



# BREWIN DOLPHIN

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European Securities and Markets Authority  
103 rue de Grenelle  
75007 Paris  
France

30 March 2012

**Ref: Brewin Dolphin response to the ESMA Consultation paper "ESMA's guidelines on ETFs and other UCITS issues"**

Dear Sirs,

Please find attached our response to the above consultation in Annex 1 to this letter. Before we proceed to answer individual questions, I would like to make a few general points about how we use UCITS Exchange-Traded Funds (ETFs) at Brewin Dolphin, and our general understanding of the current policy and market practice.

Firstly, our investment managers are accustomed to including UCITS ETFs into client portfolios. We see them as liquid and sufficiently flexible instruments which offer exposure to a number of asset classes at a low cost to the client.

We accept that ETFs have gained much negative publicity of late. The associated risks were highlighted in the report published by the Financial Stability Board last year. The UK Financial Services Authority identified ETFs as an emerging risk in its Retail Conduct Risk Outlook 2012. It must however be noted that most ETFs are already subject to the UCITS Directive which offers a robust and comprehensive regulatory framework. We thus advocate a balanced approach to policy formation where clarification of rules does not come at the expense of unjustified complexity.

At the same time, we welcome the proposed ESMA guidance which builds on the existing framework and aids further harmonisation of the rules in the EU.

We would be delighted to discuss our position further, should you wish to consult us on any finer details of our response.

Yours sincerely,

Angela Teodorescu  
Divisional Director, Consultations & Policy

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## Annex 1

### I. Index-tracking UCITS

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

We agree with the proposed guidelines, and we welcome the ESMA's proposal that the prospectus of an index-tracking UCITS should contain a description of its investment policy and sufficient information about the underlying index.

Furthermore, we believe that the following guidance is helpful: "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." It would however be desirable to see more information about the composition of the indices. Some indices, particularly smaller ones, are not always transparent about their composition. We would suggest that ESMA requires the UCITS ETF providers to publish information about the composition of the underlying index on their website and update it in real time.

#### 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.

We are not certain as to what the existing guidelines are, and whether they already provide sufficient guidance with regards to the calculation of the tracking error. In any event, we believe that it is not necessary to make a specific policy distinction between physical and synthetic UCITS ETFs. Regulatory framework for synthetic UCITS ETFs is very extensive whereas physical UCITS ETFs are not as closely regulated. The risks attributable to physical and synthetic UCITS ETFs are therefore different, but one would not necessarily be more risky than the other.

#### 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 it would be helpful to have access to historic data. However, we feel that a binding legal definition of an "index" is currently lacking in regulation. We strongly advocate that ESMA determines such definition and escalates it to the European Commission to be included into the MiFID II or MiFIR.

### II. Index-tracking leveraged UCITS

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

We agree with the proposed guidelines.

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

We believe it might be helpful, although care should be taken with regards to particularly onerous disclosure requirements. Given that the markets remain volatile and sensitive to data shocks, the consequences of an excessive disclosure requirement are unpredictable: it can both help UCITS ETFs gain new investors and harm them in the long term as a result of an increase in their compliance costs. Also, there is always a potential for data to be misinterpreted, which can further harm the fund in question.

We strongly encourage the regulator to clarify the transparency and accountability requirements of the underlying indices.

## **III. UCITS Exchange Traded Funds**

### ***Definition of UCITS ETFs and Title***

**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 agree with the proposed definition of a UCITS ETF.

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

We broadly agree with the proposed guidelines on the use of the identifier. We are however concerned that, under the proposed guidelines, only UCITS ETFs are allowed to use identifier "ETF." This could create confusion between UCITS ETFs on the one hand, and exchange-traded notes (ETNs) and commodities (ETCs) which are not UCITS, on the other.

A more far-reaching measure would be introducing a unique identifier in the ISIN code. It can be difficult to identify UCITS ETFs on the system, especially the ones with similar names. We would encourage ESMA to consider introducing a unique ISIN code identifier to help distinguish between different funds.

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

No. As stated above, we believe that a distinction between physical and synthetic UCITS ETFs is not necessary.

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

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We believe that a UCITS ETF should use either "ETF" or "Exchange-Traded Fund" as an identifier. Using two identifiers at the same time is unnecessary and could add confusion to the market.

**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 would suggest that there should be a requirement to apply to at least two market makers before proceeding with the trade.

## ***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?**

We agree with the proposed guidelines.

## ***Secondary market investors***

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

We prefer Option 2 on the grounds of simplicity.

**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.**

Not applicable: see answer to Q12.

**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.**

We believe that additional guidelines may be beneficial for the sake of regulatory clarity. At a high level, our preference is for ETFs to remain available for retail investors in the secondary market. This facilitates intraday pricing and also removes the potential costs that providers may levy if dealt on the primary market.

**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?**

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We believe that ETF providers are best positioned to provide this information.

## IV. 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 agree with the proposed guidelines. We believe it would be advantageous to align the requirements for collateral with the CESR's guidelines. The quality of the collateral is a contentious issue. The availability of clear guidelines will help resolve many outstanding issues and questions.

**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 no, please justify.**

Yes, we believe that would be the case.

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

Yes, we believe that would be helpful. Regulation is currently lacking in this area, which makes the products more opaque. As a result, end investors can be exposed to heightened liquidity and counterparty risks without any explicit prior knowledge and/or agreement.

**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 believe that high correlation is helpful but not crucial. The most important thing is that these assets are of a high quality and sufficiently liquid. These ingredients facilitate more accurate pricing and provide comfort that this collateral (or 'back stop') is adequate insurance against the provider defaulting.

**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 agree with this contention.

**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 would prefer to have an indicative list of eligible assets, especially given the fact that the composition of the portfolio of the collateral changes constantly to respond to the market movements.

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**Q22: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?**

Yes, we believe that that would help reduce the overall exposure in synthetic UCITS ETFs. However it may not have any noticeable effect in physical UCITS ETFs.

**Q23: 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.**

No, that would be too restrictive. See our answer to Q 21.

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

Yes, tougher prudential requirements may help reduce counterparty risk.

**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?**

We would suggest that no particular threshold should be imposed, but a UCITS ETF should be under an obligation to disclose. This relates to ESMA's own proposals to enhance investor disclosure in this consultation.

At the same time, we have no objections to the level of stock lending provided the collateralisation procedures are robust and the fees split is appropriate.

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

Market practice varies, but we have seen one of the funds lending out up to 80% of the NAV and another lending out up to 100% of its NAV.

**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)?**

Yes. If ESMA adopts guidance on determining the proportion of the underlying assets for stock transfer, we believe that that would help enhance investor protection.

**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?**

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Yes. This would facilitate the harmonisation of the UCITS ETF regulation in the European Union, promote greater transparency, and ensure that investor protection meets the same high standards in all EU Member States.

**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?**

Yes, we would like to see this information published on the fund's website on a quarterly basis.

**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 interests? 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.**

Yes, these situations can occur. Such risks can be mitigated by a detailed conflicts of interest policy, which is reviewed periodically subject to the regulatory requirements and business need.

**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 automation of portfolio management can compromise the conflicts of interest policy of the UCITS management company.

## **V. Total return swaps.**

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

We agree with the proposed guidelines.

**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.**

We believe that this outcome can be reached by harmonisation of the rules throughout the EU.

**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?**

Yes, we believe that would clarify the fund rules.

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**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 would prefer to have the qualitative criteria complemented by an indicative list of eligible assets.

**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.**

No, that would be too restrictive.

**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 agree with this contention.

**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?**

Yes, we believe that that would further help harmonise the rules.

## VI. Strategy indices

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

Yes, we believe that the proposed guidelines are appropriate. The already existing index criteria are good, and they would be further improved by the ESMA guidelines.

We would like to use this opportunity to reiterate the need for a legal definition of an "index" to aid business certainty. ESMA defines a strategy index as "an index which aims at replicating a quantitative strategy or a trading strategy." We would like to see a more detailed definition embodied into the final guidance or into one of the upcoming Regulations.

**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?**

Yes, we strongly believe that should be the case. A UCITS ETF must have a clear conflicts of interest policy and disclose where the index provider is affiliated with the management company. Abuse of this policy may give rise to market manipulation.

## VII. Transitional provisions

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

We believe that the transitional provisions are generally appropriate; however we are concerned about the lack of certain implementation dates. We would suggest that ESMA allows at least 6 months to implement the change, before the rules come into effect.

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