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ESMA
Rue de Grenelle 103
75007 - Paris
France

Re: Consultation paper - ESMA's guidelines on ETFs and other UCITS issue

ASSOSIM¹ welcomes the opportunity to comment on the ESMA's guidelines on ETFs and other UCITS issues and is pleased to provide the following observations.

Feedbacks

Assosim supports ESMA in promoting the transparency of UCITS products and improving investor understanding, particularly in relation to Exchange-Traded Funds (ETFs).

Here below, you can find our answers to the consultation paper. We acknowledge that this response may be published by ESMA.

I. INDEX-TRACKING UCITS

Q1: Do you agree with the proposed guidelines?

Yes, we agree with the proposed transparency measures.

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.

¹ ASSOSIM (*Associazione Italiana Intermediari Mobiliari*) is the Italian Association of Financial Intermediaries, which represents the majority of financial intermediaries acting in the Italian Markets. ASSOSIM has nearly 80 members represented by banks, investment firms, branches of foreign brokerage houses, active in the investment services industry, mostly in primary and secondary markets of equities, bonds and derivatives, for some 82% of the Italian total trading volume.

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We think that it could be helpful to have some guidelines explaining the way tracking error should be calculated. In particular:

1. "Tracking Error" and "Tracking Difference" should be clearly differentiated.

On this regard, a recent IOSCO consultation² provides that:

"The Tracking Error (TE) measures how consistently an ETF follows its benchmark. Tracking error is defined by the industry as the volatility of the differences in returns between a fund and its benchmark index. The tracking error helps measure the quality of the replication."

The Tracking Difference (TD) measures the actual under- or outperformance of the fund compared to the benchmark index. Tracking difference is defined as the total return difference between a fund and its benchmark index over a certain period of time."

ESMA should adopt the above definition of Tracking Error in order to avoid that some operators refer to "tracking error" with the meaning of "tracking difference".

2. The proposed clarification could contribute to a better comparability of funds. In this respect, the tracking error could be annualized for funds with a track record above 1 year; it could specify the number of periods over which it has been measured, the return frequency (daily, monthly), etc. A 1 year tracking error on weekly data could be a reasonable option.

3. The publication of clear Tracking Error data permits to assess that funds that qualify themselves as indexed funds are really indexed. In fact, above a certain threshold of tracking error, an indexed fund could not be considered as a real indexed fund.

There should be of course no distinction between so-called "synthetic" and "physical" replication. They are all indexed funds and, as such, they should be transparent as regards their tracking error.

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?

This question relates to the concept of "Tracking Difference"³ mentioned in the above IOSCO consultation.

² "Principles for the Regulation of Exchange Traded Funds - Consultation Report - <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD376.pdf>, page 9, Box 3

³ "Principles for the Regulation of Exchange Traded Funds - Consultation Report - <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD376.pdf>, page 9, Box 3

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To this regard, please note that the Tracking Difference is already mentioned in the "Key Investor Information Document (KIID)". The Commission Regulation 583/2010 (Articles from 15 to 19) defines the presentation of past performances, providing that yearly the past performance is compared to the benchmark which, in the case of an indexed fund, is by definition the index. So the investor can easily check the difference between the performance of the fund and the performance of the index.

Furthermore, with the aim of strengthening investor protection, we would recommend that the main risks of the replication method are also presented. Indeed, although the tracking error is higher for physical replicating UCITS, these are not necessarily riskier than synthetically replicated UCITS. In this respect, we consider it is fundamental that investors understand that the tracking error measurement is not a risk indicator. With this view, the risks involved with the different types of index-tracking UCITS should be shown first of all in the KIID, besides giving them evidence in the annual report.

II. INDEX-TRACKING LEVERAGED UCITS

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

We agree with the proposed guidelines.

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

All UCITS already disclose in their prospectus how they achieve their strategy. Specific guidelines are not required.

III. UCITS EXCHANGE TRADED FUNDS DEFINITION OF UCITS ETFS AND TITLE

Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?

We agree with the proposed definition.

Nevertheless, we suggest not including into the definition the number of market makers (see Q10).

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Box 3 – Definition of UCITS ETF and identifier

Text proposed by ESMA

Amendment

<p>1. A UCITS exchange-traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradable on at least one regulated market or multilateral trading facility (MTF) with at least one market maker which takes action to ensure that the stock exchange value of its units or shares does not significantly vary from their net asset value.</p>	<p>1. A UCITS exchange-traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradable on at least one regulated market or multilateral trading facility (MTF) with at least one market maker which takes action to ensure that the and whose stock exchange value does of its units or shares not significantly vary from their its net asset value.</p>
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Q7: Do you agree with the proposed guidelines in relation to the identifier?

Yes, we agree.

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

No, we do not believe that this distinction is appropriate. In particular:

1. Funds are usually classified according to their strategy, not considering how they implement their strategy.

There are several classification systems for funds but none is based on the instruments they use. The strategy of the fund is indeed the principal aspect an investor should be able to understand.

Furthermore, the proposed classification would prevent the flexibility to switch from one replication methodology to another in case, for instance, the regulatory/tax environment changes over time.

2. The KIID already addresses this issue.

The issue of understanding the fund and how it is managed has been addressed by UCITS 4 with the Key Investor Information Document (KIID), a two pages document, written in simple language, which explains the fundamental characteristics of the fund.

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We believe that it is not viable making the investor understand the fund characteristics on the basis of its name. Moreover, the proposal might be misleading as it emphasizes an aspect that is less important than other characteristics like the circumstance that the fund is equity or fixed income, the index is broad or narrow, the replication is sample or full, not to mention the degree of risks of such fund, etc. In addition, investors would have the feeling that the synthetic replication is more risky, whereas this is not necessarily true. Securities lending could create similar risks to investors, depending on the collateral used.

3. What about hybrid situations?

If an ETF replicates an index by purchasing the constituents of the index, for 60%, and with some swaps for 40% of the index, is it physical or synthetic replication? If such regulation is adopted there should be some guidelines about how to deal with such hybrid situations.

4. Distinction between ETFs and any other form of exchange-traded products

The main distinction should be made between exchange-traded funds and any other form of exchange-traded products/structures (ETN, ETC, etc.) rather than within the fund space itself (be it UCITS ETFs or other regulated funds under equivalent regimes). A possible approach to increase transparency in this respect (and consequently increase investor protection) could be achieved by asking the Stock Exchanges to introduce specific segments that clearly distinguish between the different exchange-traded products that are currently available (the distinction would be based on their legal structure).

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

No, it is not advisable.

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 that UCITS ETFs should have a liquid secondary market but it is on the Stock Exchange competence the decision about how many market maker have to guarantee the liquidity on the market.

Furthermore, we deem it is not appropriate to distinguish whether or not a market-maker belongs to the same group as the asset manager. In fact, we consider that European regulation of conflict of interests properly addresses the issue yet, relying on standards, policies and controls.

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 agree.

SECONDARY MARKET INVESTORS

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

In our experience, investors that have bought ETF on the secondary market rarely request the reimbursement from the issuer, even when this facility is available. This is mainly due to the difficulties of the administrative process and, consequently, to the related costs.

We agree that in time of market disruption, it might be useful for unit/shareholders to be able to redeem on the primary market.

For this reason we are in favor of option 2 of Box 5. However, we would suggest that investors should be made aware of the potentially high costs that they would incur by using this particular type of redemption. Redemption fees (either in the form of fixed fees or as percentage) are required by issuers for this service on the primary market, as well as a minimum number of shares required to be redeemed. This could be done through an appropriate disclaimer in the prospectus

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.

We believe that investors should have the right to redeem at NAV if the secondary market is disrupted, with no excessive fees.

We are in favor of adding to the proposed ESMA guidelines that the fund prospectus should clarify such right.

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.

Q15: Can you provide further details on the relationship between the ETF's register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?

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IV. EFFICIENT PORTFOLIO MANAGEMENT TECHNIQUES

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

Yes, we agree.

This solution has the advantage of treating equally the collateral of derivatives and the collateral of EPM since the risks involved are similar.

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.

We believe that such standards could assure a better investors' protection.

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

Yes, we do.

We propose that ESMA guidelines clearly state that the reinvestment of the collateral should be considered as an investment of the fund to the extent of eligibility, diversification, exposure and cost transparency.

Q19: Would you be in favor of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio? Please explain your view.

No, that does not seem appropriate.

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 believe that there is no need to require the diversification of such combination.

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?

As a first step, we prefer qualitative criteria.

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.

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Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?

Yes, we believe that it is reasonable to add those risks in order to achieve a consistent and efficient regulatory framework.

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

Yes, we agree.

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?

No, we believe that such limit would not be in the interest of investors because securities lending activities, as well as Total Return Swaps, can improve the performance of the fund.

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

There is not a unique market practice for the amount typically lent, the latter depending on the asset class and on the exposure. Anyway, in some cases the amount lent can be very high (up to 95%).

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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)?

No, as we said above, securities lending should face no limits.

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?

The prospectus seems to be appropriate.

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?

We believe that yearly and half-yearly reports would be suitable.

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

As above said, there are already rules dealing with conflict of interests, that rely on standards, policies and controls and not on criteria linked to affiliation.

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.

No, we do not see any critical issue.

V. TOTAL RETURN SWAPS

Q32: Do you agree with the proposed guidelines?

1. We do not agree with the last sentence of paragraph 58 of the consultation:

"This investment can represent up to 100% of the assets, in which case the UCITS can be qualified as a structured UCITS."

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Structured UCITS are already defined in the Commission regulation related to the KIID⁴:

"(...) structured UCITS shall be understood as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance, or to the realization of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features."

Therefore, we believe that this sentence should be deleted from the final guidelines.

2. We are against measures focused on a specific structure.

We are in favor of a broad derivatives regulation. Moreover, there is not an official definition of TRS. Moreover, the proposed guidelines do not specify if they would be applicable to all TRS or only to TRS on the whole assets of the fund. It is also not clear if they are applicable when the fund has several counterparties.

3. As regards the information to be disclosed, we agree with the proposal, provided that the counterparties are stable. On the contrary, should there be several counterparties, it would be not possible to state them in the prospectus.

4. We disagree with the diversification requirements.

5. We strongly disagree with BOX 7, paragraph 5 (d), which in some circumstances requires that the counterparty must be considered as an investment manager.

Box 7, paragraph 5 (d) is the following:

"Where the swap counterparty has discretion over the composition or management of the UCITS portfolio or can take any other discretionary decision related to the UCITS portfolio then the agreement between the UCITS and the swap counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation. Thus, the counterparty should be treated and disclosed as an investment manager."

In particular:

a) It is not correct to qualify as an investment manager a swap counterparty.

⁴ COMMISSION REGULATION (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website

b) It is not correct to consider that any flexibility that is given to the swap counterparty makes such counterparty and investment manager.

c) Such requirement is not provided for securities lending. As a matter of fairness, consistency and in order to avoid regulatory arbitrage, ESMA should treat in the same way operations that are economically similar in kind.

d) The counterparties can be numerous and may change every month. How would those changes be managed if counterparties are supposed to be investment managers?

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.

Yes, we do.

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?

No, we believe that including this information in the prospectus is sufficient.

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 prefer qualitative criteria. In addition, we fully sustain the choice of treating in the same way the collateral of securities lending operations and the collateral of total return swaps.

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.

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Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

We do not support the proposal.

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?

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In order to assure consistency and fairness, we believe that any regulation concerning the collateral of TRS should be applicable to all derivatives and all EPM.

VI. STRATEGY INDICES

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

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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?

No, we do not believe that this linkage should be taken into consideration.

VII. TRANSITIONAL PROVISIONS


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

Yes, we do.

On the contrary, grandfathering clauses would create some embedded competitive advantages for existing providers.

We remain at your disposal for any further information or clarification.

Yours faithfully,


Gianluigi Gugliotta
Secretary General