



The International Securities Lending Association

4 Lombard Street
London EC3V 9AA

European and Securities Markets Authority

(submitted via www.esma.europa.eu under 'Consultations')

22 September 2011

Dear Sirs

ESMA's policy orientations on guidelines for UCITS exchange-traded funds and structured UCITS

We refer to your above discussion document and thank you for the opportunity to comment.

The International Securities Lending Association (ISLA), represents the common interests of lenders and borrowers of securities internationally. ISLA has more than 90 members comprising insurance companies, pension funds, asset managers, banks and securities dealers representing more than 4,000 clients. While based in London, the Association has members from more than 20 countries. ISLA has an elected Board of twelve industry professionals from all parts of the industry. Full details of ISLA and its membership may be found on our website [www.isla.co.uk].

ISLA is a member of a committee of industry experts based in the UK, the Securities Lending and Repo Committee (SLRC), which was set up under the auspices and chairmanship of the Bank of England in 1989. SLRC maintains a Code of Good Practice and has sponsored and published a number of explanatory documents and booklets¹, designed both for market practitioners but also those who have little or no experience of SL. A number of our members have sponsored translations of certain of these documents for use in their home countries in Europe.

Given the focus of our Association, we will confine our comments to Section III.IV which relates to Securities Lending.

¹ Please see <http://www.bankofengland.co.uk/markets/gilts/slr.htm>

Executive Summary

Securities lending is a well established and highly regulated investment activity and, as is the case with many other institutional funds within the EU and elsewhere, is widely undertaken by UCITS ETFs. Most national regulators have implemented their own rules that govern which entities can engage in securities lending, and certain additional criteria such as eligible counterparties and collateral. The UCITS Directive itself also contains comprehensive provisions covering securities lending and we do not believe that additional regulatory restrictions or measures are generally necessary as these provisions have proved fit for purpose over a period of market disruption . The various iterations of the Directive have been implemented by major UCITS fund regulators such the Central Bank of Ireland and Commission de Surveillance du Secteur Financier in Luxembourg to ensure that securities lending is undertaken with regulated counterparties, that collateral received meets minimum standards of credit risk and liquidity and is marked to market daily. The more recent CESR Guidelines on Risk Measurement further ensure that any risk from securities lending is controlled and restricted, by ensuring that any net exposures or cash reinvestment exposures are included within the UCITS's global risk limits. Whilst many ETFs disclose their securities lending policies in their prospectus or other product documentation, we support proposals to require such disclosure as per our answer to Q20 below.

The paper notes the Financial Stability Board's interest in securities lending. We are following this work closely and are engaged with the FSB process. We do not believe that securities lending, conducted in accordance with best practice, gives rise to any form of broader systemic concerns, however we welcome the FSB's interest in the matter as a potential mechanism for ensuring a consistent approach to the regulation of securities lending around the world.

We understand that this response may be published on your website and would be happy to discuss our responses in further detail if you wish.

Yours sincerely

A handwritten signature in dark ink, appearing to read 'Kevin McNulty', with a long horizontal stroke extending to the right.

Kevin McNulty

Chief Executive

Answers to specific questions

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

In general we agree with your overview, which could equally apply to most, if not all, other types of securities lenders. We are not convinced however that securities lending by ETFs gives rise to any particular systemic risks as noted in paragraph 37. Whilst ETFs have grown significantly in size in recent years, their participation in the securities lending market is still dwarfed by other types of lenders. It is, we believe, essential that ETFs are not subject to unnecessary constraints which are not also imposed on competing funds and products. Whilst we have no comment on the rules that might be applied to synthetic ETFs, we believe there is a risk that additional regulation of securities lending within ETFs (such as limiting the amount of lending that can take place) could result in physical ETFs being disadvantaged. We can see no reason why ETFs should be treated in a different fashion to other investment vehicles or, for example, pensions funds. The risk management criteria are sufficiently robust to ensure that ETFs can safely engage in securities lending on equal terms with other products.

Securities lending is practised by a very large number of funds/investors. We believe that our members, mostly through the global custodian agent lenders, represent some 4000 lenders who all derive useful income from lending which either defrays the costs of managing their funds or acts to enhance investment returns and performance.

In addition, securities lending is a vital component of global markets, not only ensuring that settlement success is enhanced but also allowing investment banks and market makers to hedge their risks and otherwise operate in the interests of a deep, liquid market with improved price discovery and trading at fair value. It is, we believe, essential that securities lending continues to be encouraged by the authorities and that potential sources of supply, such as the subjects under discussion, are not discouraged or otherwise disadvantaged in this activity.

We note that securities lending has over the years been encouraged by the authorities as a vital component of the market.

We would also note that the activity has proved the robustness of its overall *modus operandi* through the financial crisis which commenced with the demise of Lehman Brothers.

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

- We agree in principal with the majority of the policy orientations proposed.
- The proposals for information to be included in the prospectus are acceptable. We believe that it is important that potential investors should be aware of how funds are managed and this would include the funds policies with regards to securities lending. An important aspect to achieve this is to ensure that the prospectus is not unduly long thereby increasing the risk that it is not actually read and we would recommend that

disclosures are based upon a description of general policies. There may be some benefit in developing a generic description of securities lending which would only need tailoring for specific aspects, if any, and ISLA would be willing to help with this.

- The proposal to describe collateral policy is acceptable
- Similarly, details of fee sharing arrangements are acceptable
- We note that the above proposals only relate to the prospectuses. Would it be the intention to have similar requirements for the annual reports? (We believe that this is already a requirement in Ireland and Luxemburg)
- Disclosure of any connected companies in the securities lending chain is acceptable, provided this is merely a statement of the fact, rather than any proposal to restrict such arrangements.
- Whilst we agree with the majority of the proposals for permissible collateral, those for the reinvestment of cash collateral are far too restrictive. An interpretation of the policy orientation is that it would restrict cash collateral reinvestment to G10 government bonds only. Whilst there are certainly risks involved in the reinvestment of cash, this restriction would render cash collateral as commercially non-viable and we do not believe this to be the actual intent of the proposal.
- The risk management requirements contained in UCITS Directive for securities lending are very comprehensive and impose ongoing requirements on the management of the funds. We consider that the collateral requirements should be controlled within the remit of these general risk management rules. Thus, provided a particular line of collateral falls within the general policies of the fund, it should be deemed permissible. The collateral mandate should not be allowed to distort or materially alter the risk profile of objectives of the fund.

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.

Subject to our comments above, we consider your proposals to be sufficient.

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.

We do not. Please see our answer to Q20 above.

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?

No. We see no reason to restrict the amount of a portfolio that can be lent. There are comprehensive regulations within the UCITS directive dealing with risk management and the calculation of risk within a UCITS fund. Provided that the overall securities lending

exposure falls within the policy parameters set out by the directors, there is no reason to impose further restrictions. We would also note that collateral is invariably provided for securities loans and this must be sufficiently liquid and easily saleable at a price close to the latest mark to market valuation.

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

No