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ESMA,
103 Rue de Grenelle 75007 Paris

Milano, Sept. 19, 2011

RE: Discussion paper on ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

Dear Sirs,

I welcome ESMA initiative to conduct a consultation about Ucits synthetic Etf and structured funds. I take the liberty to participate to this consultation even though I am not any longer representing a asset management company or a trade assoiciation. I am just a consultant. I was CEO of a large asset management company (Eurizon Capital) up until the end of 2009. I hope the consulting commission will take my comments in account all the more so as for obvious reasons they are clean of any self interest.

I remain available for any further consideration ESMA may wish to obtain regarding the comments contained in my here-below reply to the consultation.

Regards,

Francis Candylaftis

REPLY TO THE CONSULTATION

Q1: I fully agree with ESMA adopting a more restrictive approach to the issue of marketing of synthetic Etf and structured UCITS to retail investors. For reasons detailed herebelow, I even advocate that the label Ucits be removed from these products so that they cannot be bought by retail investors without professional advisory assistance.

All swap-based Etf or funds are indeed misusing the UCITS regulation by displacing the actual investment management activity out of the UCITS vehicle to delegate it to a swap counter-party that is not subject to the control procedure provided for by the UCITS regulation, i.e essentially in most countries to the control of the depositary bank.

Indeed the performance of such swap based products is much more a function of the activity of the swap counter-party than it is a function of the UCITS official investment manager's endeavor.

For example, in a synthetic Etf, the counter-party is going to manage the assets (sampling, switches, security lending...) so as to reduce the tracking error with the replicated index, whereas the Etf sponsor/manager will just book in the balance-sheet of the Etf a few “risk free” bonds or, worse, the illiquid portfolio dictated by the swap counter-party. The same observation can be made for structured funds.

This is a key issue to be considered by ESMA. Should ESMA continue to tolerate this hidden delegation to counter-parties that are not necessarily regulated fund managers. Indeed they are often investment banks or commercial operating as ex-investment banks. In their role of swap counter-party, their fund management activity as such is under no control. As long as they accept to take risks and put their balance-sheet behind these risks, no external authority is verifying on on-going basis that they are properly hedging for their swap commitments, not to mention that they comply with the various Ucits rules.

This misuse of the UCITS regulation has been made possible because of the way the off-balance-sheet risks are accounted for, i.e only the negative mark-to-market amount is taken into account and not the nominal amount of the swap. Some limit should be introduced on the nominal amount of counter-party risk even for off B/S derivatives. Such a measure would prevent the Etf from “delegating” to a single external counter-party the bulk of the asset management activity which predominantly determines the performance of the swap-based Etf or fund. It would also have the merit to limit the counter-party risk due to overnight market gap, which cannot be covered by the margin system.

In addition, the mechanism of swap replication for UCITS introduces an element of opacity with regards to major issues such as the fiduciary role of the ETF for the voting rights in the shareholders meetings, in the management of dividends, in the activity of securities lending among others. These issues arise from the fact the counter-party can have at its disposal and convenience a portfolio (the replicated index portfolio) of which it does not assume the performance risk but of which it may extract all the benefits.

Q2: as mentioned above if the actual asset management function is brought back within the UCITS and not delegated to some swap counter-party, the complexity of the management of the UCITS will diminish naturally or at least will be subject to a tighter control.

Q3: inappropriate UCITS products should not be sold to retail investors, or they should not be labelled UCITS.

Swap-based Ucits as they are constructed today can definitely be considered inappropriate to retail investors for the reasons exposed in various points of this note, but in particular for the reason expressed in Q1.

Q4: The actual asset management of a Ucits fund should not be delegated to a third party thanks to a derivative
as already expressed in the comment Q1 above, particularly where the third party is not an authorized investment manager and does not operate under the control of the Ucits depositary bank.

Q5: The other issues that need addressing are the following and will be raised in other parts of this note.

- Synthetic or structured funds and Etf are often a channel to provide funding to swap counter-parties at favorable terms whether this is achieved through funded swaps or securities lending. In terms of systemic risks, no Ucits should be at risk or under stress because of potential funding problems experienced by a swap counterparty.

- More and more Etf are used by professional managers as trading instruments. It should be advisable to avoid that Etf (being traded like any other security) be used to short the market as this practice could involve the risk to generate an amount of Etf shares larger than the amount of underlying assets held by the Etf sponsor./ manager (this issue has been raised many times in the US where the problem may be more acute as the result of naked shorts) .
- Etf that trade very easily in normal market conditions may create the deceiving illusion to provide liquidity even when they replicate portfolios of illiquid securities (small caps, emerging markets...). Strong warning should be given about this misconception particularly as Etf are growing rapidly and account for an ever increasing proportion of the holders of these illiquid securities.
- The Etf industry keeps on growing rapidly and is dominated by a dozen major entities worldwide. Etf volume and outstanding interests are huge. Even when these dominant players (and the group to which they belong) have a large balance-sheet (which does not mean anymore solid balance-sheet) their financial stability (hence the system stability) may be imperiled by a mis-management of the Etf underlying swap which is under no external control.

In some cases, the commodities Etf for example, the Etf counter-party swap may be hedged with futures. So derivatives are compounded. Disruption in one market will ripple through this cascade of derivatives to shaken one of more of these dominant players and rattle the whole system.

Concern has already been expressed in this respect for oil or gold related Etf for example.

- When taking into account the above-mentioned comment, it appears unhealthy that the synthetic Etf sponsor, the swap counter-party and the depositary bank may belong to the same financial group which unfortunately is the case most of the time. When markets are disrupted, given the size of some Etf segments, a financial group could find itself under stress and serious conflicts of interest (between the group's and the Etf investors' interest) may arise. The fact that the three main protagonists of the Etf, at some point, respond to the same boss, is not comforting for the Etf investors who want to be sure that the Ucits rules will be duly complied with and that their assets are somehow ring-fenced in a segregated account.

Depositary banks and fund or Etf sponsors / managers should never belong to the same group.

Q6: To the extent that Ucits funds are directed to a retail investor base, they should be governed by a specific set of rules which make them suitable to the targeted clientèle.

Non Ucits vehicles mainly designed for institutional investors need not meet the same criteria.

However ESMA should devise an appropriate set of rules (possibly different from the UCITS') so as to make sure that these non UCITS products do not endanger the liquidity or the stability of the securities market.

But the Ucits set of rules is meant primarily to create an investment product appropriate to the retail investor, it needs not be necessarily extended to the non-Ucits products.

Q7: To create a level playing field between the Ucits funds and the various products mentioned in paragraphs

9 to 11 would be a desirable achievement, difficult as it may be.

Q8: I agree with the proposal of adding a compulsory identifier such as UCITS to the Etf that qualify to have it.

Q9: refer to my position above: synthetic Etf should not be considered as UCITS funds for the reason expressed in Q1. It does seem necessary to distinguish with an identifier the passive from the actively managed Etf. The KIID and the prospectus will provide all necessary information.

Q10: Yes

Q11: Yes

Q12: ESMA has identified the proper policy orientations.

However regarding the tracking error, it seems difficult to determine ex-ante what the maximum level can be. In particular as ETFs are covering an ever growing universe of indices, some of them aim at replicating small cap or exotic indices where liquidity can vanish very rapidly. An honest estimate of what the maximum TE for some Etf could significantly dampen the potential commercial success of the proposed Etf.

As a matter of fact this is an issue to be addressed: because ETFs trade like any other equity security, they give the illusion of liquidity even when they aim at replicating indices made of securities that can become very quickly illiquid. In illiquid markets, volatility increases and as a result the tracking error may exceed any desired maximum level whether the ETFs adopt full replication or even more so with sample replication.

Strong warning should be given in this respect in the KIID and in the prospectus, with a provision for the sponsor of the ETF to suspend reimbursements if market conditions warrant so.

Q13: Yes

Q14: There are index tracking issues to be considered that are not in the ESMA's analysis:

First issue

If the Etf is to be given the Ucits status, the composition of the index should comply at any time (not just in the prospectus during the approval process) with the Ucits regulation (diversification, single security limit exposure, nature of the components of the index). It has not always been the case. A simple example is where an equity index includes a security which accounts for more than 10% of the index. Etf replicating such indices usually ignore the 10% Ucits single exposure limit. In the case of synthetic Etf, the compliance of the index with the Ucits regulations should be under the supervision of the depositary bank of the Etf as if the index itself was the Ucits since, in the end, investors in the synthetic Etf will bear, for the better or the worse, the performance of the index.

Second issue

More and more Etf replicate bespoke indices which very often are managed by a company belonging to the same group as the Etf sponsor. Where there is a cost to manage the index ("managing fee" for the index) such a cost should be explicitly indicated in the prospectus and in the KIID and be part of the Etf TER. It should not be hidden in the swap where the performance of the index paid to Etf is reduced by the index managing fee. The performance of these bespoke indices is usually not published in a widely distributed medium (newspaper or internet).

Investors in such Etf have difficulty in knowing if they get the performance of the index or the performance of the index minus the hidden index managing fee.

Creating and managing the replicated index internally can be a way for the Etf sponsor group to derive more revenues without proper disclosure.

Third issue

Most of the time with ETFs, there is an unfortunate extreme lack of information regarding the treatment of dividends paid by the securities composing the replicated indexes.

Retail investors are getting lost in the ever growing universe of available indices all the more as ETFs sponsors are trying to push their own proprietary indexes. Retail investors need help to

understand what they may be dealing with. One very relevant issue where they need more information is the treatment of dividends.

ETFS may replicate total return (dividends included) or price only indexes.

In the first case, dividends are cashed in and re-invested by the ETFs or by the swap counter-party who is expected to pay the total return performance.

In the second case, which in real life is very frequent, the treatment of dividends is opaque and this is unacceptable.

Let us take an example.

A swap based ETF is set to replicate the CAC 40 index, which is a price only index. (There is also a version of the CAC 40 total return, but the most frequently used is the price only). The example could be set with other indexes.

The swap counter-party is going to benefit from the funding provided by the ETF to build a CAC 40 portfolio as a hedge to its commitment in the swap. This portfolio will generate dividends. (If the hedge was to be done with futures, the price of the futures would incorporate the dividends).

In such cases because the available information regarding the terms and conditions of the swaps is scarce or completely absent, it is very difficult for the retail investor to understand what the counter-party is meant to do with the dividends generated by the CAC 40 portfolio. Is the swap counter-party supposed to pay the dividends to the ETF? Has the swap counter-party a responsibility in the way these dividends are received and paid out to the ETF? How can the retail investor verify the quality of the service provided by the ETF and its counter-party? Is it possible that with funding provided by the ETF and without any risk on the performance of the index (the CAC 40) the counter-party keeps the benefits (or part of it) of the dividends for itself?

Because the ETF is meant to replicate the CAC 40, all the graphs provided by the sponsor may evidence a satisfactory performance (i.e low tracking error) whereas a significant portion of the revenues generated thanks to the risk assumed by the retail investors has not been paid to them!

Such situations would not exist if ETFs were managed with an internal physical replication and securities lending was forbidden. On the issue of securities lending, please see my comments below in this note.

In any case, the treatment of dividend deserves greater attention and clarity. If synthetic ETFS were to remain available under a UCITS passport to retail investors, they would have to clearly mention if, how and when the dividends are paid on top of the performance of the index.

Q15: suggestions are included in the remarks expressed in Q14.

Q16: If this discussion paper is meant to be a review of derivative based ETFs and funds with a view to recalling that UCITS products by definition (see MiFID Article 19(6)) are deemed to be non-complex products, then the disclosure requirements proposed by ESMA are clearly not sufficient. Let us recall that a UCITS ETF or fund is supposed to be available to a retail investor without the necessary intermediation / assistance of a consultant.

It is unlikely for any retail investor to come to know all the disclosure suggested by ESMA and even if he did, he would surely not understand as these issues are very complex even for people operating in the industry.

On what basis for example, will the retail investor verify that the collateral is ring-fenced from what may happen to the counter-party?

If cash is accepted as collateral, how can cash be in a separate account?

Paragraph 28 seems to assimilate the collateral in the swap margin account with the actual assets that the counter-party would have forced on to the ETF. They are two different things.

Is it acceptable for the synthetic ETF to have in its balance-sheet “an illiquid portfolio that cannot otherwise be financed in the repo market (by the swap counter-party)? Even if this information is disclosed to the retail investor, how will he be able to assess the risk?

The publication once year of the synthetic ETF is not enough. It lends itself to end of year window dressing.

As a last point on this issue, let's recall that the margin mechanism, be as solid as it can be, cannot provide any protection for overnight risk. Let us recall the Lehman case. The bankruptcy was declared on a monday morning before the opening of the markets. In such a situation, in general the equity market slumps. So the mark-to-market of the swap would probably be in favor of the counter-party but since it cannot operate any longer the problem is not so much the delta of the performance from the day before, the problem is on the portfolio itself in the B/S of the Etf. The UCITS would have to liquidate the collateral AND the assets in its balance-sheet. At that point, it is paramount that the portfolio in the balance-sheet of the UCITS (if materially different from the index) has not lost more value than the index because the difference would be an additional loss for the investors who would have a claim (through the UCITS?) on the bankrupt counter-party (thanks to the netting of the ISDA agreement between the UCITS and the bankrupt counter-party)? All these issues are very complex as evidenced by the Lehman case and take years to be settled. Retail investors should be shielded from such potential complexities.

Q17: For the above-mentioned reasons and reasons expressed in other parts of this note, I re-iterate my position: synthetic ETFs and funds should not be regarded as UCITS products for retail investors.

However if such a drastic change (with respect to the present situation) were not possible, the following conditions should be imposed on the synthetic ETFs:

Assets in the B/S of the ETFs should at any time consist of risk-free assets or securities related to the replicated index, so as to have a portfolio the liquidity of which is at any time at least equivalent to the liquidity of the replicated index.

Collateral should satisfy the UCITS guidelines and be held by the depositary bank of the UCITS in a segregated account. It should be composed of risk free securities or securities related to replicated index of the ETF.

Performance and valuation of the assets managed by the swap counter-party should be verified by the depositary bank of the synthetic UCITS and the collateral should also be monitored by the depositary bank.

Swap terms and conditions should be disclosed in details, at least once year in the B/S and at any time on an investor's request. It should provide information about:

payments to be made by the parties to each other, treatment of the dividends, policy regarding the participation to shareholders meetings and other fiduciary responsibilities.

Q18: answered in Q17 above.

Q19: YES

Q20: The policy orientations identified by ESM would not protect retail investors because they are based on complex and sophisticated disclosures that would not reach and any case would not be understood by retail investors. All these disclosures would only be a way for the sponsor of the ETF/fund to legally escape his fiduciary responsibility in case of serious problems.

A retail investor who buys an exposure to an equity market, is not meant to understand what the security lending market is, how it operates and the risks involved.

Q21 to Q25: My position is that securities lending on behalf of UCITS ETFs /funds ought to be prohibited for the following reasons.

- Retail investors who are taking an equity risk, are not supposed to understand all risks involved in securities lending. It is not fair to let them bear these risks for a return on which they cannot have any control and which is not subject to any external control.
- In any case, the management fee charged by the Etf /fund is supposed to pay for the management activity as a whole (including possibly the cherished security lending activity). It is remarkable that the sponsor of the UCITS or even worse an affiliated company may derive substantial additional revenues out of a portfolio the risks of which are borne by the investors in the UCITS.
- In this respect, it is astonishing that a few years ago, regulators across Europe, did their utmost to eradicate soft commissions and nonetheless today they debate the conditions to accommodate revenues derived from securities lending.
- In case of a sudden and violent drop of the replicated index which would trigger an exit from the Etf, there is the risk that the swap bank counter-party may face difficulty in recovering the repo-ed securities or in raising the necessary alternative financing to be channelled back to the Etf. In this case the Etf would have to liquidate the assets booked in its B/S with the risk that these assets are even more illiquid than the assets composing the replicated index. To put simply, even before a swap counter-party goes bankrupt, rumors about its capacity to raise the necessary funding, could have a devastating impact on the Etf markets and consequently on the securities markets as a whole.

Q26 to Q28: I agree with ESMA policy orientations.

I reckon that actively managed funds are wrapped into Etf for distribution purposes, i.e. to make these funds available to any investors and overcome the barriers raised by the prevailing bank distribution network system.

It would be simpler and less costly if all actively managed funds were compulsorily listed and traded on one of the prominent exchanges in the EU.

Q29 to Q32: Leveraged Etf are definitely not appropriate for retail investors. They compound many of the issues previously raised. They should not be made available as Ucits to retail investors.

Q33: Yes

Q34: For synthetic Etf, market participants should not belong to the same group as the swap counter-party.

Since swap counter-parties can use the swap with etf to raise funding (through the mechanism described above

i.e. they may have some of their illiquid portfolio booked by the Ucits), there can exist situations of conflict of interest between the activity of market maker and swap counter-party.

Q35: already suggested above in Q34.

Q36: It would be desirable for secondary market investors to have the right to request direct redemption of their units from the Ucits Etf. However this is a tricky issue as the intermediaries (brokers, banks)

through whom retail investors buy their Etf, are not necessarily equipped to process a redemption request from the Ucits Etf. Needless to say that retail investors themselves would not know how to do it themselves.

Therefore, I do not see this possibility in concrete terms as practicable. Market making is another layer (hence another potential risk) which is not perceived by retail investors when dealing in Etf.

Q37: see above Q36

Q38: It would be the function of the arbitragers and other market makers for the Etf to make sure that there does not exist significant value discrepancy between the Etf quoted price and its underlying value. But it is impossible for the Ucits Etf to guarantee it unless direct redemption by secondary investors is made possible but then we are back to Q36 above.

In many ways synthetic Etf are derivatives. In normal market conditions they may make the dealing process easier. Under strained circumstances, like any other derivative, their value may differ substantially from the underlying asset.

Q39: Yes

Q40: The sponsor / the manager of the Ucits must at any time keep full and free control in the asset management of the Ucits. The fact that a swap counter-party may dictate management decisions to the Ucits asset manager, seems contrary to the spirit of the Ucits regulation. Even when a delegated manager is a licensed investment manager, the Ucits manager must keep the upper over the fund. Consequently irrespective of any disclosure in the prospectus, the counter-party should never be allowed to impose any decision on the manager of the Ucits, whether it is a structured Ucits or a synthetic Etf.

How can the “best execution” requirement provided for in the Ucits regulation be met if the swap counter-party can impose to be the sole provider of securities bought by the Ucits?

It is worth underlying again that most of the considerations raised for the structured Ucits apply as well to the synthetic Etf.

Q41: the other issues to be considered are the same as the ones raised for the synthetic Etf:

- the main issue is that the actual asset management activity of the Ucits is displaced and a delegated to a third party who, on top of it, may not even be an authorized investment manager,
- the Ucits control set-up provided for in the Ucits regulation very often is not carried out properly at the counter-party level. More explicitly all the control functions that the depositary bank is supposed to perform on the Ucits do not apply to the counter-party' activities and the assets it manages,
- lack of transparency of the swap terms and conditions which rarely not to say never fully disclosed.
- Hidden costs on behalf of the counterparty which are deducted from the performance of the assets managed by the counterparty.

Q42: structured Ucits like synthetic Etf should not have the Ucits label. They are too complex and fraught with unappreciated risks.

Q43 to Q46: to a large extent, the issues raised in this section are the same as those related to synthetic Etf and structured Ucits. Indeed these strategy replicating Ucits, (very often constructed and distributed as Etf) are a sub- category of the structured Ucits.

Consequently considerations and suggestions made in Q41 apply here as well.

To sum it up, if Ucits funds / etf are supposed to be plain vanilla vehicles that retail investors can

buy without external professional advisory support, swap based constructions should be banned.

- The asset management activity which determines the return and the risks of the Ucits must be performed WITHIN the Ucits and not delegated to any single counterparty all the ore so as this counterparty may not even be an authorized investment manager.
- Swaps and other derivatives must remain instrumental to the actual investment management activity of the Ucits manager and must never be a way to outsource the investment management activity. In this respect, Ucits rules regarding counterparty limit for off-balance-sheet risks should be revisited. Nominal amounts should somehow be taken into account not just positive mark-to-market at risk. The current approach regarding this issue is too complacent, it is implicitly based on a scenario of normal market conditions where one single entity may have trouble. It does not take into a account very disruptive conditions or systemic risks.
- Performance and solidity of Ucits vehicles should not be in any way intertwined with funding issues of swap counter-parties, whether this is the result of the swap terms and conditions or the consequence of securities lending,
- Depositary banks ought to have a exhaustive control over all aspects of the Ucits. It is unacceptable that major components of the factors determining the risks and performance of the Ucits escape the depositary bank control monitoring.