

30 March 2012

The Institute of Financial Services Practitioners is an association of professionals working across the entire range of financial services in Malta. The Institute's membership pulls together lawyers, accountants, investment managers and advisors, bankers and insurers.

The Institute provides a forum for the continuous exchange of ideas and even increased co-operation between various professions. In effect, the Institute represents a distinct and separate professional person - the financial services practitioner.

The IFSP is glad of the opportunity to contribute its commentary to the consultation paper (ESMA/2012/44) on *ESMA's guidelines on ETFs and other UCITS issues*. This second document includes the IFSP's responses to the questions in Sections VII (Total Return Swaps) and VIII (Strategic Indices).

Section VII – Total Return Swaps

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

The IFSP generally agrees with the proposed guidelines. The main concern relates to the fact that the collateral posted by a counterparty to reduce the counterparty risk exposure need not be diversified such that, the portfolio composed of collateral and the other investments made by the UCITS, comply with the UCITS diversification rules. The main reason is that the UCITS does not have a market risk exposure in respect of the assets it receives as collateral. If the value of the collateral drops, the counterparty will be required to post additional collateral or otherwise the UCITS will have not option but to reduce the counterparty risk exposure.

Whilst the adoption of a generally diversification principle is advisable, requiring UCITS to satisfy prescriptive UCITS diversification rules in so far as collateral is concerned would be an unnecessary constraint, which should be covered within the Risk Management Policy of the UCITS Management company and left to the discretion of the UCITS Management company.

Another concern relates to the fact that certain collateral (such as units in other funds) may need to be deposited with entities that comply with Article 50(f) of the UCITS Directive. Where a UCITS is receiving units in other funds as collateral, the transfer of the units in the other funds to an entity referred to in the consultation document would be an unnecessary constraint. A record in the register of members of the fund whose units are being given as security [ie that the units belonging to the counterparty

(pledgor) are being given as security to the UCITS Fund (pledgee)] should suffice. The UCITS Management company should be allowed to assess the best manner in which security (collateral) is posted in favour of the UCITS Fund (which in certain cases might not result in the assets granted as security being transferred to an entity that complies with Article 50(f) of the UCITS Directive).

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

The IFSP is of the view that the guidelines do not address the quality of the collateral that a counterparty is required to post in favour of the UCITS Fund. These qualitative characteristics are adequately covered in CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788).

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?*

The IFSP is of the view that the disclosure of information on the counterparty(ies) and, where relevant, the type and level of collateral required and, in the case of cash collateral, the reinvestment policy is unnecessary. The type of counterparty(ies) and the type and level of collateral that a counterparty may require to post in favour of the UCITS should be set out in the Risk Management Policy of the UCITS Management company and not in the Prospectus. Furthermore, the UCITS investment limits set out counterparty risk limits applicable to different types of the counterparties and these requirements suffice for the purposes of mitigating counterparty risk exposure.

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?*

The IFSP is of the view that the criteria set out in CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788) are sufficient and need not be supplemented with an indicative/ prescriptive list of eligible collateral.

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.*

Please refer to our reply to Q35.

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?*

Please refer to our reply to Q32.

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?*

The IFSP is of the view that the application of haircuts on collateral posted in favour of a UCITS is a sensible risk management approach. Notwithstanding this approach should be left at the discretion of the UCITS Management company and be appropriately documented in the Risk Management Policy of the UCITS Management company.

Section VIII – Strategy indices

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

The IFSP is generally in agreement with the proposed guidelines. The main concern relates to the extent of due diligence that the UCITS Management company is expected to undertake on the Index. Clear guidelines in this respect should be published. Reference to independent valuation in para 14 should clearly provide that the calculation agent is expected to be independent from the UCITS Management company.

Q40. *Do you think that further consideration should be given to potential risks of conflict of interests when the index provider is an affiliated firm of the management company?*

The IFSP is generally in agreement with this approach and specific disclosure on the potential conflict of interests should be disclosed in the Prospectus.
