



29 March, 2012

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

Source – Response to ESMA's guidelines on ETFs and other UCITS issues

Dear Sir/Madam,

Source is a specialist provider of exchange traded products (ETPs) for European investors with approximately €7bln of assets under management.

As such we would very much like to contribute to "ESMA's guidelines on ETFs and other UCITS issues".

Please find attached our response. We are happy to make ourselves available to ESMA to discuss the points herein as and when required.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "THOOD", written over a horizontal line.

Ted Hood
CEO
Source UK Services Limited



Source UK Services Limited

Response to ESMA's guidelines on ETFs and other
UCITS issues

I. Index-tracking UCITS

Q1 Q1. Do you agree with the proposed guidelines

Source agrees with the need to provide clarity around indices and their underlying components. We also welcome that ESMA intends to broaden the scope of these guidelines to all index tracking UCITS.

On the proposed guidelines we are broadly in agreement however would like to note:

Box 1; 1a – we note the desire to ensure investors have access to the exact composition of the index. This is information we already provide – within the terms of our index licence arrangements. The index providers hold and licence the intellectual property in such information and make it publicly available on a delayed basis. One of the many reasons for purchasing index trackers is that investors do not have the time or means to directly replicate – as such we do not think that immediate publication of index composition will provide a material benefit to investors.

Box1: 1c – Ex-ante tracking error is of use to institutional investors and those with a short investment time horizon. As such we do not think this of particular significance to buy and hold investors but is something Source can implement if required.

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.

Source are fully in favour of the provision of a harmonised EU framework for the calculation of tracking error. We would agree, however, with the IFIA position that this is a large and complex issue which would ideally be dealt with in a separate consultation.

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?

Source believes that tracking and comparison information is very useful to investors – particularly when presented in a clear and simple manner. As such we think the comparison information mandated by the KIID to be sufficient in this regard.

II. Index-tracking leveraged UCITS

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

Yes.

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 do not believe that additional guidelines, beyond what is proposed here, are necessary.

III. UCITS Exchange Traded Funds

- 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)?
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Yes, we agree with the proposed definition of a UCITS ETF. We do note EFAMA have proposed an amendment which better reflects some issues raised in Denmark and Germany and have no objection to that amendment.

- Q7 Do you agree with the proposed guidelines in relation to the identifier?
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Yes.

- Q8 Do you think that the identifier should further distinguish between synthetic and physical ETFs?
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No. "Synthetic" and "Physical" would require further definition. Most European UCITS use, or have the flexibility to use, synthetic techniques in whole or in part. Clarity would be required on how use of certain techniques, such as securities lending, would re-characterise a fund (e.g. some providers represent that funds engaging in extensive securities lending are physical – a large percentage of the fund could be on loan with the only recourse being to collateral – a serious risk as the physical asset has left the fund).

- 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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Source use "ETF" but we have no objection to the use of "Exchange-Traded Fund".

- Q10 Do you think that there should be stricter requirements on the minimum number of market makers?
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No. We believe the exchanges are best placed to set standards and would welcome ESMA's input into harmonising standards for market making and trade reporting across European exchanges.

- 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?
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Source agrees with the proposed guidelines in relation to actively-managed UCITS ETFs. We also note there needs to be some balance between "portfolio transparency" and the need to protect proprietary trading strategies (assuming market makers are at all times facilitated with the portfolio information required to make a market).

- Q12 Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?
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Source notes the importance of ensuring the availability of liquidity for ETF investors. We believe both options are suitable for this purpose, and would suggest that ETF providers be asked to ensure that at least one of the options is made available with respect to their funds.

- 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.
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No, we have nothing further to add at this time.

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- 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.
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Source is not aware of any specific concerns regarding this practice and do not believe it is detrimental to investors.

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- 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 depositories and any other sub-registers held, for example by a broker or an intermediary?
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We have nothing to add on this point.

IV. Efficient portfolio management techniques

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- 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?
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Source believes that it is important to separate the role of collateral from the means by which a fund achieves its investment objectives. While correlation may have a role, in some circumstances relative volatility and liquidity are more important (e.g., US Treasury Bills are not correlated to equity markets, but are generally regarded as high quality collateral). Accordingly, a common collateral policy across all OTC exposures is desirable, but integrating collateral attributes with fund assets is not.

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- 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
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Source concurs with the response of EFAMA on this point and are of the view that the criteria in Box 26 of CESR's guidelines on risk management are appropriate in setting requirements for good quality collateral and should be sufficient.

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- 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)?
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Source think greater clarity is required around the meaning of "risk-free assets" before we could provide meaningful comment.

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- 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.
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Source is supportive of the IFIA view on this matter.

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- 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?
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No, we do not believe that the collateral should be aggregated with assets of the UCITS for the purposes of

compliance with the UCITS diversification rules. It is an important principle that collateral is not a fund asset and is not considered part of the portfolio and should not be considered to be a fund asset until such time as there is a default. We refer you again to our response to Question 16 above.

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?

Source believes the universe of eligible collateral is already sufficiently catered for by CESR and the relevant local regulators.

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, and this is the case for our Irish domiciled UCITS. We would welcome EU harmonization on the point.

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, we believe an exhaustive list would remove flexibility to address changes in markets and liquidity.

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

Yes, Source agrees.

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?

While Source do not believe a cap on securities lending would be in the interests of investors or the industry we do think that funds which lend in excess of 20% of assets should not be allowed hold themselves out as physical. This is misleading to investors (particularly those not sophisticated enough to understand to associated risks).

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

We do not, currently, engage in securities lending. With respect to the rest of the market our view is that there is a lack of transparency around assets lent, counterparty exposure and fees received. This should be improved.

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)?

Source does not have a view.

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?

Source agrees with the EFAMA response on this point.

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?

No.

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

It should be noted that we do not collateralise our counterparty exposure – we choose to cash settle that exposure to reduce risk in our funds. The valuation of collateral is the responsibility of the fund or management company, depending on the legal form of the fund. Such valuation duties may be delegated. Where conflicts arise we believe these can be dealt with through sufficient disclosure.

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 fully understand to what this question relates. Before we can make an informed response, we would like further clarification from ESMA.

V. Total Return Swaps

Q32 Do you agree with the proposed guidelines?

Source support the views of ESMA on many of the proposed guidelines. ETF providers have pushed for greater transparency over the last two years and anything which aids that process is a positive thing for investors.

While Source uses total return swaps to ensure a high degree of tracking in our funds, we do not view our equity portfolios as serving the same purposes as collateral. In fact, a very substantial proportion of the performance of most of our funds comes from the equity positions that we hold and only a relatively small portion comes from our swap transactions. This being the case, we follow the UCITS diversification rules in our equity portfolios and will continue to do so.

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 are in agreement with the points raised by both the IFIA and EFAMA in this regard.

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?

We do not agree with this proposal. Shareholder consent may be required to amend fund rules and this is wholly inappropriate if a UCITS wanted to change counterparties, change the type and level of collateral or change its reinvestment policy, for example. The fund rules often include provisions regarding the use of derivatives in accordance with the requirements of applicable law and the requirements of the relevant regulator.

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 support the idea of a qualitative framework for collateral. Within this construct, we support the creation of a list of eligible assets that is purely indicative and not exhaustive. We do not support a prescribed list of eligible assets.

We also believe that the UCITS IV guidelines have already sufficiently addressed this point.

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.

While we see merit in the idea we feel the risk of our reduced flexibility outweighs the benefits.

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?

No, we do not believe that the collateral should comply with the UCITS diversification rules. The purpose of collateral is as a mitigant for default of the fund's counterparty and is only relevant upon crystallisation of such a default. It was never envisaged that the purpose of collateral would be to reflect a fund's investment policy. The overriding requirement for collateral is that it is of good quality and liquid so that if default ever occurs the fund can quickly sell good assets to mitigate its potential loss due to counterparty default.

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?

Source is of the view that the same collateral requirements should be apply to all OTC derivative transactions.

VI. Strategy Indices

Q39 Do you agree with ESMA analysis of the issues raised by the use of total return swaps by UCITS? If not, please give reasons.

We find it difficult to comment on the proposed guidelines without understanding the specific concerns they are intended to address. Source would be grateful if ESMA could provide more information in this regard.

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

We do not see any in principle reason why such conflict, once adequately disclosed, should be a cause for concern.

V.II Transitional Provisions

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

Source is of the view that it is not reasonable or practicable to bring the guidelines into effect in 2012. We would, however, ask ESMA to note that many of the recommendations, particularly those impacting ETFs are have already been adopted by the industry.

Therefore, the guidelines should generally come into effect not less than fifteen months after their final publication.
