



OCU's response to ESMA Discussion about UCITS ETFs and STRUCTURED UCITS

OCU (Organización de Consumidores y Usuarios) OCU is an independent consumer association established in December 1975 which represents the interests of over 300,000 Spanish families. OCU is a member of the executive board of the European Consumers' Organisation (BEUC), and a member of Consumers' International (CI) and the International Consumer Research and Testing (ICRT). Registered under number 59415653013-57 in the European Transparency Register (<http://ec.europa.eu/transparencyregister/public/consultation/search.do?locale=en#en>).

General policies, financial stability and systemic risk:

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?

Yes, we agree with the fact that a common European approach is the best way to tackle the difficulties resulting from synthetic ETFs. Those products can be manufactured in one Member State, wrapped and distributed in another member state and listed in a third one. The international character of those ETFs makes any national initiative to improve retail investor protection inefficient.

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'?

Yes. Complex UCITS such as synthetic ETFs and structured UCITS should be considered as complex and undergo the MiFID appropriateness test when made available to the retail investor.

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?

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. We think that a minimum investment threshold should be stated. It must be high enough (50.000 eur) to prevent small investors, who usually operate with smaller amounts of money, from accessing these riskier products.

Since January this year the Hong-Kong market put in place an asterisk as indicator for the synthetic ETFs ¹. This is a good example of what can be done to distinguish complexity and other types of risky leveraged/short ETFs.

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

Yes.

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?

Yes. The guidelines to be adopted should be applicable to all substitutable investments products, such as unit linked insurance product, structured notes or non-UCITS funds established or sold within the EU.

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?

Yes. It is needed to avoid gaps in the regulation. The reasons that make the PRIIPs initiative necessary are also justifying a common approach for all substitutable products to the ETF or structured UCITS. Some of the guidelines that could be adopted, like a greater care in the denomination of investment products that may not be misleading and should reflect risks, should be extended to the other investments than UCITS. Some products, like poorly regulated and non-transparent SPVs are not suitable for retail investors, whether directly or indirectly (when wrapped in other funds).

Exchange traded funds:

Q8:Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material?

Yes.

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

¹ New measures to raise investors' awareness of synthetic ETFs, Press release <http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=10PR134>



Yes. Retail investors have some knowledge of physical tracking ETFs. A lot of publicity has been made for those non-complex ETFs. It is essential that the synthetic or more complex ETF are clearly distinguished as we mentioned it above.

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

Yes. An identifier must be incorporated in the name of the ETF, the fund rules, prospectus and marketing material. As the complexity and increased risks are essential characters of the product, it must be explained in the KIID.

Index tracking issues:

Q11: Do you agree with ESMA's analysis of index-tracking issues?

Yes.

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

Yes. Regarding the policy orientations, the suggestion that the information should include a description of issues which will affect the index-tracking ETF's ability to fully replicate e.g. transaction costs, small illiquid components, dividend reinvestment etc. seems for us too technical to be correctly assessed by the retail investor. In the KIID, it could be reflected by the mention that the index could be not perfectly replicated and that the tracking error could reach certain (maximum) percentage of the index evolution.

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. Information should be disclosed in the prospectus and the Key Investor Information Document. We consider that all risks, counterparty risk included, should be reflected in the synthetic risk indicator.

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?

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 word 'tracker' in the name as this may lead consumers to assume 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?

Yes. At OCU we are particularly concerned by the counterparty risk and the conflict of interest when the ETF manager and the counterparty are member of the same financial group.

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?

We agree. Special attention should be given to the collaterals issued by the counterparty itself: a bond issued by the counterparty cannot compensate the risk of default of the counterparty itself. We are concerned that the collateral provided for some synthetic ETFs consists of a significant proportion of corporate bonds issued by other banks. 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.

We also believe that if the quality of collateral is poor or if the correlation of the collaterals with the fund strategy is weak, the manager must ask for over-collateralisation. The suitability of the collaterals must be assessed during the entire ETF life. If conflict of interests between manager and counterparty are not avoided, the collateral should be of high quality and correlated with the ETF strategy.

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, the UCITS diversifications rules should apply to the collateral.

Securities lending activities:

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

Yes, we agree with the issues raised by ESMA.

Q20: Do you support the policy orientations identified by ESMA?

At OCU we consider that disclosure of the fact of securities lending and the existence of a risk are of little help for the retail investor who cannot assess that risk. The risk must be quantified to permit the retail investor to understand the implication of it.

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?



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?

We express the same concern about the collateral than in our answer to the questions 16 to 18.

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, a limit should be discussed.

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?

From our point of view, for physical ETFs, whenever the lent securities exceed this threshold limit, it loses its physical character, so it must be considered as a complex UCITS.

Actively managed UCITS ETFs:

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

Yes we agree with issues and policy orientations raised by ESMA

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?

Leveraged UCITS ETFs:

Q29: Do you agree with ESMA's analysis of the issues raised by leveraged UCITS ETFs?

At OCU we believe that the disclosure of the impact of reverse leverage as proposed by ESMA is too technical to be understood by retail investors, and therefore, of little help. We also expresses concern about the misleading presentation of those leveraged ETFs in some newsletters sent by brokers to their clients or even in financial press.

Q30: Do you support the policy orientations identified by ESMA?

Inverse and leveraged ETFs are only likely to be suitable for a tiny minority of investors. The risks should be reflected in the synthetic risk indicator. A high



minimum threshold must be established and a special warning in the KIID and a careful appropriateness test could help.

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?

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?

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?

KIID should be easily available for all ETFs available on a secondary market. Appropriateness test (or suitability test if there is an investment advice) should be carefully performed. The fact that the price on a secondary market can be different than the iNAV is an important information that should be reflected in the KIID and by the broker before the order registration.

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?

We are concerned that secondary market investors could suffer from lower liquidity if the ETF market maker is unavailable when they need to trade their shares. 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. We believe that ESMA should examine whether its proposal has the potential to increase liquidity in ETF markets at these times.

Structured UCITs:

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?



Q39: Do you agree with ESMA's analysis of the issues raised by the use of total return swaps by UCITS?

Q40: Do you support the policy orientations identified by ESMA?

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

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?

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

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

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

In Spain there are mainly two kinds of structured products available to investors: structured deposits and guaranteed funds. Structured deposits are often proposed to small investors as an alternative to safer products such as deposits. At OCU, we totally disagree with this kind of practice as it misleads investors to think they are investing in a product of equivalent risk. Measures should be established to clearly distinguish these two different investment options.

As for the guaranteed funds or "Fondos Garantizados". These funds have a fixed return which is known (guaranteed) in advance under the condition to hold the investment until maturity. When this condition is not met, the initial capital is no longer guaranteed and the investor is exposed to losses as well as a usually high refund commission.

At OCU we ask for this kind of product to have the investor clearly informed and warned about the redemption fees and risks before passing the order to the broker. We are also concerned about the quality of the assets that cover the principal guarantee at the end of the investment. It can be that, because of this guarantee, the retail investor is not aware of his sometimes high exposure to the financial sector or the sovereign debt of countries facing difficulties. Information in the annual report won't help the retail investor, even if the information is detailed enough. The risk must be lowered.

In addition, a lot of our comments regarding the ETFs are applicable to structured UCITS (requirements for collateral, diversification, conflicts of interests, mention of the complex character in the name of the UCITS and the KIID etc.).



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