

Response to

Discussion paper “ESMA’s policy orientation on guidelines for UCITS Exchange-Traded Funds and Structured UCITS”

The Alternative Investment Association Austria (VAI) is thankful for the opportunity to reply to the discussion paper “ESMA’s policy orientation on guidelines for UCITS Exchange-Traded Funds and Structured UCITS”.

Our institution represents national and international alternative investment houses totaling more than € 75 bn in assets under management and with a current exposure of more than 7,5 € bn to the Austrian alternative investment market. A lot of the members of the association offer UCITS Exchange-Traded Funds and Structured UCITS.

Already 2004 - 2006 focusing on eligible assets and hedgefunds indices VAI has been in touch with Austrian and European authorities particularly with CESR and thus has contributed intensely to the current regulation.

Kindly find our comments as below:

Retailisation of complex products

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? If not, please give reasons.

We think that synthetic ETFs and structured UCITS embedding an Index Swap with a linear pay-off profile are non-complex. The definition of complexity of a product must be in line with the classification of derivatives, i.e. a linear payoff profile is non-complex. An Index Swap as such has a linear pay-off profile, i.e. rises and falls proportionally with the index and therefore is considered a Non-Complex derivative.

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’?

The directive as such has no definition of “complex portfolio management techniques” and it is not needed. Additionally “shorting” is used by all market participants might it be for hedging or yield expectations. This activity (shorting) as such is non-complex.

We strongly believe that complexity needs to be determined on the basis of non-linear pay-off profiles. For example a binary pay-off profile (outcome 0 or 1) might be considered complex. A linear payoff profile (proportionally up or down) is not considered complex.

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?

As such any UCITS that has the UCITS label shall be appropriate for retail investors. A segmentation of the UCITS brand into a professional investor UCITS and a retail UCITS is not appropriate. Of course inappropriate risks shall not be introduced into the UCITS by financial engineering however performance risk is not an inappropriate risk.

Counterparty risk as such is not an inappropriate risk and Investors are informed about this and other risks in the UCITS's prospectus.

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

No, we think that the characteristics of the funds discussed are well suitable for the UCITS Label.

Identifier of 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? If not, please give reasons.

We are not sure what this identifier shall signal to the investor. Since UCITS is a reliable brand ETF's will be branded as reliable as well. But maybe ETF's should not be structured as UCITS at all, since obviously the generation of shares by market makers by exchanging the ETF's portfolio constituents with the UCITS is not a share subscription/ redemption process the UCITS directive accepts. ETF's as matter of fact work more like "closed end funds" in the United States and this is probably the right way to do. Our understanding is that a "closed end fund" with no obligation to redeem shares cannot be structured as a UCITS so therefore since actually this also applies to ETF's, i.e. there is no obligation by the market maker to redeem shares, we think they should not be structured as UCITS at all.

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

Yes, it will be helpful to provide information to investors.

Total Return Swap

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

A portfolio that is swapped would be a basket swap and therefore look through approach is applicable i.e. UCITS diversification 5/10/40 is applicable and only eligible instruments are allowed. (Article 52 of UCITS directive).

The underlying of an index swap is an index therefore index diversification is applicable (Article 53 of UCITS directive).

We want to point out that if the counterparty is actually managing the underlying of the swap then it should be considered as an investment management delegation agreement irrespective of the contract between the parties.

Swap counterparty should only be liable for the UCITS in case it is actually managing the portfolio, irrespective if the parties have an investment management delegation arrangement between them.

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

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

No.

Strategy indices

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

Yes we agree. We believe that the UCITS Diversification as per the article 53 should be applicable to strategy indices.

No we do not agree with ESMA's findings on the topic "index publication in an appropriate manner"

As a matter of fact the directive does not differentiate between different indices, i.e. all kind of indices fall under the same provisions of the directive. Therefore a traditional long only index might also be considered a strategy index since the only difference is that there is an index committee and not a mathematical model determining the allocation. It is obvious that the new ESMA rules on full publication of an index is harming long only indices, strategy indices as well as intellectual property rights of index providers. Therefore all indices shall be treated the same.

It is common policy of index providers such as MSCI, S&P that the constituents are published but the weights are not published. If a user needs to replicate the index he is allowed to do after signing an index license agreement and paying a license fee. If ESMA's policy is meant to also publish the weights then long only indices such as the S&P 500 and others would not be eligible for UCITS investments.

To achieve a level playing field, strategy indices shall therefore publish all constituents and constituents' changes but not the relevant weighting. If a user wants to replicate the strategy he might be able to do so after signing a license agreement. Additionally the investor can always for risk purposes assume equal weighting which already provides the investor with enough risk information.

We also warn ESMA on potential systemic risks that could arise if unknown and unidentifiable parties are able to replicate successful indices based on internet information only with understanding the strategy and risks involved.

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

By achieving article 53 diversification.