

22 September 2011

ESMA
103 Rue de Grenelle
75007 Paris
France

Dear Sir/Madam

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

IMA represents the UK-based investment management industry. Our Members include independent asset managers, the investment management arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of over €4 trillion of assets, which are invested on behalf of clients globally. In particular, they manage both retail funds (UCITS and non-UCITS) and institutional funds.

We welcome the release of a discussion paper covering ETPs which recognises that most, if not all, ETPs in Europe are UCITS and are therefore subject to detailed rules. Our responses to the individual questions are attached and we have a number of general remarks.

We are surprised by some of the policy orientations identified by ESMA as we believe that a number of the proposals are already required under UCITS. However, it is for national regulators to ensure compliance with these requirements.

We do not understand the justification for singling out certain types of UCITS and not covering other retail investment products with similar underlying investment strategies, such as non-UCITS exchange-traded products. In the interests of retail investors, it is extremely important that all retail investment products are subject to similar constraints and obligations.

We question why regulators are concerned about "complexity" in retail products or what evidence there is of market failure. Complexity does not necessarily equate to risk and sophisticated investment strategies often mean less risk for investors.

We believe the position of UCITS is absolutely clear; namely, in accordance with MiFID, UCITS are non-complex products.

UCITS products are uniquely subject to detailed product regulation and a critical feature of UCITS regulation is the focus upon governance and separation of roles of the parties

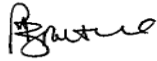
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responsible for the oversight and management of the activities and the assets. We strongly believe that regulatory intervention should be taken only where there is a clear market failure and supporting cost/benefit analysis.

However, we recognise that investment strategies have developed over time and that it might be timely to review the rules in certain areas. Any matters should be considered for all retail investment products.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Perry Braithwaite', written in a cursive style.

Perry Braithwaite
Adviser – Product Regulation

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

Retailisation of complex products

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.

If regulators have concerns about the use of certain types of investment strategies in products sold to retail investors, then we urge that these be looked at in the round. We do not understand the policy justification for singling out certain types of UCITS and not covering other retail investment products with similar underlying investment strategies, such as non-UCITS exchange-traded products. It is important that all retail investment products are subject to similar constraints and obligations. ESMA cannot justify imposing yet further constraints and disclosures on UCITS but not on other retail products.

In relation to UCITS, regulators and the industry have only begun the implementation of UCITS IV, which included extensive work on development of the KIID. In particular, "structured" UCITS are now subject to specific additional disclosures in the KIID. It may be that there is some merit in extending this approach to other types of UCITS. This might include "synthetic ETFs". But "synthetic" strategies would need to be clearly defined, and we would wish to understand why exchange-traded synthetic UCITS would be differentiated from non-exchange-traded synthetic UCITS.

As to the second part of the question, in relation to UCITS it is important to bear in mind that these products are uniquely subject to detailed product regulation. The EU created UCITS as an investment brand for retail investors, to be marketed freely cross-border. UCITS are subject to requirements designed specifically to ensure a prudent spread of risk and in a restricted set of assets. Even if the view is taken that some UCITS are internally complex (whatever that might mean), a critical feature of UCITS regulation is the focus upon governance and separation of roles of the parties responsible for the oversight and management of the activities and the assets.

It is the overall UCITS framework that makes UCITS appropriate for purchase by retail investors. They are the EU's non-complex retail investment vehicle. We strongly believe that regulatory intervention should be taken only where there is a clear market failure and supporting cost/benefit analysis.

Therefore we believe the position of UCITS is absolutely clear; namely, in accordance with MiFID, UCITS are non-complex. This reflects the will of the Commission, Parliament and the Council. MiFID was finalised a number of years after the UCITS III Product Directive was finalised, so the wider investment powers set out in UCITS III were clearly in the contemplation of the above-mentioned bodies when they took the decision to treat as non-complex all UCITS. We can see no reason for bringing into question the decision taken by those bodies at that time. To ignore the UCITS governance structure and to equate a UCITS with any arrangement mirroring an exposure to the same investments (such as by a structured bond exposure) would be misleading.

However, we are strong proponents of transparency in financial products. In particular, it is right that information provided to retail investors should be fair, clear and not misleading. We therefore welcome ESMA's proposed approach of further improvements to UCITS disclosure rules for certain types of UCITS.

This approach must, though, be applied to all types of retail investment products. To do otherwise widens the scope for regulatory arbitrage and investor detriment.

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'?

Concerns expressed about collateral requirements, stock lending, conflicts of interest/governance structure, and ETF redemption arrangements and liquidity may merit further discussion but should not be regarded as relevant factors in any definition of "complex".

Equally, the use of derivatives in a fund should not in isolation be used to determine whether a fund is complex. Fully-backed, exchange-traded derivative positions can be less risky, be more liquid and more efficiently and accurately express an investment view than the physical equivalent.

Also, and very importantly in the context of this debate, complexity does not necessarily equate to risk. Sophisticated investment strategies often mean less risk for investors (in terms of expected return of investment). Many retail investors with modest sums to invest are seeking products that limit down-side risk at the cost of a reduction in up-side return. Such outcomes cannot be achieved without the use of derivative strategies or guarantees, neither of which are "simple".

Again, we question why regulators are concerned about "complexity" in retail products or what evidence there is of market failure.

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 UCITS framework provides a range of investor protection safeguards designed precisely so that any UCITS can be made available to retail investors (see response to second part of question 1). We question on what basis ESMA now believes that some UCITS are "inappropriate". It may be that certain UCITS are appropriate for investors with a particular risk-return appetite, while others are more appropriate for a different set of investors who have a different risk-return appetite.

Also, why single out UCITS?

We do, though, support an approach involving more consistent application between different national regulators of the current disclosure requirements for UCITS (in the prospectus) and the possibility of extending the KIID requirements for structured UCITS to certain other types of UCITS strategies.

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

No. UCITS are UCITS. See response to second part of question 1.

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

We do not believe that there are any other issues. We would emphasise, however, that most of the papers issued in recent months by different authorities fall into the trap of using the acronym "ETF" to cover all types of ETPs, including structured banking products and funds that are not UCITS. Great care needs to be taken when drawing on or drawing conclusions from those analyses as regards exchange-traded UCITS.

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.

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.

Categorically, yes. It is essential that all retail investment products are subject to similar rules on disclosure and on marketing/selling. We remain a strong supporter of the Commission's PRIIPs initiative and are very concerned both that the initiative is being fragmented and that it appears to be being given a lower priority than it so clearly warrants.

Exchange Traded Funds

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?

The suggestion of establishing some form of mandatory identifier is worth pursuing. We would emphasise though that it is as important that non-UCITS exchange-traded products be banned from using that identifier as it is that exchange-traded UCITS use it. It is the use of the acronym "ETF" by or about ETPs that has caused investor confusion.

We suggest that other distinctions between different types of UCITS strategies should be handled via the KIID.

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?

We are surprised by some of the policy orientations identified by ESMA as we believe that a number of the proposed disclosures are already required to be in the prospectus and report & accounts. That is certainly the case in the UK.

Moreover, the disclosure requirements should apply to all index-tracking UCITS, not just those that are exchange-traded.

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

We question ESMA's description of tracking error. We understand that tracking error is defined as the annualised standard deviation of the difference in returns between the fund and the index although it can be calculated in a number of ways. Requiring tracking error to be disclosed in the prospectus and/ or KIID without there being some standardisation of the way or ways in which it is calculated will at best be meaningless and at worst (and most likely) cause additional confusion for retail investors. In addition, stating a maximum tracking error in fund documentation may imply a guarantee that is not the case.

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.

As stated above, we believe that a number of the policy orientations identified by ESMA should already be a requirement e.g. the disclosure of counterparty risks. For example CESR's Guidelines on Risk Measurement for UCITS states that collateral should be diversified (Box 26). There are already quite stringent collateral requirements for UCITS, including UCITS ETFs. It is as much for regulators to ensure that national rules follow UCITS requirements, as it is for the industry to ensure compliance with those rules.

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

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

Securities lending activities

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

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

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.

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?

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?

Details of securities lending and the risks involved should already be disclosed in the prospectus as well as levels of fees earned. Again, these are already requirements in the UK for all UCITS.

We agree that the collateral received should comply with the criteria for OTC Derivatives in CESR's Guidelines.

Securities lending requirements should at least cover:-

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

We do not believe that a cap on the amount of a UCITS portfolio that can be lent as part of securities lending arrangements is necessary.

Actively managed UCITS ETFs

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 agree with ESMA's proposed policy orientations but would note that the fact that a UCITS is actively managed should be clearly stated in all fund documentation. The risks should also be clearly stated.

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

Leveraged UCITS ETFs

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

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

We agree with ESMA's analysis of the issues raised by leverage.

We suggest ESMA builds on the current KIID provisions for "structured" UCITS i.e. that KIIDs for certain types of UCITS should be longer in order to enable additional disclosures to be made.

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?

It is a fundamental tenet of UCITS that all investors should be able to redeem directly at NAV. In any case, we agree that ESMA should clarify exactly what rights secondary market investors are entitled to as there appears to be confusion. They should be entitled to the same rights as direct holders of UCITS (e.g. provision of KIID etc.), which should already be the case, but which we are surprised to learn for the paper is not so.

There cannot be any guarantee that the stock exchange value of units will not differ significantly from the NAV. However, market activity will ensure that the market price of

units does not move significantly from the iNAV. The NAV will only be correct at a specific point in time.

Total return swaps

39. Do you agree with ESMA 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?

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

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?

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

We suggest there should be proper consideration as to whether strategy indices are appropriate in UCITS sold to the mass-retail market. If this is the case, then the Eligible Assets Directive wording would need to be augmented.

We agree that strategy indices which involve proprietary information on the composition that the index provider is unwilling to disclose should not be considered as eligible financial indices and suggest a minimum number of components be used to determine whether an index of interest rates or FX rates complies with the diversification requirements.

We note that the components of many indices will change and evolve over time depending on market conditions and suggest this is taken into account by ESMA. Indeed, the Eligible Assets Directive states that the index must be "*revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers*".

We agree that the rebalancing frequency should be disclosed in the prospectus but disagree that there is a requirement under UCITS that investors be able to replicate the index. Restrictions on the frequency of rebalancing could lead to under-performance and an increase in costs for investors.

It should also be remembered that, under UCITS IV, managers are already subject to detailed requirements to safeguard against and disclose conflicts of interests. Therefore it is already a requirement that there be appropriate independence between the index provider, the swap counterparty and the investment manager even where these are part of the same group. It is for national regulators to ensure compliance with these requirements.