European Securities and Markets Authority

Submitted online: [www.esma.europa.eu](http://www.esma.europa.eu)

Dear Sir

We are pleased to have the opportunity to provide feedback on the ESMA consultation on its guidelines for ETFs and other UCITS issues.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of a number of pension funds and institutional investors from the US, Australia and Canada, as well as across Europe. We assist these clients to act as good owners of the assets in which they invest. In all, EOS’s advises clients with regard to assets worth a total of over €100 billion (as of 31 December 2011).

As institutional investors, we are principally concerned about the problematic systemic implications of ETFs. Therefore we have both a strong interest in the transparency of these investment products, especially with regard to their interconnectedness within the financial system. We would welcome clear definitions of their underlying elements and better understanding of the extent of risk they carry. We support the current debate surrounding these investment instruments and would welcome seeing the gains in transparency and accountability resulting from this debate spilling over to a wider part of the investment management industry.

We support the current efforts to create a regulatory environment which allows investors accurately to ascertain the risks associated with UCITS ETFs, specifically synthetic and swap-funded ETFs. Even though physical and synthetic ETFs can share a similar risk profile in practice and synthetic ETFs may often produce a lower tracking error, we are concerned about the potential effects for market stability resulting from their role as shorting instruments. At present, ETFs are able to issue new shares without necessarily buying new assets. If synthetic ETFs are systematically used to short markets, this can therefore result in more assets being shorted than physically exist in the market. Accordingly, we encourage ESMA as market regulator to insist on asset matching or to consider disallowing ETFs from issuing new shares if appropriate matching ceases to be the case.

We particularly welcome ESMA’s efforts in the topic of efficient portfolio management techniques (EPM), especially securities lending. While securities lending as such is not a practice specific to ETFs, it can in many cases have a decisive effect on the fund’s performance and profile. Appropriate disclosure of the securities lending practices of the vehicle in question is essential for investors if they are to perform an accurate cost-benefit analysis of the ETF. Furthermore, we would welcome further clarity on the role that returns from securities play in the structure of the fund’s returns. Furthermore, we encourage further consideration of the overall effects of the practice upon financial systems, specifically in the (common) case that securities are being lent out for the purpose of being shorted by the borrowers. Due to the popularity and influence upon the market of this type of EPM we encourage ESMA to consider dealing with it holistically.

While we believe that the debate on ETFs has positively influenced the transparency of that market segment, we find that exact definitions of several key concepts are still missing. A precise legal definition of what constitutes an index-tracking instrument, and what degree of connection to a certain index is sufficient, would be very welcome. Similarly, we encourage ESMA to consider what type of index is suitable for tracking via an ETF directed towards retail investors. We are sensitive to principal-agent problems that may arise in relation to an ETF, which is why we prefer disclosure of total costs and returns generated by ETFs, especially agency fees.

Conflicts of interest, along with risk management and transparency, are at their core a governance problem that is not unique to ETFs. Many of the challenges faced by listed investment vehicles, especially regarding accountability, are not dissimilar to those of listed equity. The creation of a comprehensive best practice behavioural standard which has the protection of investors as its central principle would address these underlying issues without the need for increasingly detailed regulation. Therefore, we would encourage a wider debate into the development of governance standards for this type of instrument.

We answer the specific questions below.

Yours sincerely,



PAUL LEE

Director

1. **Index-tracking UCITS**

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

We welcome the level of disclosure proposed by the guidelines. As mentioned above, we would propose that ESMA creates a robust definition of an index-tracking UCITS, determining in particular the range of tracking error a fund is allowed to produce if it is to indentify itself as an index-tracker. This would provide a clear statement of which UCITS the guidelines apply to, and limit potential efforts to circumvent them.

**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.**

Yes. We believe that the UCITS ETF should disclose the components of the tracking error. Furthermore, a standardised measure of tracking error would make it easier for investors to compare the performance of UCITS ETFs in that regard, and would increase accountability towards UCITS ETFs shareholders. As it is often the case that synthetic UCITS ETFs produce a smaller tracking error than physical ones, we believe that the measure used should be the same for both types and allow direct comparison between them. In that way, investors would be able to make a more meaningful comparison between the different investment vehicles available when making their decisions.

**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. We believe that this would enhance investors’ understanding of the character of exposure to the tracked index and the sources of the fund’s performance. Furthermore, investors would be able to detect if a fund systematically takes risks of a different economic nature than the ones implicit in the chosen benchmark.

1. **Definition of UCITS ETFs and identifier**

**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)?**

We welcome the emphasis put on the role of the market maker in assuring asset-matching in ETFs. However, we believe that the definition should specify the manner of unit creation required for an UCITS to be identified as ETF (e.g. the type of asset held, basket assets vs individual assets, etc.) Also, we would welcome an indication of what type of benchmark would be required from an UCITS in order to be able to identify itself as an ETF.

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

Yes.

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

Yes. We believe that a further distinction in the identifier would be helpful in order to better signify the level of risk involved. We are not convinced that the distinction between synthetic and physical ETFs is per se a useful measure of that, any more than a distinction between complex and non-complex ETFs would be. Unless there is a clear definition of what exactly makes an ETF “synthetic”, the distinction would only be marginally helpful in terms of risk assessment.

**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?**

We see the role of the market maker as essential in ensuring appropriate asset-matching. Therefore, in order to ensure that this role is not compromised, we believe that the presence of at least one market maker who is independent of the ETF promoter should be required.

1. **Actively-managed UCITS ETFs**

**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 the prospectus, the KIID or any marketing communications of the UCITS ETF?**

While we agree with the proposed guidelines, we urge ESMA to clarify the distinction between actively managed funds and index-trackers, specifically the degree of relation to the performance of the chosen benchmark, the source of tracking error and the significance of EPM for the returns that are allowed in a passively managed fund.

1. **Efficient portfolio management techniques**

**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 are in favour of requiring compliance with the CESR guidelines for UCITS.

**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 are aware of the fact that a high correlation between collateral and underlying portfolio could potentially endanger the repo margins earned through EPM, and therefore endanger the raison d’être of the ETF structure itself by removing a significant stream of revenue. However, we believe there is no one size fits all solution to this particular question and the answer depends on the overall strategy of the fund. For UCITS ETFs whose strategy limits their exposure to counterparty risk, the CESR guidelines would be sufficient to provide a suitable level of investor protection. This would not be necessarily the case for ETFs with high levels of exposure to counterparty risk, for which insisting on a higher correlation between collateral and portfolio would make sense.

**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?**

**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 assets in paragraph 52 is appropriate.**

We believe that an exhaustive list of assets could potentially be counter-productive as fund managers would be incentivised to devise strategies to circumvent its requirements. The CESR guidelines provide a workable list of qualitative criteria that captures the main characteristics of quality collateral.

**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. We believe that the source of counterparty exposure is not relevant to the calculation of its level. EPM exposure should be included in the maximum exposure under the UCITS directive in order to provide an accurate picture of the risk present in an investment structure.

**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?**

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

Although current industry practice varies very widely, we believe that lending out very high proportions of the portfolio is liable to introduce levels of counterparty risk into the structure that fundamentally change its character and operation. We see 20% to 25% as a reasonable threshold for the proportion of the portfolio that could be subjected to securities lending.

**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)?**

We are not sure that it is feasible to set any requirements as to the use of lent securities. This fact is largely invisible to the lender, not least as the securities may well simply be on-lent by the initial counterparty. We therefore do not believe that it is realistic to amend the rules on the proportion of the assets eligible for lending based on the intent of the counterparty.