms of disclosure by physical and synthetic-based funds, such swap related risks (and the potentially 'hidden' costs) should also be disclosed to investors.

Whilst we agree that appropriate risk disclosures should be contained in the relevant fund's prospectus (and, to the extent necessary, in the KIID), **we do not agree that it is appropriate to disclose the specific tracking error figure in the prospectus or KIID**. The figure could vary from time to time depending on a range of circumstances (including liquidity in the market, taxes applied on the underlying securities, etc.) and could result in the relevant ETF having to make frequent changes to the prospectus (and KIIDs) if disclosed in such documents, which would not be helpful to investors.

As such, we would be in favour of providing high level information in the prospectus and setting out the detail, to the extent it would actually be meaningful to investors, on the fund's website or in its annual reports.

III. Synthetic ETFs – counterparty risk

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

17. 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.

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

ESMA rightly identifies in paragraph 28 that **neither the collateral nor the holdings of a fund need to be in alignment with the underlying index which is being tracked**. This should be an acceptable position provided that the collateral is of high quality, liquid and a small multiple of the average daily trading volume of the relevant security ("ADTV"). We would, therefore, **support a drive towards greater transparency for investors in relation to the underlying exposure, counterparties and the collateral taken by providers of synthetic ETFs to ensure that these standards are met** (question 16).

Whilst we agree with the proposals and direction of question 17, **we don't believe that there should be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index**. We don't consider this necessary, but additional requirements around liquidity might be helpful. ESMA could consider the introduction, for example, of a maximum ADTV holding to ensure that, in the event of a swap counterparty default, the amount realized upon sale of the collateral is not significantly less than the amount that the collateral was valued pre-sale as a result of downward price pressure resulting from the sale.

Collateral received by synthetic ETFs, which are typically brought forward in a UCITS-wrapper in Europe, should therefore comply with the broad principles laid down in the UCITS diversification rules, but need not necessarily adhere to the specific risk diversification limits for direct investments held by UCITS (question 18). This should help maintain flexibility in respect of the provision of collateral and help ensure that any collateral provided is of high quality rather than having to take collateral that is perceived to be of a lower quality just to comply with specific diversification limits.

IV. Securities lending activities

Transparency and disclosure to investors around whether and how ETF lends securities is extremely important. ESMA's proposed guidance in this area would serve to raise the level of

transparency of securities lending activities in general, as well as especially in this particular case of ETFs.

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

In general, yes. We disagree, however, with ESMA's statement that securities lending increases the tracking error for index tracking UCITS.

We would ask ESMA to note that:

- **Securities lending activities can take place in respect of a physical or a synthetic ETF model.** We understand that ESMA may be more familiar with the physical model. In the case of the synthetic model, this would typically be where synthetic ETF providers are part of (or connected to) the same group of companies as the investment bank that writes the swaps for the synthetic ETF. In the synthetic model, the investment banking affiliate may engage in the lending of its hedging basket and derive income from such activity (thereby commercially benefiting the group to which the ETF provider belongs). We consider that it is appropriate for the fund to benefit from any securities lending activity carried out directly or indirectly in connection with its assets. However, given the lack of transparency in connection with synthetic ETFs, we do not have any data available to indicate whether a benefit is passed back to the fund and/or end investor. As such, increased transparency in respect of synthetic ETFs would provide greater clarity. With this information, investors would be better placed to consider any potential benefits which may ultimately be passed back to them.
- **Securities lending returns contribute positively to tracking difference** (and, therefore, counter any embedded costs such as management or swap fees that contribute negatively to tracking difference) so any concerns ESMA may have around tracking error should be set in the context of the long-term performance contribution of securities lending to the funds and the subsequent benefit to end-investors.
- **In the case of cash collateral, the fee is generally expressed as part of the "rebate rate."** As payment for the loan of securities, the parties negotiate a fee, quoted as an annualised percentage of the value of the loaned securities. If the agreed form of collateral is cash, then the fee may be quoted as a "rebate", meaning that the lender will earn all of the interest which accrues on the cash collateral, and will "rebate" an agreed reference rate (e.g. Libor) of interest to the borrower.⁵

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

In general, yes. However, we would ask ESMA to note that, whilst we agree that broad collateral policies should be reflected in the prospectus:

- **Detail on the collateral parameters, such as collateral types, eligibility limits and levels of over-collateralisation, may change depending on the market environment. As such, while we agree that this information should be available to clients, it is more sensible and practical to display this on the provider's website and/or upon request.**

⁵ For example a lending fee of 10 bps will be expressed as "Libor minus 10 bps". If the cash fund returns for example Libor +5 bps, the combined return (lending fee + cash reinvestment) would be 15 bps. These 15 bps would be shared between the lending agent and the fund as defined by the disclosed fee split.

- Comments relating to the orientations are given below in response to question 22.

Please see also our response to question 18.

21. 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.

22. 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.

We believe that collateral taken by UCITS funds should be regulated in a consistent manner in Europe across ETFs and all other UCITS fund structures. As such, we generally support a proposal to introduce **collateral parameters which are similar to those principles laid down** in CESR's Guidelines on Risk Management. However, such rules should take into account any relevant differences between investments in OTC derivative instruments and securities lending activity (and the corresponding differences in risk associated with each) and only be implemented once a thorough analysis has been undertaken to assess the impact that such rules will have in practice. For example, one key distinction which ought to be made is in respect of cash collateral. In the context of securities lending, **we disagree that cash collateral should be restricted to investments in 'risk free' assets only**. Rather, we think it is appropriate for applicable guidelines to be consistent with the rules under UCITS in respect of the reinvestment of cash collateral. Within conservative reinvestment parameters, cash can be a useful collateral type for investors, but requiring 'risk-free' reinvestment will reduce the viability of cash as collateral. Finally, it is crucial that any new rules be **made applicable in respect of all UCITS fund structures** which engage in securities lending (not just ETFs). Please see also our response to question 18. We would welcome the opportunity to discuss this further with ESMA.

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

No, we do not consider that it is appropriate for ESMA to prescribe such a limit. For synthetic ETF providers which are part of an investment banking group, the parent investment bank holding a hedging basket may lend out the entire basket of securities in order to generate revenues, but if limits were imposed on physically replicating providers to lend only a certain percentage, this would put physically replicating funds at a performance disadvantage (and will ultimately limit the securities lending revenue which may be passed onto the fund and reduce the benefit to end-investors. This obviously assumes swap-based providers of synthetic ETFs share in the securities lending revenues that are generated outside the ETF, which is an area where no transparency is provided at the moment for the single swap counterparty ETF providers. In this case (as noted in our response to question 19), there is no data in respect of any benefit which may ultimately be passed back to the fund and/or end investor, if any, and we would welcome increased transparency in this respect.

We do not believe it is the intention of ESMA to pick winners in this industry by introducing such guidance (nor to limit the benefits that end investors may receive as a result of securities lending activities carried out by the physical ETF providers). As such, we would urge ESMA not to do so specifically in this area.

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

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

In our view, **the disclosed securities lending revenue share⁶ that is being passed on to the fund should be calculated net of all costs; any securities lending-related costs (such as transaction charges or cash collateral management fees) should be deducted from the fund's revenue share.** Any securities lending costs should be deducted from the portion of the revenue which is subject to the fee sharing arrangement with the securities lending agent. This is so that the securities lending revenue share received by the fund is purely for the benefit of the fund and its investors.

Based on this model of showing the net return to the fund, any securities lending costs, including any fee sharing arrangement with the securities lending agent, would not effectively increase the running costs of the fund. Therefore, **it is not appropriate to require physical funds to add their securities lending costs or securities lending fee sharing arrangement to their on-going costs or Total Expense Ratio (TER).** Such a requirement would make a physical fund look artificially more expensive thereby providing misleading information to investors.

In addition, securities lending revenue generally changes from month to month for most funds depending on the level of stock lending activity. Since any fee sharing arrangement is generally a percentage of the securities lending revenue (e.g. 40% in the case of iShares), the fee sharing portion would also change from month to month. If the fee sharing portion is required to be added to the TER or ongoing charges figure, **the prospectus and Key Investor Information Document for a fund engaging in securities lending would need to be updated frequently to reflect frequent changes to the fee sharing portion, even though the fee sharing portion does not increase the actual costs of running the fund.** Such a result would be misleading and confusing for investors.

For the reasons set out above, we would like to ask ESMA to reconsider paragraph 7 of the "guidelines on the methodology for calculation of the ongoing charges figure in the Key Investor Information Document". Where a fee sharing arrangement does not increase the actual costs of running a fund, such fee sharing arrangement should not be added to the ongoing charges figure as this would be misleading. If ESMA wishes, such a fee sharing arrangement can be disclosed in the KIID but it should be disclosed as part of an explanatory note rather than added to the ongoing charges figure. We would welcome the opportunity to discuss this further with ESMA.

Whilst securities lending revenue sharing arrangements in physically replicating ETFs are disclosed to investors, there isn't any disclosure on how any revenues of securities lending derived from the hedging basket that the parental investment bank holds are shared. In our view, **end-investors would benefit from disclosure by the single swap counterparty ETF providers on the securities lending revenue that is generated in the hedging basket.**

The following example serves to illustrate this issue. The iShares Euro STOXX 50 has a TER of 35 bps, but the 60% securities lending revenue share received by the fund (net of all costs) has generated approximately 32 bps to the fund on average over the last three years, significantly reducing the cost to the investor of holding shares in the ETF. On the other hand, one of the single swap ETF providers offers a product on the same benchmark with a TER of 0. We speculate that one reason that the single swap ETF provider is willing to offer a product with a TER of 0 is that it, or its affiliates, are generating benefits from lending the hedging basket that may be of interest to investors.

⁶ e.g. 60% to the fund in the case of iShares.

We firmly believe that the policy of disclosing revenues from securities lending and TER (or investment management fees) to clients separately is right for ETFs, but also for any other product ranging from retail to institutional pension funds that includes securities lending. So whilst the current disclosure offered by single-swap ETF providers already puts physically replicating providers at a disadvantage, any calls for disclosing securities lending revenues received by the securities lending agent as an additional cost (in the case of iShares 40%), especially where such revenue does not increase the cost to the fund, would further increase this disadvantage without more clearly illustrating to end investors the total costs to them of owning synthetic vs. physical products.

In the product example described above, the swap-based ETF provider could keep the TER at 0 without being required to provide any transparency on how much securities lending revenue the swap based provider is passing back to the fund, whilst physical replicating providers (such as iShares) would have to publish a TER of 56 bps (35 + 21), even though in our product 60% of revenues (already net of costs) are passed back into the fund so the effective costs of owning the fund has been reduced from 35bp to 3bp.

To have a comparable level of disclosure between physical and swap based funds, we believe that providers of physical products should not be required to add their securities lending revenue share to the TER where such a fee sharing arrangement does not effectively increase the costs to the fund. If disclosing the provider's securities lending revenue share as part of the TER became a requirement, the inherently more transparent replicating ETF products are punished for exactly this transparency and the already existing disadvantage when compared with synthetic funds would increase.

Therefore, we believe the securities lending revenue share (net of costs) to the fund and the absolute revenues the fund has received should be disclosed by ETF providers.

V. Actively managed UCITS ETFs

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

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

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

We acknowledge that actively managed ETFs may present additional issues requiring further examination. **Provided more sophisticated strategies are married to a robust risk framework, within which transparency to investors regarding the assumed risks is prioritised** (for example, by including detailed and meaningful risk disclosures presented in plain language), **then the end-investor should be allowed access to “higher complexity” funds within the regulated UCITS framework.**

VI. Leveraged UCITS ETFs

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

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

31. Are there any other issues in relation leveraged UCITS ETFs that ESMA should consider?

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

As above, **we acknowledge that leveraged UCITS ETFs may present additional issues requiring further examination.** Provided more sophisticated strategies are married to a robust risk framework, within which transparency to investors regarding the assumed risks is prioritised (for example, by including detailed and meaningful risk disclosures presented in plain language), then the end-investor should be allowed access to “higher complexity” funds within the regulated UCITS framework.

VII. Secondary market investors

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

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

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

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

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

38. 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?

Generally speaking, the reasons why individual investors may find it challenging in practical terms to redeem directly with the ETF arise mainly due to the operational challenges imposed by the Central Securities Depositories (CSDs) which clear the shares of an ETF, which are listed on exchange (and are not due to restrictions imposed by the ETF itself). By way of example, in order for an investor to be able to return ETF shares to a UCITS ETF through a clearing system, most CSDs require such an investor to be a clearing member or to use a clearing member to do so. As most individual investors are not clearing members of CSDs, they will need to redeem their shares through a clearing member (which is usually a financial institution or company). For a UCITS fund to process redemption applications directly from individual investors who are not able to return their shares to the UCITS fund through the relevant CSD would be operationally complicated. To add to the complication, the investor may not be the legal owner on the share register of the UCITS fund which could make the tracking of the shares to be redeemed more challenging. For example, the legal owner could be the nominee of the CSD through which the shares are held, a custodian bank or a nominee company etc.

This is not dissimilar from other UCITS structures whereby investors who wish to redeem their units in the fund have to do so using a distributor, for example the distributor through which they initially subscribed for their units. Spreads between the NAV and trading price on exchange for ETF shares are usually kept tight by the activities of market makers. Market makers would carry out arbitrage if there are spreads between the trading price of the ETF shares and their NAV by purchasing ETF shares on exchange to redeem directly with the ETF when the ETF shares are trading at a discount to the NAV, or subscribing for shares from the ETF to sell on exchange when the ETF shares are trading at a premium to their NAV on exchange. Such arbitrage activities would tighten spreads of ETF shares trading on exchange as well as provide liquidity.

By way of general comment, where there are multiple parties making markets for an ETF, this would increase competition among market makers, tending to reduce spreads, and likely enhance overall liquidity. Multiple market makers provide alternatives to investors in the event a market maker experiences operational difficulties or chooses to limit its risk exposure during market volatility. Short of a catastrophic global event occurring, the chances of every single market maker in a multi-market maker model refusing to make a market or carry out arbitrage for its own profit would be extremely rare. If there were a catastrophic global event which impacts on the ability of ETFs to calculate their net asset values (NAV), it is likely that ETFs generally would have no choice but to suspend trading in any event. If this were a longer term event, to the ETF manager may need to determine how best to enable investors to exit the fund. Conversely, where an ETF is dependent only on one market maker (for example, where the sole swap counterparty in a synthetic structure is also the sole market maker), the potential risk of liquidity on the secondary market evaporating would be higher. Further, if a sole market maker is affiliated with the sole swap counterparty and the group of companies of which they are a part experiences financial difficulties, it is likely that the sole market maker would seek to limit its secondary market exposure at the same time that investors seeking to limit their exposure to the swap counterparty need liquidity.

In response to the specific questions, **secondary market investors should have a right to request direct redemption of the units which they legally own (i.e. where they are the shareholder of record) from the UCITS ETF (question 36) and this right should be limited to circumstances where market makers cease to provide liquidity in the units of the ETF for an extended period (question 37).**

IV. Structured UCITS

I. Total return swaps

39. Do you agree with ESMA's analysis of the issues raised by the use of total return swaps by UCITS? If not, please give reasons.

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

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

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

In considering Total Return Swaps (TRS), as any other financial derivative instruments, **the collateral received by the UCITS in connection with the TRS should therefore comply with the principles laid down in the UCITS collateral diversification rules, but need not necessarily adhere to the specific risk diversification limits for direct investments held by UCITS.** As mentioned above, this should help to maintain flexibility in respect of the provision of collateral and help ensure that any collateral provided is of high quality rather than having to take collateral that is perceived to be of a lower quality just to comply with specific diversification limits (see also our response to question 18 above).

We do not believe it is appropriate that a swap-counterparty should be appointed as an investment manager for a fund. We believe that this raises regarding the role and obligations of the swap counterparty and may mislead investors. We also believe the TRS counterparty would be under a conflict of interests when choosing (and replacing) the assets which should serve to mitigate the UCITS's risk of a default by the counterparty.

We do not believe that there are any other issues in relation to the use of total return swaps by UCITS that ESMA should consider.

II. Strategy indices

43. Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.
44. How can an index of interest rates or FX rates comply with the diversification requirements?
45. Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?
46. If yes, can you suggest possible actions or safeguards ESMA should adopt?

We believe that the policy orientations should apply to all indices, not only strategy indices. We are otherwise broadly in agreement with ESMA's policy directions for strategy indices.

In relation to an index which comprises an interest rate hedge or a currency hedge component, the risk diversification rules should be applied only to the main underlying investments and not to the notional of the interest rate hedge or currency hedge. The notional amount of such hedge would be represented by underlying investments which provide the main exposure that the index is seeking to provide.

For an index of interest rates or FX rates, the risk diversification rules should not be applied to the index itself. Instead, the underlying investments held by the UCITS fund to track the performance of the index that should be risk diversified."

We have one comment with regard to the policy directions for the use of Hedge Fund Indices. The requirement to carry out due diligence on both the index and more importantly, its components, (as set out in the fourth additional guidelines for hedge fund indices from CESR) could suggest that there is some degree of discretion to be applied by the UCITS as to the components of the index. **Clarification should be provided that this additional guidance does not override the principle requirement that the index be based on a set of pre-determined rules and objective criteria.**