Response to ESMA's Discussion Paper on Key Concepts of the Alternative Investment Fund Manager's Directive and Types of AIFM

23 March 2012

Response by ETF Securities

This paper responds to ESMA's discussion paper dated February 23, 2012 on key concepts of the Alternative Investment Fund Manager's Directive and Types of AIFM (the "**Discussion Paper**"). This response is jointly from ETF Securities Limited and ETF Securities (UK) Limited, the latter being a wholly owned subsidiary regulated by the Financial Services Authority of the United Kingdom.

Introduction to the ETF Securities group

ETF Securities group

The ETF Securities group is a leading, independent exchange-traded products provider with particular expertise in commodities. Our pioneering work in this asset class is complemented by specialist capabilities in currencies and some thematic equity products. We are dedicated to developing liquid, transparent investment solutions that can be traded on world stock exchanges.

We have a strong history of product innovation and independence and these remain key tenets of our philosophy. Our management team developed the world's first exchange-traded commodity (ETC), listing gold in Australia and the UK in 2003, and many other market-leading investment solutions have since followed. Today, ETF Securities offers what we believe to be the world's most comprehensive range of exchange-traded commodities and, as of 23 March 2012, is responsible for more than US$28 billion in global investor assets.

Most of our products are structured as ETCs – undated, non-interest bearing debt securities issued by special purpose vehicles, which are not currently considered collective investment undertakings. Our ETCs can be broadly classified as follows:

- ETCs that track the price of physical metal and are backed by an entitlement to allocated metal held with a custodian (each a "**Physically Backed ETC**"); and
- ETCs that track the return of commodities using indices linked to futures contracts. These ETCs are backed by fully funded OTC contracts ("**Commodity Contracts**") entered with a counterparty (each a "**Futures Backed ETC**"). The majority of Futures Backed ETCs are collateralised on a daily basis by the counterparty posting securities equal to the last reported outstanding exposure into an account held with a collateral custodian.

ETF Exchange

ETF Exchange is a Dublin-domiciled UCITS platform developed by ETF Securities to provide investors with access to a range of thematic investment solutions through an independent (non-vertically integrated) swap-based model using multiple swap providers and authorised participants / market-makers.

First introduced in September 2008, ETF Exchange uses total return swaps to replicate index performance whilst credit exposures are collateralised in excess of UCITS requirements. The platform is designed to mitigate credit risk, disperse counterparty exposure and improve tracking error and liquidity. Participant banks on ETF Exchange act as authorised participants and swap providers, and comprise Bank of America Merrill Lynch, Barclays Capital, Citi and Rabobank International.

Scope of our Response

We focus our responses on three questions raised in *Part IV. Definition of an AIF.* We are particularly focussed on the extent to which certain structured financial instruments ("**SFIs**") may fall within the definition of an AIF. Of the 14 questions raised in the Discussion Paper, questions 4, 5 and 6 are the most relevant to SFIs

SFI is not a defined term but is generally accepted as referring to a range of financial instruments that are not treated as funds/collective investment undertakings under EU or member state regulation but as transferable securities. SFIs generally come in the form of debt securities, warrants and certificates. They can be issued directly by financial institutions, by stand-alone or subsidiary special purpose vehicles or by securitisation special purpose entities that are explicitly exempt from the AIFMD requirements.[1] Our ETCs are considered SFIs for regulatory purposes.

The existing regulatory framework for EU funds contained in the UCITS regime (and used as a template for many AIFMD concepts) does not consider SFIs to be collective investment undertakings. For example, CESR guidance on eligible assets for UCITS treats closed-ended funds (identified as a type of collective investment undertaking) as a separate category of transferable security from SFIs (which are not collective investment undertakings). These distinctions are relevant across a number of areas, such as eligibility of assets, the discussion of embedded derivatives in transferable securities and the UCITS diversification requirements.[2]

Based on our reading of the AIFMD and informal conversation with Member State regulators as well as the EU Commission, we believe SFIs structured as debt instruments (which would include ETCs) do not constitute alternative investment funds ("**AIFs**"). The Discussion Paper further supports that view as well without directly addressing the issue. Recently, however, the FSA raised the question in its own Discussion Paper 12/1 on Key Elements of the AIFMD.[3] We are not aware of any other Member State regulators

[1] The definition of "securitisation" under the relevant exemption means that it might not apply to a wide variety of SFIs. While the sole purpose of many SFIs is securitisation, they may not involve an "originator" or otherwise fall within the definition set forth in Article 1(2) of Regulation (EC) No 24/2009 of the European Central Bank of 19 December 2008.

[2] See Directive 2007/16/EC article 2(2) & (3) and the related background note. "Formal Mandate To CESR For Advice on Possible Modifications to the UCITS-Directive in the Form of Clarification of Definitions Concerning Eligible Assets for Investments of UCITSS" at http://ec.europa.eu/internal_market/securities/docs/cesr/final-mandate-clarification_en.pdf "CESR Guidelines concerning eligible assets for investment by UCITS" March 2007 at http://www.esma.europa.eu/system/files/07_044.pdf, addressing the issue of whether SFIs are transferable securities under the UCITS Directive; and Background Note ESC/14/206 at http://ec.europa.eu/internal_market/investment/docs/legal_texts/assets/esc_14_2006_en.pdf.

[3] See FSA Discussion Paper 12/1, Section 3.2

considering this issue. Furthermore, we believe that existing Member State guidance and UCITS legislation remain a reasonable and stable precedent to interpret issues relating to collective investment undertakings as they are already widely used throughout the EEA by product providers, investors and regulators such as ESMA.

As a result, we believe ESMA should consider its guidance to clarify that SFIs are not AIFs.

If ESMA has any questions in relation to this response, please contact Townsend Lansing at ETFS UK on +44 20 7448 4356 or townsend.lansing@etfsecurities.com.

Responses to Questions 4, 5 and 6.

4. Do you see merit in clarifying further the notion of any of the other exclusions and exemptions mentioned above in this section? If yes, please explain which other exclusions and exemptions should be further clarified and provide suggestions.

- We believe there is merit in further clarifying the scope of the exemption for securitisation special purpose entities and how it might apply to SFIs.
- There are currently physically backed SFIs, such as physically backed ETCs, issued by stand-alone special purpose entities, which share many of the characteristics of a securitisation special purpose entity. For example, a physically-backed gold ETC is only issued against the delivery of physical gold to or the ETC Issuer by one or more Authorised Participants ("**AP**"). The AP must deliver to the relevant ETC Issuer the amount of gold equal to the amount of gold that each ETC represents). Upon redemption, the gold is returned to the AP. The ETC Issuer then issues the ETC, which is a securitised interest in gold.
- In the above example, many of the features of securitisation are present: (i) there is a stand-alone special purpose entity whose sole purpose is to securitise gold (ii) there is a transaction whereby gold is transferred to the special purpose entity by an AP, which could be considered an originator and (iii) the debt securities issued by the special purpose entity do not represent a payment obligation of the AP.
- There will, of course, be other examples of SFIs that fall within the securitisation exemption. Additional guidance from ESMA will ensure appropriate and harmonised application across the EU.

5/6. Do you agree with the orientations set out above on the content of the criteria extracted from the definition of AIF? Do you have any alternative/additional suggestions on the content of these criteria?

- Yes, we believe that the criteria provided represent the salient aspects of a collective investment undertaking
- However, we also believe ESMA should provide guidance on whether a given structure involves investment management (and indeed, an investment manager).
- An AIF must involve "investment management," a logical corollary to the statement in the AIFMD that "management of AIFs should mean providing at least investment management services."[4]
- The content of the criteria on "Collective Investment" provides some guidance as to what is expected from investment management, but we believe additional guidance should be provided.

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[4] AIFMD L 174/4 (21)

- In particular, we believe ESMA should provide additional guidance on what constitutes investment management. This guidance should focus on whether there are any indicia of investment management and whether the activities required to provide exposure involve investment management. Such indicia and activities would include:
    - The extent to which the Issuer has a designated investment manager;
    - The extent to which the Issuer (or any person on the Issuer's behalf) has any discretion or control over the capital raised;
    - The extent to which there is any actual investment of that capital;
    - To the extent the Issuer is tracking a strategy index, whether the index embeds some level of actual investment management
- We believe the above would be particularly helpful in the context of SFIs, because they generally provide purely passive exposure without any real investment management activities. For example, ETCs do not invest any capital. They either securitise physical assets (such as precious metals) or engage in the relatively administrative task of entering into prepaid OTC commodity contracts (similar to prepaid forward/fully funded swap contracts).[5] Other SFIs, such as structured products issued by special purpose vehicles, may have similar structural features that do not involve investment management.

[5] Physically backed ETCs are only issued and redeemed against the delivery of physical metal to or from the ETC Issuer's account with the relevant custodian. For example, to issue an ETC physically backed by gold, the relevant ETC Issuer must receive the amount of gold equal to the amount of gold that each ETC represents. Upon redemption, the relevant amount of gold is returned to the AP. Futures-backed ETCs are issued and redeemed against the delivery of cash equal to the relevant closing price of the underlying index. Each Futures-Backed ETC involves fully funded exposure, with cash delivered from the AP directly to the counterparty providing the exposure. For example, to issue an ETC backed by the DJ-UBS All Commodities Index, the ETC Issuer will not receive any cash from the AP. Rather, the AP will deliver the cash directly to the counterparty providing the exposure, and upon receipt of confirmation from that counterparty, the Issuer will engage in the administrative task of ensuring that an appropriate Commodities Contract is executed.

Appendix 1
Table of Financial Products

Financial Products	
SFIs	Collective Investment Undertakings
Exchange Traded Notes	UCITS Funds
Exchange Traded Commodities	Non-UCITS Funds
Structured Products	Private Equity Funds
Securitisation Products	Venture Capital Funds
	Real Estate Funds
	Hedge Funds
	Funds holding alternative assets
	Alternative Investment Funds[6]

[6] See the ESMA Discussion Paper, February 23, 2012, "Key Concepts of the Alternative Investment Fund Managers Directive and Types of AIFM", page 9. ESMA provides an initial list of AIFs from its internal mapping exercise.