



SCM PRIVATE

Response to Discussion paper

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

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Background

SCM Private LLP are not affiliated to any single ETF manufacturer but simply build ETF only portfolios on behalf of individuals and institutions. The sector is regulated by the FSA within the UK.

For the ESMA's recommendations to genuinely help retail investors rather than it is imperative that EXACTLY the same standards are applied to ALL retail funds rather than just ETFs in order to have a level playing field. For example there have been wholly misleading and misguided comments recently by a senior UK regulator questioning the suitability of synthetic ETFs for retail investors. However, no mention whatsoever was given by the individual about the suitability of either physical ETFs or mutual funds involved in the similarly "opaque" and "risky" area of stock lending. Nor has there been any comparison given by the same senior regulator over misleading labels which are still attached to significant areas of the UK mutual industry e.g. Absolute Return funds or significant complex investment activities e.g. shorting or leverage that takes place within many UK retail funds or the frequently dangerous concentration of exposures, or closet index tracking which are all common within the UK mutual fund industry.

It is imperative that ESMA does not fall into the UK regulatory trap of "not seeing the wood for the trees". If it genuinely wants to help the end investor improved transparency and disclosures are urgently required but not just for ETFs but for mutual funds too where standards are (at least in the UK) shockingly poor helped by the amateurish and consumer unfriendly self-regulation of the UK investment industry by the Investment Management Association.

Overall in terms of cost, transparency, risk and performance standards within the ETF industry are miles ahead of the mutual funds equivalent. There is no harm raising the bar and improving standards further but the same standards should be set on the much larger mutual fund industry which has been allowed to be ignored by regulators so far. To date

there have actually been no ETF mis-selling or mis appropriation scandals unlike the UK mutual fund industry which has often suffered from mis labelling, mis management and mis selling as recently evidenced by the £400m+ Cru fiasco in which a fund investing in African private equity was allowed by the FSA to offer investors daily dealing and by the IMA to be described as “cautious balanced”. If improved transparency and disclosures and labelling was introduced to all retail funds rather than just ETFs it is much less likely that such scandals will continue.

We note that, on the basis of responses received to the present discussion paper, ESMA proposes to come forward with a consultation paper on proposed guidelines for UCITS Exchange-Traded Funds and structured UCITS. While we would, in principle, support such an initiative, we believe it is important that ESMA takes full account of the work of the International Organisation of Securities Commissions, which we understand is due to publish early next year a draft framework for regulating Exchange-Traded Funds worldwide. We would urge ESMA to allow due time for discussions to unfold at international level before taking any decisive position on the future framework at European level.

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?

NO unless similarly complex mutual funds are required to meet the same new standards. Instead on limiting distribution it is much better to explain the risks to investors so they can choose, but based on a clear label which explains the particular investment and its associated risks. The definition of “complex” is of course arbitrary and bound to be defined in a partisan and uneven manner. In a free market the investor should be able to choose what suits them subject to clear labelling and clear transparency. There is no evidence whatsoever that by allowing a “professional” to make such decisions actually improves the outcome and will necessarily increase the cost for investors. Nobody bans various sectors of the listed share market e.g. speculative mining stocks as being too risky for retail investors. They are allowed to buy or sell any share as they choose. They are allowed freedom here – why can’t the same principles of freedom apply when they want to buy more speculative ETFs?

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’?

No for reasons outlined above. The important issue is to explain to investors how the UCITS portfolio management techniques are employed and the risks attached.

Which criteria could be used to determine which UCITS should be considered as ‘complex’?

None as this is a game not worth playing as outlined above as it will lead to higher costs without significantly protecting or helping the investor. For example 50% of mutual funds

currently participate in stock lending thereby involving counterparty and collateral risk. One could easily view this as complex, yet as long as the practise is undertaken properly and the risks and procedures and details explained properly to investors, it can benefit the investors. It would be easy to arbitrarily decide what is deemed to be complex without ensuring that the same issues are applied equally across the board and without questioning the fundamental question as to whether or not investors benefit from such techniques.

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?

The best policy is education through clear warnings but these warnings need to apply to all retail products not just ETFs. Such warnings should be clear and consistent and applied uniformly e.g. method of index tracking, level of concentration, hidden significant costs (e.g. large turnover related dealing costs), counterparty and collateral risks etc.

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

N0, however regulators must ensure clear, transparent, and objective labelling of fees, strategies and risks across all funds rather than just ETFs.

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

There is much more systematic risk within mutual funds as these have often significant counterparty, collateral and liquidity risks within the much larger mutual fund industry which currently have not been addressed by international bodies. For example there is often a significant liquidity mis-match between the investments in many mutual funds which price daily but where many of the investments are illiquid. Were there to be a major financial crash and investors decided en masse to sell many of the much larger retail funds the substantial amount invested in less liquid securities and the concentration of many individual shares through a handful of institutions could easily pose systemic risk. There are currently no controls which force managers to ensure funds have a liquidity match between their investments and their investor dealing terms. If a number of large mutual funds were to face substantial redemptions they would be forced to sell often 10-20% of the shares of particular companies, thereby causing a collapse in those companies.

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.

Yes without these recommendations being applied to all retail products NOTHING will have actually been achieved. In fact there is a severe danger that unwittingly investors will be more likely to buy less safe, less transparent, less well performing products as a result through selling their highly regulated UCITS retail fund to buy an un-regulated non UCITS

fund available to retail investors. For example the UK spread betting industry has significantly higher leveraged products and counterparty and collateral risk than exist today within almost any mutual fund or exchange traded fund.

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 definitely. Either do it properly or not at all. ETNs (Exchange Traded Notes) are highly dangerous and yet retail investors think they are being offered the same protections as are prevalent within ETFs.

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

Yes this is a good idea.

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

All that retail investors' need is to be able clearly to understand how the investment works and any related potential risks. All that is needed, therefore, is a simple template covering the fees, strategies and risks of each investment product.

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

NO

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

YES

Q12:Do you agree with the policy orientations identified by ESMA for index-tracking issues?

Yes

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?

Yes

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

No

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

No

Questions to stakeholders

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

Yes provided equally full and detailed disclosures are given regarding stock lending within all mutual funds and physical exchange traded funds in which the exposure to stock lending, the counterparties and the collateral are fully disclosed by fund on a daily basis.

Q17:For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.

Yes there should be a mandatory minimum collateral of 100% with set percentages to different categories (e.g. 120% for equities, 100% for AAA rated government bonds etc) and set minimum quality requirements. The same should apply to all counterparties, for example by requiring a minimum A2 S&P credit rating. It would be preferable that a minimum of collateral assets was in the same index which the ETF tracks, say 50% but such policy would need to be used in the stock lending industry whereby no more than 50% of a portfolio can be lent out. Otherwise a physical etf or mutual fund could have a higher mismatch of the assets actually held than its equivalent synthetic ETF.

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

Q19:Do you agree with ESMA's analysis of the issues raised by securities lending activities?

Yes

If not, please give reasons.

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

Yes. However details of stock lending in terms of the precise amount, the actual lenders and the actual collateral needs to be disclosed by fund and daily in order for investors to properly judge the risks associated with such activities.

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.

Yes – in particular the current FSA standards in the UK are exceptionally poor as they allow up to 100% of a portfolio to be lent out, risks only to be disclosed in prospectuses rather than all marketing materials, no prescribed credit criteria for lenders and no prescribed credit criteria for collateral in which more risky/volatile assets are required to have significantly higher than 100% daily cover.

Q22: Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral? If not, please give reasons.

Yes

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?

Yes certainly.

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

There is a significant conflict of interest whereby the manager can receive a share of the stock lending income without any exposure to any associated stock lending losses. Unless the manager acts as first guarantor of any stock lending losses they should not be allowed to take a share of the stock lending revenues. Otherwise there will always inevitably be a conflict between what is best for investors and what is best for the managers.

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

The safeguards should be:

1. Max 50% exposure to stock lending
2. All marketing materials to disclose key information and risks attached to stock lending
3. All funds to daily disclose largest counterparties and all collateral lodged against assets
4. The precise amount retained by the fund after fees of stock lending income to be disclosed.
5. Stock lending to be only permitted where the manager or a third party with a minimum credit rating of A2 has separately acted as first guarantor over any losses incurred through stock lending.

Q26: Do you agree with ESMA's proposed policy orientations for actively managed UCITS ETFs?

Yes however subject to similar disclosures by all UCITS mutual funds on the main sources of risks due to investment strategy otherwise you could have an identical fund with different disclosures to ETF investors than their mutual fund investors. Again there should be similar rules by all mutual funds (index or active) indicating level of portfolio transparency and where details of the underlying portfolio can be obtained.

If not, please give reasons.

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

No

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

III.VI. Leveraged UCITS ETFs

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

Yes

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

Yes

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

No

Q33:Do you support the policy orientations identified by ESMA?

Yes it is a good idea provided that a sensible way of implementing such a policy efficiently and simply can be found. For example if one bought an ETF via the market rather than through the manufacturer direct, how would it work in practise if one wanted to sell back that ETF directly to the manufacturer?

If not, please give reasons.

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

See above

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

No

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?

Yes subject to costs not being significant, maybe there should be a fixed administration charge agreed otherwise there would effectively be a cross subsidy between those investors using such a mechanism and the others dealing via the market.

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?

No should be at all times subject to above

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?

By encouraging a number of market-makers and by allowing investors to deal direct at NAV.

Questions to stakeholders

Q39:Do you agree with ESMA's analysis of the issues raised by the use of total return swaps by UCITS? If not, please give reasons

Yes

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

Yes

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

No

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

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

Yes

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

I have no strong views on this.

Q45:Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

No

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

NA