Markets & International Banking
Retail Structuring & Structured Funds
250 Bishopsgate
London, EC2M 4AA
United Kingdom

30 March 2012

European Securities and Markets Authority (ESMA)
103, rue de Grenelle
75007 Paris
France

Dear Madam,
Dear Sir,

Response to the Consultation Paper ESMA/2012/44: "ESMA's guidelines on ETFs and other UCITS issues"

This paper is the response on behalf of the Structured Funds group of The Royal Bank of Scotland plc to your recent consultation paper entitled ESMA's guidelines on ETFs and other UCITS issues.

The Royal Bank of Scotland plc manages over GBP 2.44 billion of assets (as of March 2012) in its Structured Funds business, including the RBS Market Access ETFs, closed-ended protected funds and various tailor-made funds for large institutions.

Following our previous contribution to the discussion paper ESMA/2011/220 on "ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS", we would like to thank ESMA for the opportunity to contribute to this new consultation paper.

Please find below our detailed comments and answers.

Please do not hesitate to contact us should you wish to discuss any of our comments or answers.

Yours sincerely,

Danny Dolan
Managing Director, Structured Funds

Index-tracking UCITS

Q1: Do you agree with the proposed guidelines?

We fully agree with ESMA's proposals concerning the various disclosures that should be included in the prospectuses of Index-tracking UCITS. We also support ESMA's proposal to request tracking error is included in the annual and half-yearly reports.

However, we would suggest tracking <u>difference</u> (performance difference between the fund and its target index) is a more meaningful measure than tracking error as defined in the Consultation Paper (volatility of such difference). In our opinion (and experience), investors are interested in whether a fund has underperformed or outperformed the index it is tracking over specific periods and, crucially, by how much. The volatility of such under/outperformance is far less meaningful or relevant to the majority of investors. Accordingly, we would suggest that tracking <u>difference</u> should be required to be shown over prescribed, standardised periods.

As previously mentioned in our response to the discussion paper ESMA/2011/220, we also agree that a description of the risk factors likely to affect a fund's tracking error should be included. We share the view that this disclosure requirement should be limited to a description (rather than an attempt to quantify the impact of such risk factors), since certain factors such as transaction costs are variable (relative to the number of trades).

Importantly, we disagree with Guideline 1 a) recommending that the exact composition of the index be published. For a simply long-only index, consisting solely of equities or bonds, we consider that publication of the index methodology and its largest constituents is sufficient. Full disclosure of all index constituents on a real-time basis would endanger the intellectual property of index providers, and lead to fewer specialist or niche indices being offered in UCITS format. For long-only equity or bond indices, we don't believe this would represent a good outcome for investors.

Rather than full constituent disclosure on a real-time basis, we would suggest the top 10 current constituents should be disclosed on a website specified in the prospectus. (If an index has fewer than 15 constituents, the top 5 current constituents should be disclosed). The full index composition should then be disclosed on a delayed basis, no later than the next rebalancing. In this way, investors are provided with detailed information about the index composition, but without undermining the index provider's intellectual capital or creating a disincentive to research and innovation. In addition to the top index constituents, the redacted index methodology would also be available on the UCITS website, providing investors with further transparency.

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 ESMA should provide some further guidelines on the calculation of the tracking error.

To the full extent possible, the calculation and presentation of information on tracking accuracy should be aligned across all UCITS ETFs, to allow for a like-for-like comparison between all UCITS ETFs.

As outlined under Q1 above, we consider that (a) tracking difference rather than tracking error is more relevant for investors; and (b) the time periods over which tracking difference should be measured and disclosed should be standardised. We would suggest one year and each further full year since inception, subject to a maximum of 5 years (earlier data less relevant).

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 comparison (referred to above as tracking difference) is the most valuable information for investors concerning tracking accuracy. We consider that it should be the primary focus of disclosure on tracking accuracy.

We consider that tracking error (as measured by volatility of tracking difference) is useful supplementary information, particularly for institutional investors (who may have a shorter investment horizon). This is because tracking error (volatility of tracking difference) essentially measures how much a fund's tracking accuracy varies from day to day. Accordingly, it can help short-term investors (e.g. large institutions using ETFs to invest or hedge for short periods) assess how important the timing of their investment is to the tracking accuracy they will experience.

For longer term investors (e.g. the majority of retail investors), tracking difference is a far more important consideration than the volatility of such difference (tracking error). Accordingly, we believe that some supplemental information on tracking error should complement the primary disclosure on tracking difference, rather than the other way round.

Index-tracking leveraged UCITS

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

Yes, we agree with the proposed guidelines. Most of these disclosures are already required in certain jurisdictions.

However, as previously mentioned in our response to the discussion paper ESMA/2011/220, the information could be requested in the KIID, but only if the format of the KIID allows it (constraints on the size of the document or use of plain language).

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 the disclosure required by paragraph 1 of Box 2 above is sufficient.

However, we do consider that paragraph 13 makes a valid point about the characteristics of daily leveraged UCITS, and that their performance over longer periods can differ considerably from the target multiple of the relevant index. Monthly leveraged UCITS go some way towards addressing this issue, by fixing the applicable leverage factor for a longer period. We believe that the maximum positive or negative leveraged return for monthly leveraged UCITS should also not exceed twice the return of the index.

However, we believe that the frequency of global exposure calculation for leveraged UCITS should match the leverage period. This means daily calculation of global exposure for daily leveraged UCITS, and monthly global exposure calculation for monthly leveraged UCITS. Applying daily calculation to monthly leveraged UCITS would risk giving a distorted impression of the leveraged return available to investors. Instead, the global exposure calculation should match the leverage frequency, to accurately capture the return profile of the UCITS.

UCITS Exchange Traded Funds

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 agree with the proposed definition.

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

Yes. We agree with a global naming convention that would clearly identify UCITS ETFs from other funds or products. We also agree with using the acronym “ETF”.

In our view, the identifier should be used in the sub-fund name, as this may be more relevant in the context of an umbrella fund.

It is significant that a number of non-fund products will still be able to use the term ETF in their name, whereas UCITS that do not fall under the proposed definition will not be allowed to under the proposed new guidelines. Although we agree that the term ETF should only be used by funds meeting the definition in Box 3, we believe it is vital that non-fund products should also be prevented from using the term ETF or Exchange Traded Fund to describe itself.

We agree with Box 3 paragraph 2 that the identifier “ETF” should be included in all documentation relating to those UCITS which meet the definition of UCITS ETF in Box 3 paragraph 1.

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

No. We do not think that the identifier should distinguish ETFs on the basis of their investment policy. We believe the delivery mechanism and investment policy should be disclosed in detail in the fund documentation, but not in the identifier.

Differentiating between physical and synthetic ETFs in the fund identifier would in our view create a misleading impression that synthetic funds and physical funds are inherently different, even though they are subject to the same risk monitoring and compliance regimes. It would also create confusion within ETFs and other UCITS that may at times use derivatives, repo agreements or stocklending for EPM (would they be classified as semi-physical, semi-synthetic or other).

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

We do not have any objection to the use of ‘Exchange-Traded Fund’ as an alternative identifier.

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?

No, we do not support the idea of requiring a minimum number of market makers.

Such a requirement would not necessarily be in favour of investors. In particular, it would mitigate against the provision of specialist or niche market or nascent ETFs. For esoteric underlyings or proprietary indices, there is often a natural limit on the number of market makers that are possible. An arbitrary requirement for a minimum number of market makers would therefore exclude some indices from being offered in UCITS ETF format. This would be detrimental to investors, both by limiting the choice of UCITS ETF available to them, and by encouraging them to invest in less regulated products when seeking market exposure.

We believe the number of market makers for a particular product is a commercial matter rather than a regulatory one. In a choice between similar products, investors are likely to favour the one they perceive as more liquid. So there is already a strong commercial incentive for UCITS ETF providers to appoint multiple market makers. And product providers typically list the market makers in their marketing material, as well as disclosing them upon request. Prospective investors should therefore be in a position to make an informed investment decision, taking an ETF's market makers (both their number and identity) into account. Investors are also further protected by the rules any market marker needs to abide by on the exchange where it is operating.

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?

Yes, we fully agree with these guidelines. No, we do not consider that further additional disclosures are necessary, beyond those set out in Box 4 plus those already required for all UCITS ETFs.

Secondary Markets Investors

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

Of the two alternatives proposed, we strongly favour Option 1.

As mentioned in our response to the discussion paper ESMA/2011/220, we believe that giving secondary market investors a direct right to redeem with the fund would not be manageable from a technical/practical perspective. It would also not be a good outcome for investors, because the redemption fees that would need to be charged by the UCITS ETF or its management company under Option 2 are likely to be significantly higher than the secondary market trading costs typically payable by ETF investors currently.

In the case of funds in the form of ICVCs/SICAVs, the investors would have to be registered in the shareholders' register of the fund, and have to redeem via the registrar and transfer agent. This would effectively turn the UCITS ETFs into regular daily-dealing mutual funds, and remove the benefits to investors of the exchange listing. Specifically, the benefits removed by such a requirement would include the enhanced on exchange liquidity from market makers and other market participants, and the ability to trade intra-day, rather than just once-daily at NAV.

In addition, from a purely practical perspective, we don't see how the registrar and transfer agent would be able to better manage these redemptions if a large number of investors request their redemption simultaneously during a period of disruption of the market. The registrar and transfer agent of regular daily-dealing mutual funds usually charges a fee per transaction, so this would end up as an additional cost to investors – on top of the redemption fee which would be charged in such circumstances.

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. As mentioned above, we do not think this possibility of direct redemption is either viable practically or beneficial to investors.

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.

Yes additional guidelines should be provided for these certificates.

These products are not ETFs and should be clearly distinguished, as outlined under Question 7 above. This should include a clear indication in the product name, which should not be allowed to use the term ETF.

Certificates representing units in a UCITS ETF bear additional risks compared to those ETF units. For this reason, it is very important that investors are made aware of the difference between such certificates and UCITS ETF units – through prominent disclosure in such certificates' prospectus, marketing material and product name.

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?

The ETF shares are traded on exchange or over the counter (OTC) and settled Delivery-Versus-Payment via the relevant settlement systems. As ETFs tend to be listed on more than one exchange, it's important to ensure their shares are fungible across the settlement systems. The ETF shares in issue are represented by a Global Share Certificate (GSC) which is deposited in Clearstream Banking Frankfurt. Settlement then occurs by the transfer of shares of this GSC to the relevant settlement account.

The ETF's official share register is held by the registrar and transfer agent. Such register reflects the ownership of the shares/units directly issued by the ETF. The GSC agent who marks up or down the GSC on behalf of the registrar and transfer agent is the only entity appearing on this register.

The ETF shares/units are traded in blocks of shares/units called "creation units". Upon the creation of fund shares during the subscription process, the GSC agent will increase the size of the GSC and allocate these shares to the settlement account of the subscribing entity. Cash equal to the value of the units created is credited to the Fund via the Transfer Agent's settlement account.

An investor can themselves have a settlement account in which the ETF shares will be held, or if not (as is usually the case) the shares will be held on their behalf by an entity which does have such an account. However, the GSC itself is a bearer instrument, meaning the entities holding ETF shares in the settlement systems, and the end investors for which the shares are held, are unknown to the Fund.

Efficient portfolio management techniques (EPM)

Q16: Do you agree with the proposed guidelines in this section? 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?

Yes. As previously mentioned in our response to the discussion paper ESMA/2011/220, we agree with the ESMA proposal to apply the same requirements to collateral received in the context of EPM techniques as those applicable to OTC derivative collateral.

However, we also believe that the CESR guidelines outlined in CESR 10-788 are in need of clarification and/or amendment in certain areas, as outlined elsewhere in our response.

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.

Yes. We agree with ESMA that the quality, type and quantity of assets constituting the collateral received in the context of EPM techniques are of vital importance. We also agree that the proposed guidelines set out in Box 6 would ensure that such collateral is of good quality.

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 TRS section below)?

Yes. We do believe that further guidelines should be provided in respect of the reinvestment of cash collateral (both in the context of EPM techniques or TRS) as is currently already the case in certain jurisdictions.

We agree that the re-investment of cash collateral in non-risk-free assets should not be permitted. We also agree that entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive. Further, we agree that the UCITS diversification rules in relation to entities at which cash is deposited (Article 52.1.(b)) should also apply to cash collateral.

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 a high correlation should be required between collateral provided and a UCITS' underlying portfolio.

We believe any such requirement would be detrimental to investors. For example, the collateral posted should be highly liquid, whereas the relevant portfolio could track less liquid equities (e.g. emerging or frontier market equities).

In addition, such a requirement would not be possible to implement for a number of UCITS funds which track UCITS-compliant commodity indices. To achieve a high correlation with such indices, commodity collateral would need to be used. However, this is not permitted under the UCITS regulations. It is also not feasible from a practical perspective, meaning commodity derivatives rather than physical commodities would need to be used in such instances.

UCITS funds linked to property indices would also be unable to comply with such a requirement, for similar reasons.

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?

Regarding the assets of the UCITS, it is important to differentiate between assets whose returns are swapped out by the UCITS ("Substitute Assets") and assets held by the UCITS for investment purposes ("Investment Assets").

We agree that the combination of (a) the collateral received by the UCITS (including collateral against securities lent) and (b) Investment Assets of the UCITS not on loan should comply with the diversification rules set out in Articles 52 and 54 of the UCITS Directive. However, in implementing this it should be noted that if portfolios (a) and (b) are individually compliant then the combination is by definition compliant. Therefore, for efficient management we would suggest that the two portfolios are monitored individually for compliance. For the sake of clarity, if there are many counterparties to a portfolio (a) then they should not need to individually be compliant in respect of collateral diversification but rather collectively compliant.

However, if the assets of the UCITS not on loan are Substitute Assets (i.e. their returns are swapped out, such that the UCITS does not have economic exposure to their performance), then we do not believe the usual UCITS diversification rules should apply. In such circumstances, we believe that a limit of 20% per issuer, by analogy with the limits applicable to cash deposits under Article 52.1.(b) or index constituents under Article 53, should be applicable. Subject of course to the current derogation of Article 54 allowing a UCITS to invest up to 100% in "*transferable securities and money market instruments issued or guaranteed by an EU Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong*" which would apply to a substitute basket containing eligible government bonds.

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 think that such list of qualitative criteria should be complemented by an indicative list of eligible assets. We believe that any list of qualitative criteria also needs to be more specific than the CESR guidelines in 10-788. The CESR guidelines make broad reference to factors such as credit quality and diversification but do not make clear what the actual requirements are in respect of these factors.

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.

Yes, this would be useful. The list of assets in paragraph 52 is appropriate in our view.

As a comment, "*Sovereign debt issued by **an** EU or OECD member states*" mixes singular and plural. To avoid any ambiguity, we would suggest ESMA amends this to either "issued by an EU or OECD member state" or "issued by EU or OECD member states" (depending on the intention).

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.

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?

Not necessarily. Subject to appropriate collateralisation, including haircuts where necessary, we do not consider such a limitation necessary.

However, we do believe a UCITS should not have more than 10% exposure to any counterparty. And that counterparty exposure from EPM techniques should be added to counterparty exposure from OTC derivatives in applying this limit.

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

It is not clear at present. Relatively few UCITS engaging in securities lending have disclosed this information to date, although that has recently begun to change.

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 answer to Question 25 above.

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?

It is unclear what is meant here by "fund rules". Do these refer to the management regulations/the articles of incorporation of a UCITS, or something else?

Firstly, we do not see added value in disclosing the same information twice.

This information has its natural place in the prospectus (or the KIID).

In addition, some of the information in question may change over the time (e.g. EPM policy, collateral policy). Any such change would require amendment to the documentation where the information is disclosed. Updating the prospectus to reflect any such change is a routine event. However, being required to amend the articles of incorporation in such a case would not be proportionate or appropriate, and would create unnecessary additional costs.

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?

The rules regarding identification of EPM counterparties should be similar to the ones applicable to OTC derivative transactions. Annual disclosure in the annual report and publication on the website for example.

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.

We believe that any potential risk of conflict of interest must be disclosed clearly in the prospectus of the fund.

When there is a potential risk of conflict of interest, the appropriate measures or processes must be put in place to avoid any conflict of interest having a detrimental effect on investors. These processes and measures include inter alia putting in place information barriers/"Chinese walls", organising the segregation of functions/teams and systems, creating separate lines of reporting, and disclosing the risks both to the regulator and to investors.

In the specific context of collateral valuation, we believe that there is very little discretion or subjectivity involved. Accordingly, there is less potential for a depositary who is affiliated to the collateral provider to be influenced by a conflict of interest into mis-valuing the collateral. The list of eligible collateral assets proposed in paragraph 52 all have a publicly-available price or NAV. Accordingly, valuing such collateral should be quite a "black-and-white" process.

The risk of a detrimental impact on investors from such a conflict of interest is therefore likely to be limited to fraud or negligence on the part of the depositary. However, we do consider it preferable - and more consistent with industry best practice – for a UCITS not to select an affiliate of its depositary as counterparty / collateral provider.

Any "vertical integration" in respect of a UCITS' service providers is a commercial disadvantage to the UCITS in seeking to attract investors. For example, if a UCITS' depositary was an affiliated entity of that UCITS' counterparty/collateral provider, this would typically be readily apparent to prospective investors from the UCITS' prospectus and marketing material. This would typically lead to such prospective investors questioning whether the apparent conflict of interest was a risk they were comfortable taking. Accordingly, there is already a commercial incentive for a UCITS or its management company to avoid selecting affiliated entities as both depositary and counterparty/collateral provider. We do not consider that additional regulatory limitations are necessary.

We would also note that in the UK it is already a regulatory requirement for any open ended investment company (OEIC, the legal form of most UK-domiciled open ended UCITS) that the depositary must be independent from the company and from the directors of the company.

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 TRS section below.

No, we do not believe the automation of portfolio management automatically creates potential conflict with the duties of the management company. If there is the correct segregation of activities and proper barriers in place, there is no obvious reason a conflict of interest should exist.

There is also no reason for the quality and quantity of collateral to be adversely affected by the automation of portfolio management. If the correct requirements for the collateral are clearly defined, with respect to quality, quantity and any diversification requirements, there is no reason why automation should have a detrimental effect in respect of the quality or quantity of collateral.

Total Return Swaps

Q32: Do you agree with the proposed guidelines?

We share the views of ESMA on many of the proposed guidelines.

However, we would like to express concerns regarding certain guidelines, further to our earlier response to discussion paper ESMA/2011/220.

We believe that an unfunded total return swap providing a UCITS with linear (delta one) exposure to an underlying index can be considered a pure delivery mechanism. Assets held by the UCITS, whose returns are swapped for the returns of the underlying index, should not be seen as an investment comprised in the UCITS portfolio. While we agree that it should be comprised of UCITS eligible assets, we don't believe the UCITS portfolio (substitute basket) should have to comply with the "5/10/40" UCITS diversification requirements set out in Article 52 and applicable to assets to which the UCITS actually has economic exposure. This analysis has already been accepted by certain regulators in the past. In the case of a UCITS substitute basket whose returns are paid to a derivative counterparty, we consider that a limit of 20% per issuer, consistent with the limits applicable to cash deposits under Article 52.1.(b) or index constituents under Article 53, should be applicable.

In the context of a funded swap, we do not think that the same diversification requirements should apply to the collateral as apply to the UCITS' investment portfolio. The purpose of the collateral is to provide a security to the fund in case of default by the swap counterparty, and it will in all likelihood be immediately liquidated by the fund should the fund ever take possession of it. Accordingly, it should not in our view be subject to the same diversification requirements as a long-term investment portfolio. Instead of the "5/10/40" UCITS diversification rule currently applicable to transferable securities and money market instruments, it is our view that a limit of 20% per issuer, consistent with the limits applicable to cash deposits under Article 52.1.(b) or index constituents under Article 53, should apply.

Subject to the current derogation of Article 54 allowing a UCITS to invest up to 100% in "*transferable securities and money market instruments issued or guaranteed by an EU Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong*". It is our understanding that this derogation is applicable to either the substitute basket or the collateral, which we agree with in both cases.

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.

Yes. We believe that quality and quantity of collateral need to be viewed together. And that the proposed guidelines set standards which should ensure that the quality and quantity of collateral required is appropriate. Subject to our comments in respect of Question 32.

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?

It is unclear what is meant here by "fund rules". Do these refer to the management regulations/articles of incorporation of a UCITS, or something else?

Our views here are similar to those on Question 28.
Firstly, if all of the required information is disclosed in the prospectus, we don't see a significant benefit to investors from repeating the same disclosure elsewhere.

We believe the prospectus is the most appropriate place for this information to be disclosed.

In addition, some of the information in question may change over the time (for example, counterparty name, type and/or level of collateral). Any such change would require amendment to the documentation where the information is disclosed. Updating the prospectus to reflect any such change is a routine event. However, being required to amend the articles of incorporation in such a case would not be proportionate or appropriate, and would create unnecessary additional costs.

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 think that such list of qualitative criteria should be complemented by an indicative list of eligible assets. We believe that any list of qualitative criteria should ideally be more specific than the CESR guidelines in 10-788. As outlined under Question 21 above, the CESR guidelines make broad reference to factors such as credit quality and diversification but do not make clear what the actual requirements are in respect of these factors.

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.

Yes, this would be helpful. The list of assets set out in paragraph 73 is appropriate in our view.

However as mentioned under Question 22 above, it is unclear whether "*Sovereign debt issued by* ***an EU*** *or OECD member states*" is somewhat ambiguous since it mixes singular and plural. It would be helpful if this was clarified in the final version of the guidelines.

We would suggest ESMA amends this to either "issued by an EU or OECD member state" or "issued by EU or OECD member states" (depending on the intention). The former would mean that a collateral portfolio comprising sovereign debt instruments issued by a single EU member state would be acceptable if diversified in accordance with Article 54 of the UCITS Directive. We believe this would be consistent with Box 7 of ESMA/2012/44, which proposes that collateral should be sufficiently diversified to comply with the UCITS diversification rules.

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?

As mentioned under question 32, the collateral received should not in our view be subject to the same diversification requirements as a long-term investment portfolio (i.e. the "5/10/40" limits applicable for transferable securities and money market instruments). Instead, we would suggest a 20% limit per issuer in respect of such collateral, consistent with the limits applicable to cash deposits under Article 52.1.(b) or index constituents under Article 53.

For the sake of clarity, it is our understanding that the current derogation of Article 54 allowing a UCITS to invest up to 100% in "*transferable securities and money market instruments issued or guaranteed by an EU Member State, one or more of its local authorities, a third country, or a public international body to which one or more Member States belong*" applies to collateral comprising such instruments. This is appropriate in our view.

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 consider the same guidelines on collateral should be applicable to all OTC derivative transactions and not be limited to TRS.

Strategy Indices

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

Yes, we agree with almost all of these guidelines.

However, we do have some comments.

As indicated in our earlier response to discussion paper ESMA/2011/220, we agree that intra-day index rebalancing would be problematic from a replication perspective. It may also call into question the rules-based nature of a strategy index in our view. Intra-day rebalancing could imply active management or discretion in the index, which is in our view not necessarily compatible with UCITS requirements.

However, we don't agree that daily rebalancing indices should automatically be excluded from UCITS eligibility. We have seen a number of UCITS funds linked to daily-rebalancing indices which are fully rules-based, and also capable of being replicated.

We believe it is important to distinguish daily-rebalancing indices which rebalance at a pre-defined time each day from other indices which may have wide latitude in the determination of their rebalancing time. In our view daily rebalancing indices which rebalance at a pre-defined time each day, and meet the other UCITS index criteria with respect to diversification, appropriate publication, adequate benchmark and fully objective methodology, are consistent with UCITS index requirements and should be permissible as UCITS indices.

With regard to Box 8 paragraph 7, we have concerns about the proposed requirement for disclosure of the full index methodology. For certain indices, this may not be feasible without breaching the intellectual property rights attached to the index. Several regulators accept the disclosure of a redacted version of the methodology or full publication via a secured website only accessible by existing investors. These indices may nonetheless comply with UCITS index regulations and be fully rules-based as required.

The replication requirement for an index should in our view mean that the index must be replicable, but should not mean that the index provider must fully explain how to achieve it in practice. It other words, an index should be replicable by any party with access to the full methodology (in order to demonstrate both the replicability and the objective nature of the index), but this does not in our view mean that everyone should have access to the full index methodology.

We believe that a redacted version of the methodology is sufficient, provided that it provides the necessary information to fully understand the mechanisms, techniques, composition and rules of the index. The vast majority of investors would have limited interest in replicating a complex algorithm. They do, however, have an interest (and an entitlement in our view) to know what methods, techniques and assets are used in any index to which they have exposure through their investments.

If the proposed guideline requiring full disclosure of the index methodology were to be adopted, it may well to certain strategies no longer being available to UCITS investors, and act as a barrier to innovation in UCITS funds. This is because providers would have no incentive to offer proprietary strategies in UCITS format, if they were forced to immediately disclose publicly the full methodology, which their competitors could then copy.

Such strategies often represent significant intellectual capital, and are typically the product of lengthy research and development. If the proposed guideline were implemented, innovative proprietary strategies would likely cease to be offered in UCITS format. This may lead to a significant portion of investors switching to offshore or less regulated alternative funds. We do not believe this would represent a favourable outcome for investors.

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?

As mentioned earlier, we believe that any potential risk of conflict of interest must be clearly disclosed in the prospectus of the fund.

When there is a potential risk of conflict of interest, effective measures and/or processes need to be put in place to prevent any conflict of interest detrimental to investors. These processes and measures include inter alia putting in place information barriers("Chinese walls"), organising the segregation of functions/teams and systems, creating separate lines of reporting and disclosing potential risks to investors.

Transitional provisions

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

Yes. These are appropriate in our view.

However, to avoid ambiguity we believe that the transitional provisions should be more explicit for Structured UCITS (i.e. UCITS with a predefined payout at the end of a specific period). In particular, it should be made clear that Structured UCITS which were launched prior to publication of CESR 10-788 should be exempt not just from the new ESMA guidelines, but also from any of the CESR guidelines which did not apply at their launch date. This is because of the potential impact on the pre-defined fund payout from retrospectively complying with new guidelines – which we do not believe would be in the best interests of investors.

ESMA issued a supplementary paper on 14 April 2011 (ESMA/2011/112) which explicitly exempted pre-existing Structured UCITS from Box 1-25 of the guidelines on global exposure in CESR 10-788, due to the potential impact on the fund payout. It was considered not to be in the best interests of investors to change the pre-defined redemption amounts, on the basis of which they initially invested. However, to date no such exemption has been granted to pre-existing Structured UCITS in respect of Box 26 of CESR 10-788.

We believe that the above mentioned principle set out in ESMA/2011/112 is equally applicable to Box 26, and that similar grandfathering for pre-existing Structured UCITS should apply to Box 26. This is because the consequence of applying the new collateral diversification guideline to pre-existing Structured UCITS would be equally detrimental to investors. The reason for this is that t**he cost of the agreed collateral is fixed prior to launch for the life of the fund, and factored in when the fund's terms are designed.**

Among the parameters which determine what economic terms can be offered to investors (including volatility, interest rates and correlation), collateral costs are a key factor. These collateral costs are determined by the collateral agreement fixed at launch for the duration of a Structured UCITS. **The fixed collateral cost directly determines how much money is available to purchase the fund's derivative contract, and therefore directly determines what level of participation, annual income, and/or capital protection at maturity can be offered by the fund to investors**.

For Structured UCITS with pre-defined payoff terms, all costs must be priced in at inception. This is because no further costs can be imposed subsequently on such funds without reducing the pre-defined payout based on which unitholders chose to invest. Changing the collateral after the fund's launch can have a material cost impact on the fund, since the cost for different types of collateral can vary widely. Such cost impact is magnified over the life of a Structured UCITS, which is typically a 5-7 year period. This post-launch change in fund costs would lead to the fund having to change its objective, since it would alter the fund's original budget. As outlined above, the fund terms originally sold to investors (e.g. level of participation, annual income and/or capital protection at maturity) would have to be changed as a result.

To quantify the impact of retrospectively imposing the current CESR guidelines on Structured UCITS launched prior to July 2010 (CESR 10-788 publication date), we can consider the example of a UK-domiciled Structured UCITS launched in 2009 with 100% Japanese government bond collateral diversified across 10 different issues. To exchange that collateral today for an equally-weighted portfolio of bonds from Germany, UK, US and Japan would cost an additional ca. 0.50% per annum. So if there are 3 years remaining to the fund's maturity, the fund will be in deficit at maturity by 1.50%.

In the case of Structured UCITS with pre-defined redemption amounts which were structured and launched prior to the issue of CESR 10-788, the collateral will have been based on the regulations and/or guidance prevailing at launch.

In the example above, the original collateral (on which the pre-defined terms offered to investors was based) was government bonds of a single G7 country, which met the prevailing COLL guidance at the time of the fund's launch ("negligible risk"). The change outlined above to the original collateral is in order to achieve compliance with Box 26 of CESR 10-788. However, the financial impact of subsequently imposing CESR 10-788 on a pre-existing Structured UCITS results in a material shortfall in the payoff to investors at maturity, compared to the fund's pre-defined payoff based on which the investors originally subscribed.

We believe that ESMA recognises in its current consultation paper (paragraph 89) that pre-existing Structured UCITS should not be retrospectively impacted by new regulatory guidance. However, we are concerned that ESMA's previous supplementary paper establishing this principle (ESMA/2011/112) limited its grandfathering exemption to global exposure (Boxes 1-25 of CESR 10-788). And the current proposal (ESMA 2012/44) would only exempt pre-existing Structured UCITS from the proposed new guidelines themselves.

Accordingly, Box 26 of CESR 10-788 would currently "fall between the cracks", and technically still apply to pre-existing Structured UCITS, despite this clearly not being the intention of the principles established by ESMA both in paragraph 89 and in ESMA/2011/112. We would therefore strongly encourage ESMA to remove this anomaly by expanding paragraph 89 of the Transitional Provisions to make clear that Box 26 of CESR 10-788 should not apply to Structured UCITS launched prior to 28 July 2010, provided such UCITS satisfy the criteria of paragraphs 2(a), 2(b), 2 (c) and 2(d) of Guideline 1 in ESMA/2011/112.