OSSIAM
6, place de la Madeleine
75008 Paris

Bruno Poulin, CEO
Antoine Moreau, Deputy CEO

ESMA
103, rue de Grenelle
75007 Paris

Paris, March 30th 2012

Answer to ESMA's consultation paper "ESMA's guidelines on ETFs and other UCITS issues" (ESMA/2012/44)

OSSIAM favorably welcomes ESMA's paper on guidelines on ETFs and other UCITS issues.

Given the popularity of ETFs, the increasing market share they represent in the global investment management industry and the potential threat it represents to existing business structures, it is not surprising that an intense lobbying occurred in order to raise some concerns about ETFs. Also, ETF providers using physical replication played an active role in targeting synthetic ETFs in order to protect or extend their market share from this very competitive market. This has led to an intense debate biased towards ETFs in 2011, and notably towards synthetic ETFs.
OSSIAM, alongside most of the industry (ETF providers, investment management associations), stressed the need to keep, when dealing with the regulatory framework around ETFs, a level playing field approach. In particular, a biased debate had led to a misperception of the risks created by synthetic replication, as opposed to physical replication. Also, there was a focus on the use of derivatives by ETFs, as opposed to UCITS in general.
ESMA's new consultation paper very rightly corrects these mistakes and expresses the need to think regulation in a more coherent way, with the goal of achieving a level playing field approach between:

- ETFs and other UCITS
- ETFs and other Index tracking funds
- ETFs and ETPs
- synthetically and physically replicated ETFs

OSSIAM agrees with most of the positions expressed by EFAMA and l'Association Française de la Gestion financière (AFG). However we wish to bring the following comments to ESMA's attention on some specific questions.

Q1: Do you agree with the proposed guidelines?

OSSIAM globally agrees with the proposed objectives. However we wish to make the following comments:

- Giving details regarding the underlying components of an Index must be thought as a trade-off between investor protection and market integrity. Currently, some Index providers agree to give the composition of an Index, but with a lag, in order to prevent from front running by arbitrageurs and to protect the intellectual property linked to the Index. We think this is the appropriate setup and that we should not impose a real time availability of the index components.
- Calculating an ex-ante tracking error target level does not seem achievable. Tracking error depends on many factors, some of which are not precisely predictable (volatility of the underlying market constituents, dividend rates, etc…). What would be feasible though is to estimate a maximum tracking error and then communicate on a threshold.

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

We do not think it is appropriate to distinguish between synthetic and physical ETFs through the identifier for various reasons:

- It would not be consistent with the level playing field approach with regard to UCITS in general. Swaps are, like securities lending, an investment management technique, used not only in ETFs but more generally in all kinds of UCITS. It would not be consistent to impose a rule applicable only to ETFs.
- The distinction between physical and synthetic ETFs may be misleading for the investor by suggesting that in the first case the fund owns the basket of securities constituting the index, in the quantities corresponding to the index. In practice, generally part of or all of the securities are lent, thus creating some counterparty risk. Besides, sampling replication can be used, creating potential significant tracking error. Such a short category definition, in the name of the product, cannot account for all of these differences.
- The replication technique used may change over time. Some ETFs prospectuses allow for switching from one technique to the other, depending on market conditions or other factors. This excludes the possibility to incorporate it in the name of the product.

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 believe there should be at least one market-maker providing liquidity for any listed ETF.
However we strongly oppose that a minimum number of two market-makers should be imposed for the following reasons:

- An ETF provider that is an affiliate of an investment bank (assuming this bank acts as market maker) would have to find only one external market-maker to comply with the requirement.
- On the other hand, an independent ETF provider, not affiliated to a global investment bank, would have to find two external market-makers and would therefore be severely penalized.

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 think a clear definition of actively managed UCITS ETFs is needed. Paragraph 1 of Box 4 states they are not index trackers, whereas paragraph 28 states that index constituents are published on a daily basis. Also, the mentioned objective of outperforming an index probably refers to the market cap benchmark index of the market.
We are cautious on the fact that actively managed ETFs should not include ETFs tracking so called smart beta indices that are rule-based purely systematic indices.
Actively managed ETFs should imply some discretionary investment management decisions, not wrapped in an Index. Then the distinction with any other index tracking ETF would be clear. In that case, we fully agree with the guidelines.

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

We globally agree with the possibility, for existing investors, to redeem their shares directly from the UCITS ETF at any time, even if their acquisition took place on the secondary market. However, the impacts on the operational setup should be considered before implementing this guideline. In some cases, transfer agents deal with a set of pre-established investors who have access to the primary market; to be implemented, this guideline would need adjustment to occur. Therefore transitional provisions would be needed.

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?

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.

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

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?

One can note that the name "Efficient Portfolio Management Techniques", though commonly used by regulators and industry practitioners altogether is slightly misleading and contains a value judgment, since it implies other techniques such as derivatives might not be efficient, or that they could be riskier.

We support more transparency on the fees related to EPM techniques for each UCITS using these techniques, for example through enhanced disclosure on the website of the asset manager.

Answers to these questions cannot be de-connected from answers to questions 32 and 37, as the level playing field approach must ensure adequate treatment of collateral policy of unfunded swaps, funded swaps, and securities lending.
In the case of unfunded swaps for UCITS ETFs, OSSIAM already applies the UCITS diversification rules to the so-called "substitute basket", i.e. the assets inside the funds (the fund is the sum of the substitute basket, a total return swap, and if applicable a small amount of cash). We believe the whole market globally applies or should have been applying the same rules. This guarantees a sufficient diversification in the case of default of the swap counterpart, during the period in which the fund manager will either find a new swap counterpart, or will liquidate the substitute basket to buy the index components.

As far as collateral is concerned, a key issue is to know in what timeframe it can be seized. We believe Box 6 of the ESMA consultation aims, including other things, at securing this. However, if there is no strict limitation in time, the question of the diversification is a valid concern. Why do diversification rules exist for the assets of a UCITS Fund in the first place? Because it is commonly admitted that one investor should not be exposed to one or very few idiosyncratic risks, especially in a deteriorating market environment. Collateral might then become the *de facto* assets of the UCITS Fund, justifying diversification rules for the sake of investor's protection in a very bleak environment.

We believe Box 26 of CESR's guidelines on risk measurement are general principles, that are not sufficient if the setup is such that the fund investor is in the situation of being exposed during a reasonable period of time to the collateral basket. Hence quantitative criteria are needed to ensure genuine diversification. Also, a closer look at the - sometimes published - collateral of some UCITS Funds is very instructive in the subjectivity of what is liquid and what is not, what is of good credit quality and what is not. If we assume that everything could work perfectly in most traditional market configurations, a severe deterioration of the market environment would make collateral not to be only considered as a recourse to the original assets of the UCITS Fund. Perception or reality on liquidity and credit quality can change drastically. We believe that since 2008, credit quality and liquidity cannot be disconnected from diversification any more.

Therefore we support the proposal that the collateral posted by the relevant third party to mitigate the counterparty risk arising through EPM techniques should be sufficiently diversified in order that at any time, the portfolio composed of the collateral and the assets not subject to the EPM technique complies with the UCITS diversification rules. The UCITS should comply with the UCITS diversification rules in relation to entities at which cash is deposited, taking into account both the cash received as collateral and any other cash held within the fund.

However, we are fully aware that imposing UCITS ratios, or other precise guidelines, would have major operational impacts for most investment managers engaging in securities lending. Hence discussions with the investment management industry regarding transitional provisions would be needed.

Q32: Do you agree with the proposed guidelines?

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?

See answer to questions 16, 17, 18 and 20 above. To ensure a true level playing field, rules should be the same for all UCITS, and for all collateralization operations, being used under the securities lending or swaps techniques.
As a general principle, applying UCITS rules to the substitute basket of an ETF using the synthetic replication mode (unfunded type) is already supposed to be a standard practice.
It is logical, from a risk management and investor protection perspective, to extend this rule to UCITS funds in general.

However, we want to stress that the proposed rules by ESMA would be very hard to formalize in the case of a fund using various investment techniques (for instance, a total return swap on part of the portfolio, and securities lending on another part). Reaching a clear rule as to how the UCITS diversification ratios would apply would prove very difficult.

Regarding 5.d), we understand there is an ambiguity as to ESMA referring to the swap counterpart having discretion (1) on the assets composing the underlying strategy, let's say the index components if we talk about an index tracking UCITS (se understand from paragraph 62. that ESMA may consider this case), or (2) on the assets of the fund whose performance is swapped back, in this case their return does not impact the UCITS's return.

If we are in the case (2), we strongly disagree with the interpretation that the swap counterpart should be treated as an investment manager. Swap counterparts give a price for providing a substitute basket and a swap that cancels the economic exposure to this substitute basket. The overall price of this combination depends on the composition of this basket and entering into this transaction is the ultimate decision of the Investment Manager. The fact that a swap counterpart may, within pre-established guidelines, and obviously with the pending validation and approval of the Investment manager of the fund, suggest some basket constituents that improve the performance of the fund is an obvious benefit. Since this practice does not have any consequences on the exposure of the fund, the counterpart cannot be considered as acting as an Investment Manager.

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

We understand the general principles that ESMA wants to guarantee through these guidelines.

However we think the scope of the guidelines is not clear:

- "Strategy Indices" are not precisely defined. We understand that ESMA may put behind the same name different concepts, including systematic Indices following quantitative or fundamental strategies, but also discretionary strategies.
- Some guidelines should apply to all Indices.

More specifically, we have the following comments on Box 8 :

- 6. We do not understand the scope of the "replication" concept. In most cases investors will not be able to physically replicate an Index, they may - for a small portion of them - be able to recalculate an Index according to its rule book. If ESMA targets recalculation and not replication, then the issue is to know after which time lag this should be achievable (see answer to Q1). Also we make a clear distinction between indices depending on their rebalancing frequency. We think daily rebalancing brings no complexity compared to less frequent rebalancing, provided the index methodology follows the same standards regarding disclosure, absence of discretionary decisions, etc… On the other hand, intraday rebalancing will almost systematically imply discretionary aspects in the index construction because execution prices will not have objective and undisputable references. We believe ESMA has in mind some very specific products through intraday rebalancing, maybe some so called "Newcits" funds, that are not comparable to standard index tracking funds or strategy index tracking funds.
- 7. 8. and 9. We believe standards regarding disclosure should apply to all indices.
- 12. and 13. Concepts of "independent audit" and "independent assessment" of the Index are not particularly straightforward to us and might need additional explanations.

CONTACTS

Bruno Poulin
bruno.poulin@ossiam.com
+33 1 78 40 56 83

Antoine Moreau
antoine.moreau@ossiam.com
+33 1 78 40 56 81