Please note that the comments expressed herein are solely my personal views

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- Your Ref: Comment letter on ESMA's guidelines on ETFs and other UCITS issues

Dear Sir.

Thank you for giving us the opportunity to comment on your consultation paper on ESMA's guidelines on ETFs and other UCITS issues. In general I agree with the issues that you have raised here concerning investor protection and market integrity, and the policy orientations that you have identified. I would like to comment in particular on the retailisation of complex products, exchange traded funds and rider activities.

Retailisation of complex products

Market and financial product developments have brought more complex products within the reach of retail investors. Without discussing whether this trend is appropriate or not, it is critical that retail investors are clearly informed of the risks inherent in more complex products, and that they fully appreciate their risk. Structure and form should not be used as a means of circumventing the intent of securities' and markets' rules and regulations. Therefore it is important that regulators consider substance over form. In this case, we can take a "look through" principle to more complex products.

For example, the definition of complex product should consider two features: a latent feature test would determine whether the product exposes the investor to any new risk factor compared with investing in the basic underlying instruments; and a quantitative test would determine whether the product arbitrarily or artificially increases the exposure to the existing risk factors of the basic underlying instruments. This consideration of "new risk" and "increased risk" is a good starting point for defining complex products, and such a principles-based approach is generally superior to (by definition non-exhaustively) listing the various complex or non-complex instruments or products. Under this dual approach, almost any non-linearity in payouts would be considered complex, which is reasonable and appropriate in the context of retail investment.

Exchange traded funds

Exchange traded funds (ETFs) have become increasingly more complex. This is especially the case for those ETFs which replicate returns using derivatives products. These synthetic ETFs are less transparent to investors, and are therefore more difficult to assess and monitor. Therefore, as a minimum, the strategy and index replication process should be disclosed along with a description of its key risks and discretionary elements.

Rider activities

The additional risks from rider activities, such as securities lending, repo and collateral management should be disclosed and of course measured, monitored and controlled. The prospectus should include a detailed description of such activities, which should be sufficient and complete so that investors would be able to understand the risks involved in these rider activities.

Answers to specific questions raised by ESMA

I generally agree with your analysis of issues and policy orientations.[1]

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

I prefer option 1. Investors should have a right to request direct redemption of their units from the UCITS ETF, but only when market makers are no longer providing liquidity in its units.

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?

I agree that the collateral received in the context of EPM techniques should comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS. This is more consistent and is also basic risk management.

[1] E.g. answer yes to questions 1, 4, 6-11, 16, 32, 39, 41.

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?

I agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with UCITS diversification rules. This is basic risk management.

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?

I agree 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. This should ensure that there is no counterparty risk "creep" and that this risk does not become arbitrarily excessive.

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?

I would not support a limit on the proportion of a UCITS portfolio that can be subject to securities lending activity. Such a limit would be arbitrary and should not be necessary in the context of the principles described in the paper.

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?

I agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with UCITS diversification rules. This is basic risk management.

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?

I agree 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. This is more consistent and is also basic risk management.

Yours faithfully

C.R.B.

Chris Barnard