

CONSULTATION RESPONSE



ESMA's policy orientation on guidelines for UCITS Exchange Traded Funds and Structured UCITS

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Which? is an independent, not-for-profit consumer organisation with around 1 million members and is the largest consumer organisation in Europe. We have a long and successful track record of campaigning for improvements in financial consumer protection.

Q1: Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.

Q2: Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria could be used to determine which UCITS should be considered as 'complex'?

Q3: Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

Yes we believe that ESMA should explore common approaches to the issue of marketing of these products to retail investors. Sales of these products are growing strongly and these products are increasingly being marketed to retail investors. According to fund manager BlackRock, total assets invested in ETFs in the UK grew to \$93.4 billion in 2010, a 49% increase on 2009. In the UK, the reforms implemented at the end of 2012 as part of the Retail Distribution Review are likely to result in further increases in the sale of these types of products. These changes will prohibit the payment of commission by product providers to financial advisers and intermediaries for 'advised sales' of investment products. ETFs have never paid commissions to intermediaries and so will be expected to gain market share at the expense of products which previously paid higher levels of commission. Already, some companies have entered the UK market offering low-cost portfolios built purely on ETFs. We published an article in the May 2011

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issue of Which? money magazine, attempting to explain ETFs and to highlight the possible downsides and risks associated with synthetic structures.¹

With regard to concerns about Exchange Traded Funds, UK consumers could be purchasing a financial product manufactured in Luxembourg or Ireland, managed from Paris and listed in London, with potential exposure to swap counterparties located elsewhere. This means that it is vital that action is taken at a European level to control the risks from these products. We broadly welcome the proposals but believe that they need to go further in a number of areas. In particular, we would highlight that whilst disclosure about ETFs is important, it does not provide an appropriate substitute for action to eliminate conflicts of interest and set clear product standards.

Disclosure surrounding risk characteristics, counterparty issues, collateral baskets and securities lending is unlikely to be understood by the average retail investor. We question whether retail investors are able to exercise an 'adequate level of scrutiny and due diligence on collateral selection and arrangements'². Furthermore, practices and the collateral provided to back synthetic ETFs could change and it is not clear that sufficient timely disclosure of these changes would be provided. If disclosure is to be the preferred policy, then the burden of proof should be on the industry to prove that retail investors are able to understand and act on this information and that this will lead to an improvement in market practice.

We believe the following policy proposals should be considered:

Universal agreement of terminology and clear labelling of synthetic/leveraged and inverse ETFs: Currently, there is no clear way consumers can identify riskier synthetic and leveraged/inverse ETFs. It is vital that this distinguishes between 'synthetic' and 'physical' ETFs and that this distinction is included in the fund name. Leveraged and inverse ETFs which rebalance daily and are not suitable for long-term holding should have the word 'daily' in the fund name. This will increase the effectiveness of any warnings issued by consumer groups and regulators for less sophisticated investors to avoid or to take greater care regarding certain types of product. There should also be much clearer labelling that in the event of default consumers do not have recourse to a guarantee scheme such as the UK Financial Services Compensation Scheme

¹ Submitted alongside this consultation, 'Getting on the right track', Which? money, May 2011

² FSB, Potential Financial Stability issues arising from recent trends in Exchange Traded Funds, page 4



Restrictions on conflicts of interest within ETFs: We see a clear risk of a conflict from the dual role of a single bank as the ETF provider and derivative counterparty. This should be prohibited.

Further restrictions on collateral management policies: We support further restrictions on the collateral provided to back synthetic ETFs. We believe ESMA should pay particular attention to avoiding situations where the collateral provided to back ETFs which are intended to track safer assets such as Government bonds is made of assets which may carry far higher liquidity and quality risks than the index being tracked.

Guidance provided to intermediaries regarding how they should provide advice to invest in ETFs and the concentration of counterparty risk within an investor's portfolio: Advisers and intermediaries will provide growing access to ETFs to their customers. We believe regulators should work together to issue guidance to these intermediaries about how they should consider the risks arising from ETFs to help ensure that they provide suitable advice to retail investors.

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

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

Q6:Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union? If not, please give reasons.

Q7:Do you agree that ESMA should also discuss the above-mentioned issues with a view to avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.

Yes we agree that ESMA should discuss issues relating to products which could be structured and issued as notes by credit institutions or Special Purpose Vehicles. Which? has expressed our concerns about the characteristics of these products, the financial promotions and the sales/advice practices.

We are particularly concerned about occasions where the name of these types of products includes the terms 'guaranteed', 'protected' or 'secure'. For example, a product was being sold by a major UK bank which was called a 'Guaranteed Capital Plus' plan with the return linked to the performance of a stock index. However, the product actually involved the consumer taking credit risk and the consumer would lose money if the bank defaulted. We have reported these



concerns to the regulator. We are concerned that buyers of some of these structured products think they are taking market risk, where as they are actually taking highly concentrated credit or counterparty risk. Our mystery shopping in 2008 uncovered risk-averse consumers who told the bank that they did not want to take any risk with their capital being advised to invest a substantial proportion of their portfolio (50-80% in some cases) in these types of products.

In the UK, buyers of a so-called 'Secure Income Bond' from a UK building society were actually purchasing bonds issued by a Special Purpose Vehicle based in Luxembourg with the proceeds used to purchase life insurance policies in the US.³ For some consumers these products represented a substantial proportion of their total portfolio.

The FSA has now issued guidance to intermediaries which include specific trigger points for exposure to risk from a single counterparty which raise questions about whether the advice is suitable. We believe that regulators should take a similar approach of issuing guidance to intermediaries regarding possible counterparty or collateral issues from ETFs and what actions those intermediaries need to take to ensure that the advice they provide to consumers to invest in these products is suitable.

Exchange Traded Funds - Title

Q8:Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.

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?

Yes, we agree that UCITS ETFs should be required to use an identifier. This should be included in their name, fund rules, prospectus, marketing material and Key Investor Information Document. It is vital that this distinguishes between 'synthetic' and 'physical' ETFs and that this distinction is included in the fund name. This will increase the effectiveness of any warnings issued by consumer groups and regulators for less sophisticated investors to avoid or to take greater care regarding certain types of product. We suggest that ESMA looks not only at exchange traded

³ http://www.fsa.gov.uk/pubs/final/norwich_peterborough_building_society.pdf



funds but the full spectrum of exchange traded products (ETPs), such as exchange traded notes (ETNs) and exchange traded commodities (ETCs).



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?

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

In addition to the issues raised we believe that all inverse and leveraged ETFs which rebalance daily and do not provide effective tracking over longer periods should be required to include the word 'daily' in the name of the ETF. We also believe that they should also avoid the phrase 'tracker' in the name as this may give the impression to consumers that they are designed to track the index (by providing the inverse or a multiple of the return) over longer periods.

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.

Which? has concerns about synthetic ETFs. Credit Suisse ETF, DB X-trackers, Lyxor and Powershares only use one counterparty; for the first three it's their parent companies, Credit



Suisse, Deutsche Bank and Societe Generale respectively. There is a clear risk of a potential conflict of interest if the swap counterparty, custodian or collateral manager is connected to the ETF provider.

We agree that provisions on the quality and type of assets constituting the collateral should be further developed and that there should be a requirement for the quality and type of assets to match more closely the relevant index. In the event of a counterparty default, investors could otherwise find themselves relying on the sale and value of collateral which provided little or no match to their original investment objectives. The collateral received by the ETF should also be required to comply with diversification rules.

We are concerned that the collateral provided for some synthetic ETFs consists of a significant proportion of corporate bonds issued by other banks.⁴ It is likely that in the event of a default by the swap counterparty (likely to be a major bank) the price of corporate bonds issued by other banks is likely to be negatively affected. This would be a particular concern for consumers if they suddenly found themselves subject to the investment performance of this type of collateral when the ETF they originally invested in was designed to track the performance of a higher-quality asset class such as Government bonds. We would support a requirement for the collateral provided to be required to be correlated to the investment objective of the ETF.

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.

⁴ For example on 19th September 2011 of the collateral provided to back the Lyxor ETF iBoxx £ gilts, 20% consists of a bond issued by Bank of Scotland plc and 9.3% consists of a bond issued by Dexia Credit Local.



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 broadly agree with ESMA's analysis of the issues raised by securities lending. We support additional rules on the collateral received by UCITS as part of securities lending transactions. However, we express similar concerns as those expressed above with regard to the effectiveness of disclosure of securities lending activities leading to pressure from retail investors for improvements in practices.

Actively-managed UCITS ETFs

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

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

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

Yes, we agree with ESMA's proposed policy orientations for actively managed UCITS ETFs.



Leveraged UCITS ETFs

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

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

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

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

Inverse and leveraged ETFs are only likely to be suitable for a tiny minority of investors. The addition of a clear identifier in the ETF name will help increase the effectiveness of any warnings issued to retail investors about these products.

We believe that all inverse and leveraged ETFs which rebalance daily and do not provide effective tracking over longer periods should be required to include the word 'daily' in the name of the ETF. We also believe that they should also avoid the phrase 'tracker' in the name as this may give the impression to consumers that they are designed to track the index (by providing the inverse or a multiple of the return) over longer periods.



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 UCITS ETF?

Q38:How can ETFs which are UCITS ensure that the secondary market value of their units does not differ significantly from the net asset value per unit?

We are concerned that secondary market investors could suffer detriment if liquidity in the ETF market is absent when they need to trade their shares. They could suffer detriment if this results in a widening of the bid/offer spread. At times of market stress there could be a significant divergence between the price of the ETF and the ‘true value’ of the index they track.⁵ We believe that ESMA should examine whether its proposal has the potential to increase liquidity in ETF markets at these times.

⁵ ETF arbitrage; Marshall, Nguyen, Visaltanachoti, November 2010

