30 March 2012

**BlackRock’s Response**

**Consultation Paper - ESMA’s Guidelines on ETFs and other UCITS Issues**

BlackRock is one of the world’s pre-eminent asset management firms and a premier provider of global investment management, risk management and advisory services to institutional and retail clients around the world. As of end-2011, BlackRock’s assets under management totalled €2.65 trillion across equity, fixed income, cash management, alternative investment and multi-asset and advisory strategies including the iShares® exchange traded funds (“ETFs”). Through BlackRock Solutions®, the firm also offers risk management, strategic advisory and enterprise investment system services to a broad base of clients with portfolios totalling more than €7.5 trillion.

iShares has over €452 billion in assets under management (in 504 funds world-wide), which represents 39% of the global assets under management in ETFs, and puts it in a leading position both in Europe and globally.

In Europe specifically, BlackRock has a pan-European client base managed from 14 offices across the continent. Public, multi-employer pension plans, insurance companies, third-party and mutual funds, endowments, foundations, charities, corporations, official institutions, banks and individuals invest over €230 billion with BlackRock in its UCITS fund ranges (including its European iShares ETF range).

We welcome the opportunity to comment on ESMA’s consultation on its proposed Guidelines on ETFs and other UCITS issues.

**Executive Summary**

BlackRock is committed to raising the standard of practices of the exchange traded product (ETP) industry and practices in respect of other UCITS issues. We welcome ESMA’s contribution to this collective exercise.

We specifically support common standards on labelling, transparency, disclosure and reporting for all UCITS, UCITS ETFs and the wider suite of ETPs. This focus ensures that end-investors understand the risks and attributes of the products that they are purchasing, while equipping supervisors with the tools they need to appropriately monitor the development of systemic and concentration risk.

We would generally support the approaches proposed by ESMA to the extent the proposed Guidelines contribute to better outcomes for end-investors.

We would also support further action by ESMA in certain areas:

* **Clearer labelling of ETPs empowers end-investors.** We believe that UCITS ETFs should use the identifier “ETF” in their name. This identifier should further distinguish between physically-replicating and derivative-replicating ETFs in the name of the ETF itself.
* **End-investors in all UCITS products require a series of metrics to assess fund performance, viability and costs.** While we agree that information concerning the tracking error should be stated in the prospectus, we are concerned about its interpretation by less sophisticated investors (and that tracking error alone be used as the means of assessing fund performance). It is important to bear in mind the different factors that have a negative impact (or cost) on fund performance. In the case of physically-replicating ETFs, these tend to be the index rebalancing costs. In the case of derivative-replicating ETFs, these are primarily the swap spread. Tracking error ignores positive contributions to overall fund performance, such as the revenue generated from securities lending activity. In our view, investors would benefit most by considering the Total Cost of Ownership (TCO), which encompasses both revenue received by the fund as well as costs incurred. Examples of the latter include the Total Expense Ratio (TER), rebalancing costs and the spread of any total return swap (used in derivative-replicating ETFs). Furthermore, since the swap spread is an integral part of the pricing structure in gaining exposure to the relevant index (but is not necessarily obvious to investors), it is important that investors be made aware of how a swap is both structured and priced. The TCO approach informs the end-investor of the true net cost of investing in a fund and enables investors then to make a fully informed investment decision.
* **Uniform standards for transparency and disclosure applicable to index tracking UCITS (including physically-replicating and derivative-replicating UCITS ETFs).** We believe that disclosure and transparency requirements should achieve consistent messaging for investors and be applied equally to all such UCITS products (allowing for ETF-specific attributes). The intention to engage in securities lending activity, possible sources of counterparty risk and potential conflicts of interest should all be highlighted in the prospectus.

We have a limited number of concerns with ESMA’s proposals, since we believe that further action is necessary in certain areas:

- ESMA has based its requirements for diversification of collateral on a wrong perception of the role played by collateral in the mitigation of counterparty risks. It is extremely important to bear in mind that collateral diversification rules and UCITS assets diversification rules have two distinct objectives, which should not be confused: the purpose of collateral diversification is to reduce counterparty risk while the purpose of asset diversification is to prevent excessive concentration of investments. We firmly believe that good credit quality and liquidity of the collateral are much more important than diversification in the context of the objective that collateral rules have.

- Classification needs to be addressed.

- Transparency and disclosure requirements are required for all ETPs.

- A focus on tracking error alone does not provide the full picture when choosing ETFs. All relevant metrics need to be explained to empower end-investors.

- Further requirements are necessary to ensure conflicts of interest in certain ETF structures are appropriately disclosed and managed.

- ‘Risk-free’ reinvestment of cash collateral is not necessary.

Finally, we would encourage ESMA to recognise that at least 12 months would be needed to bring the Guidelines into effect.

General Comments

ETFs have revolutionised the investment landscape – both in Europe and globally – allowing retail and institutional investors alike to harness the diversification benefits of buying an entire index in a single fund. A range of different exchange traded structures have emerged since the inception of ETFs, in order to meet client demand for less conventional exposures and asset classes.

BlackRock and iShares are considered to be pioneers in the ETF and index fund management businesses. Since our approach is that of an independent asset manager and fiduciary to our clients, our preference has been to offer physically-replicating ETFs with multiple market-makers, wherever possible.

Where we offer derivative-based (or “synthetic”) ETFs, for example, in markets where there are restrictions on ownership of securities, we engage multiple swap counterparties. As BlackRock is independent of any banking group, there is not any affiliation between the swap counterparty and the ETF provider. This further reduces the possibility for conflicts of interest which might adversely impact outcomes for end-investors.

A number of iShares’ physically-replicating ETFs and other BlackRock UCITS engage in ancillary efficient portfolio management techniques, such as securities lending. Securities lending is a well-established practice in the asset management industry. The revenue generated by BlackRock’s securities lending activities directly increases returns to investors in the fund. In other words, it is an activity that reduces the total cost of ownership (TCO) for investors and therefore delivers direct benefits to such end-investors. Where a fund engages in securities lending, the lent positions are over-collateralised to protect the fund.

Transparency remains at the heart of the iShares philosophy, since high levels of meaningful transparency allow the market maker of an ETF to accurately price a fund. Accurate pricing on the secondary market is dependent on market makers and end-investors knowing how their investments are constructed, and how they are performing on a daily basis.

BlackRock is committed to developing investor education on the fast growing category of ETPs. This commitment led to a launch of an investor due diligence campaign in autumn 2011. We also published a *ViewPoint* with the aim of raising the standard practices of the ETF industry, thereby enhancing the end-investor experience:

* Responding to the call from organisations representing the interests of consumers[[1]](#footnote-1) and in line with views expressed by the ESMA’s Securities and Markets Stakeholder Group[[2]](#footnote-2), the iShares’ due diligence campaign called for, amongst other things, clear identification in the product name as to whether an ETF is derivative-replicating or physically-replicating. We share consumer organisations’ position on this issue because generally an investor gathers information, initially, on a given ETF product by consulting an internet search engine, which routes the investor directly to the named fund. As a secondary step, an investor would then go on to consult the prospectus, marketing material or Key Investor Information Document (KIID).
* In the BlackRock *ViewPoint,* “ETFs: A Call for Greater Transparency and Consistent Regulation” from October 2011[[3]](#footnote-3),we provided background on the history and structure of ETFs, summarised recent concerns that have been raised by regulators, and recommended reforms that would, we believe, improve the marketplace for ETFs. We explicitly support uniform standards on labelling, transparency, disclosure, and reporting that would reduce systemic risk, improve investor protection, and would help ensure that investors understand precisely the risks and attributes of the products that they are purchasing.

Risks to both the end-investors and the financial system could arise from poorly designed or managed exchange traded products (ETPs)[[4]](#footnote-4). BlackRock’s initiatives, the reform agendas of other ETF providers and the regulators’ drive to mitigate risks, combine to create a safer, more transparent and rewarding environment for ETF end-investors in the future.

The consultation also applies to other UCITS which are not ETFs. We consider that the forthcoming ESMA guidelines should apply generally across the board to non-UCITS ETFs. Our responses only differ where the guidelines affect the specific structure of ETFs and the transparency required (given the primary/secondary market trading of ETFs). We point out these differences where they arise in the course of our response.

For other UCITS, such as actively managed funds or non-ETF index tracking funds, investors would normally deal on the basis of the published bid-offer spreads and/or net asset value (NAV), either directly with the management company, its transfer agent, or indirectly through an intermediary, such as a platform or distributor. In this case, they must be able to rely on robust valuation procedures which support the calculation of the fund’s published NAV.

While we support transparency of the fund’s portfolio which builds upon existing practice, we believe it should be provided on a periodic basis in the fund’s regular reports or on a more frequent basis in accordance with the manager’s disclosure policy. We do not consider it necessary to disclose full portfolio holdings on a daily basis for actively managed funds. Indeed, for actively managed funds it would be counter-productive to do so, as it could facilitate front-running of the fund strategy which would ultimately be to the detriment of end-investors in the fund.

Specific Comments

**III. Index-tracking UCITS**

1. The prospectus of an index-tracking UCITS should include:

a) A clear description of the index including details of its underlying components. In order to avoid the need to update the document frequently, the prospectus can direct investors to a web site where the exact composition of the index is published.

b) Information on how the index will be tracked and the implications of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk.

c) The policy of the index-tracking UCITS regarding the ex-ante tracking error including its target level.

d) A description of factors that is likely to affect the index-tracking UCITS’ ability to track the performance of the index, such as transaction costs, small illiquid components, dividend rein-vestment etc.

e) Details of whether the index-tracking UCITS will follow a full replication model or use, for ex-ample, a sampling policy.

2. The annual and half-yearly reports of an index-tracking UCITS should state the size of the tracking error as at the end of the period under review. The annual report should provide an explanation of any divergence between the target and actual tracking error for the relevant period.

**Q1: Do you agree with the proposed guidelines?**

1a) Primarily, we fully agree that frequent, clear and real time disclosure of fund constituent holdings is necessary for investors to understand what they have invested in. Furthermore, we agree that a clear description of the index and certain details concerning its underlying components need to be disclosed. We would not, however, recommend an overly prescriptive description e.g. disclosing the number of constituents at a given date, or any other information that is likely to change frequently.

While we agree with the proposals and direction of question 1a), in relation to describing the index and details of its underlying components, it might not be possible to direct investors to a website where the exact composition of the index is published. In our experience, index providers seek to impose restrictions on an index licensee’s ability to publish the exact index composition on a real-time basis to protect the intellectual property in the provider’s index. It is also worth noting that regulatory guidelines and/or rules would not be directly applicable to the index provider (unless it is also a regulated entity itself) so there may be additional constraints in compelling disclosure. That said, and as mentioned above, we fully support endeavours which facilitate disclosure of real time disclosure of fund composition data.

1b) We agree that the prospectus for any index-tracking UCITS should include information on how the index is to be tracked, the mechanism used to gain exposure to the index and the implications of using a particular method.

We believe that we act in the end-investor’s best interests when we ensure that they know how their investments are constructed. It is important for end-investors to readily identify whether an index tracking UCITS is a physically-replicating or derivative-replicating fund, as the risks associated with both types of structure differ. For physically-replicating funds, these include transaction costs and potential costs associated with illiquid components in the index. For derivative-replicating funds, these include swap-related risks (such as counterparty exposure) and financing costs within the swap. The risk of tracking error applies to both structures.

In the case of derivative-replicating UCITS, we would encourage disclosure of the swap spread by an appropriate means. Since this information forms an integral part of the pricing structure used to gain exposure to an index, it is important that investors be made aware of how a swap is both structured and priced.

1c) We agree that it is appropriate to disclose certain information concerning the tracking error of an index tracking UCITS and that investors receive meaningful and comprehensible information in this respect. We do not consider, however, that it is necessary for a UCITS to prescribe a policy regarding ex-ante tracking error and its target level. Index tracking UCITS aim to minimise tracking error (and this should be made clear to investors), however certain types of indices may naturally lend themselves to greater tracking error due to the nature of the index methodology, and in this regard the variation may be misleading.

Many indices are constructed in a manner which ensures that those indices are very difficult to replicate perfectly when trading the underlying investments. Problems can be attributed to regulatory constraints, the impossibility of buying or selling certain constituents of the index at precise times, and values used to determine the index’s return. Investors in funds that benchmark the returns of difficult-to-replicate indices frequently are willing to accept wider performance gaps in order to gain exposure to such indices.

We suggest that an alternative worth considering may be to disclose an anticipated threshold regarding tracking error, rather than a mandatory target level e.g. “the tracking error for the fund should not (in normal market conditions) exceed x% per annum…” together with appropriate risk factors which would outline why, in certain circumstances, the anticipated tracking error may not always be met (please see 1(d) below).

1d) We agree that appropriate risk disclosure of such factors is necessary. In order to create a level playing field in terms of disclosure by physically-replicating and derivative-replicating funds, the swap-related risks (and the potentially ‘hidden’ costs) should also be disclosed to investors.

1e) We agree that the prospectus for any index-tracking UCITS should include information regarding the mechanism used to gain exposure to the index and the implications of using a particular method.

2. While we would be fully prepared to provide information regarding tracking error for the period under review on the fund’s website, or in its annual reports, we query the benefit end-investors would derive from this information. The figure could vary from time to time depending on a range of circumstances (including liquidity in the market, taxes applied on the underlying securities, etc.). It would be difficult to explain any divergence between any target and actual tracking error, given the very broad range of underlying variables which affect tracking error. In this regard, we would not believe that this would be beneficial disclosure for the end-investors, as it would be difficult to identify any divergence with sufficient accuracy.

**Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs.**

To ensure consistency across products domiciled in differing Member States, it is desirable, in principle, that there would be an agreed framework for the calculation of tracking error. Since investors may wish to measure tracking error in different ways in order to suit their investment needs, BlackRock’s view is that any decision to adopt a standard measurement of tracking error needs to be very carefully considered. This decision should meaningfully weigh up the real benefit to investors, against the potential for creating confusion or misleading investors. Given the individuality of each index (taking into account, for example, the relevant asset class, underlying market exposure and any currency impact), it would be extremely difficult to impose a single tracking error limit across all index tracking funds, without introducing complex definitional issues, and potentially causing an inadvertent impediment to investor choice.

If ESMA prefers to have one single tracking error calculation methodology for consistency, then it is important that any rules introduced in this area be applied on a level playing field across all index tracking funds. This is necessary to produce a result that is meaningful and consistent for investors. As physically-replicating funds and derivative-replicating funds have different revenue streams and cost elements, the most meaningful measurement would be any methodology which reflects the TCO to the investor. Such a measurement would enable investors to compare the actual costs borne by the fund (and, by extension, investors) across different types of index trackers on a “like-for-like” basis.[[5]](#footnote-5)

**Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?**

Yes. Tracking error is an important metric but it should not be considered the sole metric for evaluating a fund (in terms of assessing a fund’sperformance, viability and costs). While the measure is of relevance to the short-term and institutional investor, it is of less significance to the buy-and-hold investor, who will be more concerned with performance against a benchmark. Focusing solely on tracking error ignores positive contributions to overall fund performance, such as the benefits delivered back to the fund by securities lending activities.

The IOSCO Consultation Report on Principles for the Regulation of ETFs (16 March 2012) has given clear definitions of the tracking error and the tracking difference:

The “tracking error” measures how consistently an ETF follows its benchmark. Tracking error is defined by the industry as the volatility of the differences in returns between a fund and its benchmark index. The tracking error helps measure the quality of the replication.

The “tracking difference” measures the actual under- or outperformance of the fund compared to the benchmark index. Tracking difference is defined as the total return difference between a fund and its benchmark index over a certain period of time.

The IOSCO has clearly stated that disclosure concerning tracking difference data is a factor that needs to be addressed.

In assessing a fund, an end-investor would benefit most by being able to examine the individual components of the TCO. The components of an ETF’s TCO can be broken down into two categories: internal and external factors:

* Internal factors include costs, such as the Total Expense Ratio (TER), rebalancing costs and swap spreads, as well as revenues (such as positive revenue from securities lending income). It is important to contrast rebalancing costs, which are an internal factor specific to physically-replicating ETFs, with the swap spread, which is an expense specific to derivative-replicating ETFs. The latter is paid by the fund provider to the swap counterparty for the total return swap agreement. The size of the swap fee depends on the fund exposure, level of over-collateralisation (for fully funded derivative- replicating ETFs) and on the agreement between the swap-counterparty and the fund provider.

There may be additional internal factors, depending on the ETF’s portfolio management style and its structure. These factors include: tracking, the cash component in the fund and tax. An ETF’s portfolio management style, either fully replicating or optimised, has an effect on the tracking of physically-replicating ETFs. Funds with liquid, accessible underlying securities are expected to track their benchmarks very closely, whereas funds with less liquid underlying securities will likely have a higher tracking cost. Another factor which may affect fund performance is the tax liability on dividends, which becomes particularly important when the taxation rules of the index are different from the taxation rules of the fund. For example, some indices are only available as Gross Total Return which implies 0% tax on distributions, while the fund will have to pay withholding tax on the distributions of the securities in the underlying portfolio. There are also often differences in Net Total Return indices and the actual tax suffered by a portfolio depending on the tax treaty between the domiciles of the ETF and underlying securities.

* External factors are costs to the investor deducted at the time of purchase and sale of an ETF and include trading costs, creation/redemption costs (which may include transactional fees charged by the custodian and foreign exchange costs), brokerage fees (e.g. commissions) and taxes (including stamp duty and applicable local transaction taxes). Trading costs are reflected in the bid/ask spread when buying an ETF on the secondary market (i.e. on-exchange or Over-The-Counter (OTC). The scale and relevance of external factors as a share of total cost will depend very much on the length of time for which an ETF is held (ie short-term vs buy-and-hold).

The TCO gives a holistic view of the total costs an investor incurs.

Internal and External Factors:



To focus on a single metric is not *per se* misleading. However, relying solely on tracking error as *the* metric in a less informed context may lead to misunderstanding especially on the part of less sophisticated investors, who may equate tracking error with performance. Therefore, end-investors would be empowered by having a range of consistent metrics at their disposal, with which they could compare and assess fund offerings.

**IV. Index-tracking leveraged UCITS**

1. The prospectus for index-tracking leveraged UCITS should include the following information:

a) a disclosure on the leverage policy, how this is achieved (e.g. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage and the risks associated with this policy;

b) a disclosure on the impact of any reverse leverage (i.e. short exposure);

c) a description of how the frequency of calculation of leverage impacts on investors’ returns over the medium to long term.

2. Information to be provided according to paragraph 1 (b) above should also be included in the KIID.

**Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?**

Yes. In particular, though, and further to the classification discussed in response to question 6, we believe that, in the naming of such funds, the use of leverage should be explicit and readily identifiable by end-investors.

BlackRock does not *per se* argue against retail investors using more sophisticated strategies, following appropriate levels of advice, to meet their investment needs. However, the currently offered inverse and leveraged Exchange Traded Products (ETP) are more suitable for daily and short term trading means. Ultimately, we would want to avoid a situation where there is potential for misunderstanding of the products, if they continue under their current designation.

**Q5: Do you believe that additional guidelines should be introduced requiring index-tracking leveraged UCITS to disclose the way the fund achieves leverage?**

No. We believe that the current guidelines applying to UCITS in this area remain fit for purpose.

**V. UCITS Exchange Traded Funds**

 **V.II Definition of UCITS ETFs and Identifier**

1. A UCITS exchange-traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradable on at least one regulated market or multilateral trading facility (MTF) with at least one market maker which takes action to ensure that the stock exchange value of its units or shares does not significantly vary from their net asset value.

2. A UCITS ETF should use an identifier, in its name and in its fund rules or instrument of incorporation, prospectus, KIID and marketing communications, which identifies it as an exchange-traded fund. The identifier should be ‘ETF‘.

3. A UCITS which does not fall under the definition of UCITS ETF in paragraph 1 of this Box should not use the ‘ETF’ identifier in its name or in its fund rules or instrument of incorporation, prospectus, KIID or any marketing communications.

**Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?**

Yes, we suggest that for clarity the definition refers to “regulated execution venue” in addition to “regulated market” and “MTF”. Note that numerous funds have non-trading listings which need to be distinguished from ETFs with active listings.

We agree that other UCITS funds which are not ETFs (as defined here) should not use the terms “ETF” or “Exchange Traded Fund” in the name of the fund or its constitutional documents.

To eliminate a potential source of confusion among end-investors, ESMA should also consider how it could influence the naming convention of providers from outside of Europe.

**Q7: Do you agree with the proposed guidelines in relation to the identifier?**

Yes. We set out our further thoughts in relation to the identifier below.

**Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?**

Yes. This proposal enhances end-investors’ understanding of an ETF, its investment objective and how that objective is achieved. This would empower end-investors when making their choice between ETFs. We have taken note that, importantly, consumer organisations and members’ of ESMA’s Stakeholders’ Group have recognised this as potentially benefiting end-investors by developing their understanding of the principal policy by which a fund achieves its investment objective.

An end-investor generally gathers information initially on a given ETF product by consulting an internet search engine, which routes the investor directly to the named fund (but not necessarily its prospectus or Key Investor Information Document (KIID)). As a secondary step, an investor would then go on to consult the prospectus, marketing material or KIID. The advantage of an identifier in the labelling is that the end-investor, when accessing information through sources other than the prospectus or KIID (eg through specialist websites, trade publications etc.), can immediately note the differences between the construction of the funds. Making a distinction in the name of the fund (ie physically-replicating vs derivative-replicating) aids the empowerment of the end-investor in assessing the associated risks and rewards of a particular ETF investment strategy**.**

Furthermore, the proposal is feasible for ETF providers to implement. It would seem logical that, if ETF providers would be prepared to identify the replication strategy in the KIID (as most appear committed to do), then there isn’t any plausible reason why it cannot be identified in the labelling of the fund. This could be achieved simply by reference to the principal policy by which the fund achieves its investment objective. It should be noted that this approach has already been adopted in Hong Kong whereby, if a fund seeks to achieve its investment objective primarily through investing substantially in derivatives (e.g. swaps), then it will be classified as synthetic and must include an asterisk in its name to identify it as being synthetic (followed by an annotation in all public documents and marketing material (“\*This is a synthetic ETF”)). The requirement has been applied by the HK Securities and Futures Commission as an “authorisation condition” which must be complied with by the ETF provider in order for the relevant fund to obtain (and maintain) its approval. The Hong Kong Stock Exchange has adopted similar measures.[[6]](#footnote-6)

It should be noted that references to the incidental use of derivatives, or securities lending activity, are confusing the debate surrounding labelling, and are ultimately misleading. These are efficient portfolio management techniques, as ESMA has recognised in this consultation document, rather than investment strategies *per se*.

In the case of hybrid strategies, the reference, again, can be determined by which strategy is the principal methodology. We encourage ESMA to consider developing thresholds to determine the principal methodology of an ETF strategy.

**Q9: Do you think that the use of the words ‘Exchange-Traded Fund’ should be allowed as an alternative identifier for UCITS ETFs?**

Yes. From a practical perspective ESMA should note that certain service providers to an ETF (e.g. custody, pricing and settlement) have system constraints in relation to the length of a fund name, so the “ETF” label may prove more workable than “Exchange Traded Fund”.

**Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?**

Yes, in principle. It is desirable that an ETF has more than one market maker**,** but it should be recognised that this may not always be possible in certain, niche, markets.

However, the arbitrage mechanism of the interaction between the primary and secondary markets should help to ensure that both markets remain in line. In the primary market, Authorised Participants (APs) purchase and redeem ETF shares directly from the ETF provider in large blocks called "creation units”. The primary market works alongside the secondary market, which encompasses trading on stock exchanges and OTC transactions. If there is strong investor demand for an ETF in the secondary market, its share price can temporarily rise above its fair value creating a possible arbitrage opportunity. Market makers have an incentive to purchase additional creation units from the ETF and sell those units in the secondary market. A similar process applies when there is weak demand for an ETF resulting in its units trading at a discount to its fair value. This process generally brings the ETF price back in line with its fair value removing the arbitrage opportunity.

Given that it is not always feasible, for the market maker – or indeed any fund service provider – to be operating through an independent relationship, this issue may be best addressed through reference to industry best practices rather than a mandated requirement.

To reduce concentration and/or default risk, ESMA could consider a requirement that an ETF must have at least one independent market maker (i.e. an entity that is not affiliated with the ETF promoter).

 **V.III Actively-managed UCITS ETFs**

A UCITS ETF that is actively managed should clearly inform investors in its prospectus, KIID and marketing communications of that fact and that it is not an index tracker.

2. An actively-managed UCITS ETF should clearly disclose the following in its prospectus, KIID and marketing communications:

a) how it will meet the stated investment policy including any intention to outperform an index;

b) without prejudice to the rules of the relevant regulated market or MTF, the policy regarding portfolio transparency and where this information may be obtained, including where the indicative net asset value (‘iNAV‘), if applicable, is published.

3. An actively-managed UCITS ETF should clearly disclose in its prospectus how the iNAV is calculated, if applicable, and the frequency of its calculation.

**Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in either the prospectus, the KIID or any marketing communications of the UCITS ETF?**

Yes – we agree with the proposals.

 **V.IV Secondary market investors**

Option 1

1. A UCITS ETF or its management company should ensure that the market maker(s) of the listed units or shares of the UCITS ETF continue(s) to offer redemption to secondary market investors whenever the market is open for trading.

2. A UCITS ETF or its management company should take appropriate action to replace the market maker(s) if it is no longer able or willing to act in that capacity, and should ensure the protection of unit-holders in the event of such a process of replacement or if the redemption in the secondary market is disrupted. This may include making arrangements for investors who have acquired their units or shares on a secondary market to sell them directly back to the UCITS ETF or its management company.

3. The prospectus of a UCITS ETF should explain that ETF units are generally not redeemable from the fund other than by authorised participants holding creation units.

4. The prospectus and marketing communications of a UCITS ETF should include the following warning:

*‘UCITS ETF units / shares cannot usually be sold directly back to the fund. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. Investors may pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them‘*

Option 2

1. Investors who acquire units or shares of a UCITS ETF on the secondary market shall be able to redeem their shares directly from the UCITS ETF at any time.

2. The prospectus and KIID of the UCITS ETF should indicate, where applicable, the redemption fee that will apply to the investor in such circumstances.

**Q12: Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?**

As an asset class, ETFs are structured to be traded by investors on exchanges in the secondary market. Therefore, Option 1 would be our preferred choice.[[7]](#footnote-7)

We have a strong preference for Option 1 because:

1. ETF end-investors are able to access intra-day markets. For many ETF investors, this is an advantage over some cash products, or traditional mutual funds which only trade once a day at a NAV level.
2. Benefits from using exchanges to conduct trading:
	* Exchanges are highly regulated trading platforms, with associated regulatory, compliance and price monitoring requirements. This provides a transparent robust platform on which investors can transact.
	* All exchanges require the presence of liquidity providers and market makers to ensure investors receive the best possible pricing. This is highly regulated by exchanges with continual price and spread performance monitoring.
	* The benefit of after trade exchange process. All exchanges have highly regulated post trade process. All use a central counterparty to minimise any settlement credit risk.
3. Transparency of the product. Portfolio Composition Files are made available to product market makers to empower them to be able to make competitive secondary prices on the product.

We also note that the Level 1 UCITS Directive (Article 1 para. 2(b)) explicitly acknowledges that healthy secondary market trading is a valid alternative redemption model: “action taken by a UCITS to ensure that the stock exchange value of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption”. In our view, the above-mentioned mechanisms achieve this.

Option 2 would be more appropriate for UCITS products which are not exchange traded, where there isn’t an active secondary market in the funds, and importantly, where holdings in the funds are held under a direct, rather than an indirect, custody regime.

**Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.**

No. We believe the ETF industry should be focusing on the most efficient and robust secondary market landscape in which investors can trade. As discussed above, there are some practical, operational questions which would need to be addressed before implementing direct trading with a fund. The current AP market allows investors to access primary market NAV trading should they want to.

**Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.**

The use of certificates for certain domiciled ETFs is common practice amongst issuers. This is due to there being inconsistencies between different legal systems in the treatment of securities holdings. Many continental European Central Securities Depositaries (CSD’s) do not accommodate registrars that are different to a CSD. This gave rise to the certificate model to facilitate dealing within these constraints.

**Q15: Can you provide further details on the relationship between the ETF’s register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?**

In the UK, registration is required at a custodian level with the register maintained by third party registrars under the indirect holding system. Elsewhere in Europe, countries operating a direct holding system, registration is required at a beneficiary level, and held by the Central Securities Depositary.

**VI. Efficient Portfolio Management**

1. A UCITS should clearly inform investors in the prospectus of its intention to employ the techniques and instruments referred to in Article 51(2) of the UCITS Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS.

2. The prospectus should also clearly inform investors of the UCITS‘collateral policy. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks arising from the re-investment policy.

3. Fees arising from EPM techniques should be disclosed in the prospectus and, as a general rule, returned to the UCITS. Where a UCITS engages in fee-sharing arrangements in relation to EPM techniques, this should also be clearly disclosed, together with the maximum percentage of fees payable to the third party. Other fees that may be deducted to the return delivered to investors should also be disclosed in the prospectus.

4. Where the third party is the investment manager or a connected party to the UCITS management company / directors / investment manager / depositary, this should also be disclosed in the prospectus.

5. A UCITS should ensure that it is able at any time to recall any security that has been lent or terminate any securities lending or repo agreement into which it has entered.

6. Collateral received in the context of EPM techniques should comply with the criteria for collateral received in the case of OTC derivatives set out in Box 26 of CESR‘s Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

7. The collateral posted by the relevant third party to mitigate the counterparty risk arising through EPM techniques should be sufficiently diversified in order that at any time, the portfolio composed of the collateral and the assets not subject to the EPM technique complies with the UCITS diversification rules. The UCITS should comply with the UCITS diversification rules in relation to entities at which cash is deposited, taking into account both the cash received as collateral and any other cash held within the fund.

8. Entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

9. A UCITS should have in place a clear haircut policy for each class of assets received as collateral. This policy should be documented and should justify each decision to apply a specific hair-cut, or to refrain from applying any haircut, to a certain class of assets.

10. The UCITS annual report should also contain details of the following:

a) the underlying exposure obtained through EPM techniques;

b) the identity of the counterparty(ies) to these EPM techniques; and

c) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

**Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR’s guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?**

We agree with the proposals in box 6 around disclosure outlined in sections 1, 2, 4, 5, 9 and 10, but we disagree on the other sections.

In particular, we consider, as a general, rule that:

* the gross returns generated from EPM techniques should not have to be returned to the fund;
* cash collateral should not have to be reinvested at a ‘risk free rate’; and
* collateral plus non-lent positions in aggregate should not have to comply with the UCITS diversification criteria.

With regards to transparency of fees, we would agree that a maximum percentage of fees payable to the provider, as well as any other costs deducted from the gross return, should be disclosed. We do not believe that, as a general rule, all returns should have to be passed back to the fund without taking into account the costs of providing the service.

Securities lending has rightly been identified as benefitting investors by reducing costs and contributing to performance. As such, it is in the best interests of the UCITS to identify a securities lending provider that has the capabilities to generate additional returns, while maintaining a low risk profile.

Securities lending is a costly activity to run. To generate incremental returns, significant investment in research and technology is required. Particularly in an OTC market, where pricing is opaque and influenced by many variables, applying research and analytics can make a significant difference to the outcomes for end-investors. Equally, significant investment in risk management capabilities is required to constantly review counterparties and collateral parameters. Since it may be difficult to assign costs, such as risk oversight and trading tools to a specific fund, in our view a transparent revenue sharing agreement is the most appropriate way of ensuring a UCITS can benefit from securities lending.

Revenue sharing arrangements in physically-replicating ETFs are usually disclosed to investors. Typically, however, there is limited or no disclosure concerning the lending activities of synthetic providers (ie lending on either the substitute basket which the fund, itself, holds or more likely lending on the hedge basket which the parental investment bank (as swap counterparty) holds outside the fund to hedge its exposure under the swap). In our view, investors would benefit from enhanced disclosure of these revenue arrangements, particularly in the context of single swap counterparty ETF providers.

The following example serves to illustrate this issue. The iShares Euro STOXX 50 has a TER of 35 bps, but the 60% securities lending revenue share received by the fund (net of all costs) has generated approximately 28 bps to the fund on average over the last three years. This has significantly reduced the cost to the investor of holding shares in the ETF. On the other hand, one of the single swap ETF providers offers a product on the same benchmark with a TER of 0 bps. One reason that the single swap ETF provider is willing to offer a product with a TER of 0 bps may be that it, or its affiliates, are generating benefits from lending either the substitute basket or, more likely, the hedging basket. In addition, its parental bank may receive a return from the swap spread. These benefits to the synthetic provider and its parental bank swap counterparty, which may not be apparent to investors at present, would be of interest to end-investors (particularly where such benefits result in hidden costs or charges to such investors).

If allocating all securities lending revenue to the fund were to become a requirement, the inherently more transparent physically-replicating ETF would be furthermore disadvantaged due to their structure. This would further exacerbate the un-level playing field that exists with derivative-replicating ETF providers, without any corresponding protection or benefit to end-investors.

Please see our responses about cash collateral and collateral diversification below questions 18 and 19.

**Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If not, please explain.**

In general, yes, except for cash reinvestment only in ‘risk free’ assets and applying the UCITS diversification rules for not lent positions and collateral in aggregate.

Please see responses to the two issues in Q18 and Q20.

**Q18: Do you see merit in the development of further guidelines in respect of the re-investment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?**

In the context of securities lending, we disagree that cash collateral should be restricted to investments in 'risk free' assets only. Rather, we think it is appropriate for applicable guidelines to be consistent with the rules under UCITS in respect of the reinvestment of cash collateral. Within conservative reinvestment parameters, cash can be a useful collateral type for investors, but requiring 'risk-free' reinvestment will reduce the viability of cash as collateral. The primary investment objectives of cash collateral should be preservation of principal and maintaining appropriate liquidity.

Furthermore, it is critical that any new rules be made applicable in respect of all UCITS fund structures which engage in securities lending (not just ETFs). We would welcome the opportunity to discuss this further with ESMA.

**Q19: Would you be in favour of requiring a high correlation between the collateral provided and the composition of the UCITS’ underlying portfolio? Please explain your view.**

We do not believe that a high level of correlation between lent security and collateral necessarily benefits end-investors and, therefore, ought not to be made mandatory. Generally speaking, though, high correlation between lent security and collateral should reduce the required level of over-collateralisation.

While we do believe that correlation is an important factor when determining the appropriate level of over-collateralisation, liquidity and volatility of the collateral should also be considered. For example, high quality government debt collateral will have a lower level of price correlation with equities, but this should not mean that high quality government debt is an inferior form of collateral.

**Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?**

We do agree that collateral should be sufficiently diversified, but we do not believe that aggregating collateral and non-lent positions reduces risk for investors.

We would make the following key points in this respect.

* The NAV calculation of a fund is based on its retained portfolio and its lent portfolio (where securities lending is used). The investment portfolio does not include the collateral received.
* In the investment portfolio, risk diversification applies to spread the investment risk across assets. While liquid assets have to be held to meet on going redemption requests, the focus is primarily on finding an asset mix which meets the long term investment objectives of the fund.
* The key driver for collateral is the speed at which collateral can be liquidated in order to buy back lent assets on a failure of redelivery. This favours the inclusion of very liquid or short term instruments.
* If collateral is included in the overall UCITS diversification rules, funds would have to run two parallel calculations, one for the standard NAV calculation without collateral, and then one including collateral with no obvious benefit.
* Typically collateral programmes are managed by specialised collateral management and risk teams, which emphasise that collateral management is primarily a risk mitigation tool rather than an investment tool. Combining the two risks blurs the boundary between the two rules. This runs contrary to recent developments in UCITS and AIFMD which encourage separate risk functions.
* Collateral is generally required to be of the highest quality under existing guidance. If collateral is added into the UCITS investment diversification restrictions, collateral would be subject to diversification in accordance with the fund’s investment policy.
* Many funds would be in breach of their investment policies, if they held significant holdings of the high quality government bonds and cash which typically make up collateral schedules. Holding lower quality but diversified assets would lead to greater potential exposure to unit holders in the event of counterparty default.

**Illustrative examples: a) Physically-replicating ETF**

**33% Coll.**

**A: 3%**

**30% SL**

**Stock A: 9.5%**

**With SL**

**A: 9.5%**

**Index**

**A: 9.5%**

In the first example, the fund lends 30% of its assets, but not stock A where the fund has a 9.5% holding. The fund then takes in 33% collateral (including 10% over-collateralisation). The collateral pool is well diversified and contains a 3% share (of AUM) of stock A. According to the rules proposed by ESMA, non-lent positions and collateral would have to be aggregated resulting in a position of 12.5%.

We believe it is important to differentiate between the holdings according to the fund’s investment objective on the one hand and EPM techniques on the other hand. In the case of a borrower default, which is the primary reason why collateral is required, only the 3% position of stock A needs to be liquidated. In this instance, accepting 3% of stock A as collateral may actually be considered better for the fund, than holding other collateral as it would increase the correlation between collateral and the fund. In addition to this lending activities are typically diversified across a number of well-capitalised counterparties that fulfill the UCITS criteria.

**b) Derivative-Replicating (“Synthetic”) ETF**

**30% Coll.**

**X: 3%**

**30% SL**

**Stock X: 8%**

**Swap Collateral**

**Index**

**A: 9.5%**

In the second example, a derivative-replicating fund holds collateral which is different from the index constituents. The fund then lends some of the collateral holdings, and in turn, receives collateral. The aggregated collateral position in stock X would add up to 11%. In this instance we do agree with ESMA that both positions should be aggregated in order to assess the riskiness of the collateral position. The reason for this view is that if a situation occurred where the fund’s collateral had to be used to purchase the index securities, the entire 11% would have to be liquidated.

In conclusion:

* We agree that collateral should be sufficiently diversified.
* We disagree that un-lent positions and collateral should be aggregated.

The un-lent positions don’t have to be re-purchased in a borrower default and, therefore, the UCITS diversification criteria or a similar diversification rule should only be applied to the collateral positions in isolation.

**Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR’s guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?**

We have a strong preference for qualitative criteria. These criteria could be supplemented with an indicative list of collateral types and permissible cash reinvestment parameters (offering non-exhaustive examples). So, while an indicative list can provide guidance, the UCITS has to consider liquidity, volatility and correlation for different loan /collateral combinations in order to assign appropriate levels of over-collateralisation and issuer limits.

**Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of as-sets in paragraph 52 is appropriate.**

Please see response to Q21 above.

**Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transactions when calculating the maximum exposure under Article 52(1) of the UCITS Directive?**

Yes, but only for unsecured exposure. Logically, if a fund lends securities and has over-collateralised the relevant position(s), this should not be viewed as counterparty exposure.

**Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?**

Yes.

**Q25: Do you believe that the proportion of the UCITS’ portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?**

No, we do not consider that it is appropriate for ESMA to prescribe such a limit. Within appropriate collateral parameters, over-collateralisation and a robust counterparty approval process, securities lending can be performed in a low risk manner that does not require it being limited at either the fund or counterparty level.

For derivative-replicating ETF providers, which are part of an investment banking group, the parent investment bank holding a hedging basket may lend out the entire basket of securities in order to generate revenues. However, if limits were imposed on physically-replicating providers to lend only a certain percentage, this would put physically-replicating funds at a performance disadvantage and would ultimately limit the securities lending revenue, which may be passed onto the fund and reduce the benefit to end-investors.[[8]](#footnote-8) We do not believe it is the intention of ESMA to limit the benefits that end-investors may receive as a result of securities lending activities carried out by the physical ETF providers. As such, we would urge ESMA not to act specifically in this area.

However, if ESMA concludes that the amount of a fund that can be lent should be limited, the same limit should effectively apply to derivative-replicating ETFs. In practical terms, the equivalent to imposing lending limits on derivative-replicating ETFs would be that such ETFs would be required to hold a certain percentage of the index constituents within the fund.

**Q26: What is the current market practice regarding the proportion of assets that are typically lent?**

In the European market, UCITS rules currently do not impose a limit on securities lending activities. Securities lending agents control risk through a combination of counterparty selection, continuous monitoring and assigning the appropriate level of over-collateralisation. In times of stress, counterparty limits can be reduced quickly and levels of over-collateralisation can be increased.

**Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?**

Please see the answers to questions 25 and 26.

**Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?**

Provided the information is disclosed in the fund prospectus, we do not see the need to repeat the information in the fund rules. These documents generally only refer to investment policies and powers in a very generic way, and generally have a more onerous amendment process than the fund’s prospectus.

**Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?**

Requiring disclosure of counterparties once a year in the annual report is sufficient in our view.

Disclosing actual balances and changes in these frequently, can have unintended consequences. Any changes in borrowing activity could be mistaken as a credit signal, which could ultimately move-markets.

**Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interest? If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps.**

Please see response to question 31 below.

**Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.**

We do not see how the duties of a management company or fund board for a self-managed UCITS, to implement both a conflict of interest policy and a risk management policy, could be overridden by the implementation of an automated stock selection process.

In our view, transacting with multiple counterparties, a credit group which is independent from trading activities, combined with disclosure of collateral parameters is best practice to minimise conflicts of interest. A structure where the ETF issuer is part of a bank that is also the sole swap provider can lead to significant conflicts of interest. This is particularly concerning in a near default situation of the parental investment bank, where the parent needs to fund lower quality assets, and the ETFs could serve as an outlet for these.

**VII. Total Return Swaps**

1. In the case of an unfunded swap, both the UCITS‘ investment portfolio, the return of which is swapped, and the underlying to the swap, to which the UCITS obtains exposure, must comply with the relevant UCITS diversification rules. If collateral is posted by the swap counterparty to mitigate the counterparty risk, this collateral should be sufficiently diversified over the course of the swap in order that at any time, the portfolio composed of collateral and the other investments made by the UCITS comply with the UCITS diversification rules.

2. In the case of a funded swap, the collateral posted by the swap counterparty to mitigate the counter-party risk should be sufficiently diversified to comply with the UCITS diversification rules, taking into account both the investments made by the UCITS and the collateral. The UCITS should comply with the UCITS diversification rules in relation to entities at which cash is deposited, taking into ac-count both the cash received as collateral and any other cash held within the fund.

3. Entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

4. A UCITS should have in place a clear haircut policy for each class of assets received as collateral of a funded swap. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.

5. Information provided to investors in the prospectus of UCITS using total return swaps should include at least the following:

a) Information on the underlying strategy and composition of the investment portfolio or index, the counterparty(ies) and, where relevant, the type and level of collateral required and, in the case of cash collateral, reinvestment policy, including the risks arising from the re-investment policy; and

b) The risk of counterparty default and the effect on investor returns.

c) Where the swap counterparty assumes any discretion over the UCITS portfolio the extent to which the counterparty has control over the investment policy and the limitations imposed in the management of the UCITS should be disclosed to investors in the prospectus.

d) Where the swap counterparty has discretion over the composition or management of the UCITS portfolio or can take any other discretionary decision related to the UCITS portfolio then the agreement between the UCITS and the swap counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation. Thus, the counterparty should be treated and disclosed as an investment manager.

e) Where the approval of the counterparty is required in relation to any portfolio transaction this must be disclosed in the prospectus.

6. The UCITS‘ annual report should also contain details of the following:

a) The underlying exposure obtained through financial derivatives instruments;

b) The identity of the counterparty(ies) to these financial derivative transactions; and

c) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

**Q32: Do you agree with the proposed guidelines?**

Apart from paragraph 2 and 3 we would agree with the proposed guidelines. Detailed comments follow below.

In paragraph 6, we note that we do not think it appropriate to show the amount of collateral held by each counterparty when disclosing counterparties and collateral. This could give rise to an inference as to the manager’s assessment of the credit worthiness of individual counterparties, which may be misleading.

**Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return swaps is of good quality? If not, please explain your view.**

Generally speaking, yes, except for cash reinvestment only in ‘risk free’ assets and applying the UCITS diversification rules for non-lent positions and collateral in aggregate.

**Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?**

As in the answer to question 28, we do not think this is appropriate.

**Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR’s guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?**

We have a strong preference for qualitative criteria. These criteria could be supplemented with an indicative list of collateral types and permissible cash reinvestment parameters (offering non-exhaustive examples). So while an indicative list can provide guidance, the UCITS has to consider liquidity, volatility and correlation for different loan / collateral combinations in order to assign appropriate levels of over-collateralisation and issuer limits.

**Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.**

See the answer to Q35 above.

**Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?**

We do agree that collateral should be sufficiently diversified, but we do not believe aggregating collateral and positions in the portfolio reduces risk for investors.

We would make the following key points in this respect:

* The NAV calculation of a fund is based on its retained portfolio and the outstanding profit and loss on a derivative contract. In neither case does the investment portfolio include collateral received.
* In the investment portfolio, risk diversification applies to spread the investment risk across assets. While liquid assets have to be held to meet on going redemption requests, the focus is primarily on finding an asset mix which meets the long term investment objectives of the fund.
* The key driver for collateral is the speed at which collateral can be liquidated in order to buy back lent assets in the event of a counterparty default. This favours the inclusion of very liquid or short term instruments.
* If collateral is included in the overall UCITS diversification rules, funds would have to run two parallel calculations, one for the standard NAV calculation without collateral, and then one including collateral with no obvious benefit.
* Typically collateral programmes are managed by specialised collateral management and risk team, which emphasise that collateral management, is primarily a risk mitigation tool rather than an investment tool. Combining the two risks clouds the boundary between the two rules, which runs contrary to recent developments in UCITS and AIFMD.
* Collateral is generally required to be of the highest quality under existing guidance. If collateral is added into the UCITS investment diversification restrictions, collateral would be subject to diversification in accordance with the fund’s investment policy. Many funds would be in breach of their investment policies if they hold significant holdings of the high quality government bonds and cash, which typically make up collateral schedules. Holding lower quality but diversified assets would lead to greater potential exposure to shareholders in the event of counterparty default.
* Swap values now include an analysis of the quality of the collateral schedules attached to the swap documentation. Swaps with diversified but lower quality collateral schedules are likely to cost more.
* Adopting standard high quality collateral schedules facilitates novation of trades.

**Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?**

We do not see particular issues with a standard application to all OTC derivatives. This would assume that FX trades are not treated as OTC derivatives as different market standards apply here.

**VIII. Strategy Indices**

1. The prospectus for an index-replicating UCITS must, where relevant, inform investors of the intention to make use of the increased diversification limits together with a description of the exceptional market conditions which justify this investment.

2. A single component of an index must not have an impact on the overall index return which exceeds the relevant diversification requirements i.e. 20%/35%. In the case of a leveraged index, the impact of one component on the overall return of the index, after having taken into account the leverage, should respect the same limits.

3. Commodity indices must consist of different commodities which respect the 20%/35% limit in order to be considered an eligible index.

4. A strategy index must be able to demonstrate that it satisfies the index criteria, including that of being a benchmark for the market to which it refers. For that purpose:

a) An index must have a clear, single objective in order to represent an adequate benchmark for the market;

b) The universe of the index components and the basis on which these components are selected for the strategy should be clear to investors and competent authorities;

c) If cash management is included as part of the index strategy, the UCITS must demonstrate that does not affect the objective nature of the index calculation methodology.

5. The UCITS‘prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.

6. The rebalancing frequency should not prevent investors from being able to replicate the financial index. Indices which rebalance on an intra-day or daily basis do not satisfy this criterion.

7. The index provider should disclose the full calculation methodology to, inter alia, enable investors to replicate the strategy. This includes information on index constituents, index calculation (including effect of leverage within the index), re-balancing methodologies, index changes and information on any operational difficulties in providing timely or accurate information. This information should be easily accessible by investors, for example, via the internet. Information on the performance of the index should be freely available to investors.

8. A financial index must publish the constituents of the index together with their respective weightings. Weightings may be published after each rebalancing on a retrospective basis. This information should cover the previous period since the last rebalancing and include all levels of the index.

9. The methodology of the index for the selection and the re-balancing of the components of the index must be based on a set of pre-determined rules and objective criteria;

10. The index provider may not accept payments from potential index components for inclusion in the index.

11. The index methodology must not permit retrospective changes to previously published index values (‘backfilling‘).

12. The UCITS must carry out appropriate documented due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark. The UCITS must also assess the availability of information on the index including whether there is a clear narrative description of the benchmark, whether there is an independent audit and the scope of such an audit, the frequency of index publication and whether this will affect the ability of the UCITS to calculate its NAV. The due diligence should also cover matters relating to the index components.

13. UCITS must ensure that any valuation of the swap includes an independent assessment of the underlying index.

14. The financial index should be subject to independent valuation.

**Q39: Do you consider the proposed guidelines on strategy indices appropriate? Please explain your view.**

Subject to a number of exceptions, we generally agree with the principles of the proposed Guidelines. However, we note, for example, in paragraph 7 that some of the requirements, if they extended to real time disclosure of full index constituents, may not be supported by some index providers (which may seek to impose contractual restrictions on a fund provider’s ability to disclose such data). As such, disclosure with a time delay may be more appropriate.

**Q40: Do you think that further consideration should be given to potential risks of conflict of interest when the index provider is an affiliate of the management company?**

We agree that there are potential conflicts here and that appropriate safeguards reflecting operation and hierarchical separation and/or Chinese walls could be usefully considered.

**IX. Transitional Provisions**

1. The guidelines will come into effect on XX 2012.

2. Any new investment made by a UCITS or any new collateral received after XX 2012, and the content of any new document or marketing communication issued by or in respect of the UCITS after XX 2012 will have to comply with these guidelines immediately.

3. Investments made by UCITS and collateral received before XX 2012 are not subject to the guidelines, except:

a) un-invested cash collateral should comply with Box 6 paragraph 7and Box 7 paragraph 2 no later than [X] months after these guidelines come into effect; and

b) fees arising from EPM techniques should be returned to the UCITS in accordance with Box 6 paragraph 3 with immediate effect unless the UCITS has engaged in fee-sharing agreements prior to XX 2012.

4. Requirements relating to the use of an identifier in the name of an existing UCITS ETF do not come into effect until the earlier of:

a) the first occasion after XX 2012 on which the name of the fund is changed for another reason; or

b) XX 2013 (twelve months after these guidelines come into effect).

5. Requirements relating to the contents of the fund rules or instrument of incorporation of an existing UCITS, its prospectus, its KIID, or any marketing communication that it has issued prior to these guidelines coming into effect, do not come into effect until the earlier of:

a) the first occasion after XX 2012 on which the document or communication, having been revised or replaced for another purpose, is published; or

b) XX 2013 (twelve months after these guidelines come into effect).

6. Requirements to publish information in the report and accounts of an existing UCITS do not apply in respect of any accounting period that has ended before XX 2012.

**Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.**

While we agree with many of the proposals and general direction of ESMA’s Guidelines, we estimate that their implementation will require significant dedicated resource and time.

By design, index funds require fewer portfolio management and analyst resources, which contributes to the low costs of operating index funds. In order to implement many of the Guidelines proposed, we need to maintain this operating model or index funds will become more expensive and less competitive.

We do not believe that bringing the Guidelines into effect in 2012 is reasonable or practicable. When the Guidelines are finalised, we may need to adapt operating models to implement them and begin the education process in respect of the new requirements – both internally in respect of all impacted stakeholders within a fund manager, and externally with the relevant regulators, boards of directors and stock exchanges and investors.

We do not believe, at this stage, that it is reasonable to advise as to whether transitional provisions are appropriate. As the Guidelines advance further, we will be better placed to determine the appropriateness of any transitional provisions.

However in terms of ESMA’s proposed provisions, we note that:

* An effective date of 2012 for any of the proposed changes is not reasonable or practicable for the reasons outlined above – at least 12 months’ notice is necessary and should be granted.
* Any changes to ETF identifiers will depend on whether the ETF provider would have sufficient time to educate internal and external stakeholders, in respect of any new requirements imposed, and sufficient time to adapt operating models if required, taking into account regulatory and other filings.
* BlackRock will have approximately 15,000 KIIDs to update which will require significant resource and time. In terms of constitutional documentation that may need amendments, any changes to constitutional documents will generally require shareholder approval. We cannot guarantee that shareholders will approve any changes put to vote and this is a factor which further complicates the process. If constitutional documents do not permit the changes to the prospectus documentation this may present additional delays. We do not envisage such a situation but, without reviewing our entire suite of documents, we cannot categorically rule this out.
* For these reasons, it is not possible to comment definitively in respect of timeframes at this early stage.
1. cf. ESMA Consultation Paper on Guidelines on ETFs and Other UCITS Issues, p.51, paragraph 63 [↑](#footnote-ref-1)
2. cf. Securities and Markets Stakeholder Group, 29 November 2011, “Advice on ESMA’s public consultation on UCITS Exchange-traded funds in the European Union”, p.6, paragraph 24 [↑](#footnote-ref-2)
3. Publication available at: <https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_INS&source=CONTENT&ServiceName=PublicServiceView&ContentID=1111150014> [↑](#footnote-ref-3)
4. |n BlackRock’s view, Exchange Traded Product (ETP) should be the broad term used to describe any portfolio exposure product that trades on an exchange. ETF should refer only to a specific sub-category that meets certain agreed upon standards. [↑](#footnote-ref-4)
5. See answer to question 3, below. [↑](#footnote-ref-5)
6. Please see press release issued by the Hong Kong Stock Exchange: <http://www.sfc.hk/sfcPressRelease/EN/sfcOpenDocServlet?docno=10PR134> [↑](#footnote-ref-6)
7. In point 2 of Option 1, please note that the issuer can only work within the constraints set by the exchange and settlement system (e.g. CREST) when replacing market makers. Such entities should be consulted before any change to current requirements is implemented in case what is proposed is not viable from an operational perspective. [↑](#footnote-ref-7)
8. This scenario assumes single counterparty swap-based providers of derivative-replicating ETFs share in the securities lending revenues that are generated outside the ETF, which is an area where no transparency is provided at the moment. In this case, there is no data in respect of any benefit which may ultimately be passed back to the fund and/or end-investor, if any, and we would welcome increased transparency in this respect. [↑](#footnote-ref-8)