THEAM RESPONSE TO ESMA'S DISCUSSION PAPER 30 MARCH 2012

THEAM welcomes the possibility to reply to ESMA's consultation paper on ETFs and other UCITS issues. THEAM thanks ESMA for the opportunity to express its opinion on these issues as THEAM manages € 45 Bn of funds, a significant part of them being under the UCITS Directive.
THEAM as a leading position Europe in Structured and Systematic Products, including ETFs, strategy based management and other Alternative solutions.

Index Tracking UCITS

Q1: Do you agree with the proposed guidelines?

Guideline 1.a) *The prospectus of an index-tracking UCITS should include: A clear description of the index including details of its underlying components. In order to avoid the need to update the document frequently, the prospectus can direct investors to a web site where the exact composition of the index is published.*

We believe that the Index Tracking UCITS should provide a link to the Index Provider's website for information on the tracking index, however please note **that the Fund Management Company has no control on the disclosure policy of the Index Providers**. We **hence encourage ESMA to promote a labelling of "UCITS Indices" that would fulfil specific disclosure standards.**

The disclosure of the exact composition of the index will most probably engender **intellectual property and competition issues**. ESMA may hence **consider allowing a delay** in the index composition disclosure.

Please note that THEAM already provides clients with analysis of the index composition, including sector breakdown, regional breakdown and top holdings, in the monthly fund report, allowing clients to understand the strategy they are investing in.

Guideline 1.b) *Information on how the index will be tracked and the implications of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk.*

We agree that information on the replication methodology **should be disclosed** in the prospectus. The **possibility to switch from one replication methodology to the other should also be an option** that would need to be clearly disclosed in the document.

Indeed, we believe that allowing some **flexibility within the prospectus on the replication methodology helps the fund manager to achieve its investment objective** (i.e. tracking the underlying index) in evolving market conditions. For example, if the fund is managed using pure replication, and the composition of the index changes in such a way that the fund manager may no longer track the benchmark properly, or if the underlying market becomes no longer accessible to the manager, this flexibility would allow the fund manager to resort to synthetic replication in order to ensure performance continuity. Similarly, if the fund is managed synthetically, and it happens that the fund manager finds no counterparty willing to swap the performance of the underlying index at a reasonable price, than the fund manager would be able to implement its management expertise to track the index directly. The flexibility in replication methodology can also bring cost efficiency to end clients. For example, if a new tax applies to physical replication, then the fund manager can swiftly convert to synthetic replication to avoid impact on the portfolio. Of course, any switch must be clearly communicated to investors and market participants (data providers, markets makers, exchanges, etc.)

We would add that the **replication methodology actually used should always be updated and highlighted in all marketing documents** (factsheets, presentations, data providers' description page, website, etc.)

We agree that the implication of the chosen method(s) for investors in terms of their exposure to the underlying index and counterparty risk should be included in the prospectus.

<u>Guideline 1.c)</u> *The policy of the index-tracking UCITS regarding the ex-ante tracking error including its target level.*

Please note that by definition the **ex-ante tracking error target of an index tracking fund is zero**. Of course, operational constraints induce non-zero tracking error. Instead of a ***target*** ex-ante tracking error, we would encourage the definition in the prospectus of a ***maximum*** ex-ante tracking error.

<u>Guideline 1.d)</u> *A description of factors that are likely to affect the index-tracking UCITS' ability to track the performance of the index, such as transaction costs, small illiquid components, dividend reinvestment etc.*

We agree that a description of factors that are likely to affect the index-tracking UCITS' ability to track the performance of the index should be included in the prospectus.

<u>Guideline 1.e)</u> *Details of whether the index-tracking UCITS will follow a full replication model or use, for example, a sampling policy.*

As for guideline 1.b), we agree that the type of physical replication used should be disclosed in the prospectus, including the option to switch from one to another.

<u>Guideline 2)</u> *the annual and half-yearly reports of an index-tracking UCITS should state the size of the tracking error as at the end of the period under review. The annual report should provide an explanation of any divergence between the target and actual tracking error for the relevant period.*

We agree that the annual and half-yearly reports of an index-tracking UCITS should state the size of the **ex-post** tracking error as at the end of the period under review. We believe that the annual report should provide an explanation if the actual tracking error is higher than the **maximum** ex-ante tracking error defined in the prospectus (please refer to our comment for guideline 1.c).

To avoid confusion, we encourage ESMA to define a standard definition for the **ex-post** tracking error.

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?

Ex-ante tracking error is a model based data and there can be no standard definition, however ESMA may develop guidelines on the following criteria:

- Observation period (e.g. 1 year);
- Frequency of observations (e.g. 1 week).

As for ex-post tracking error we highly recommend ESMA to develop a common definition. ESMA may for example follows the AMF recommendations (please refer to "*Recommendations pour la standardisation des methodologies de calcul de la 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?

As stated in question Q1 above, we believe that the annual report should provide an explanation if the actual tracking error is higher than the **maximum** ex-ante tracking error defined in the prospectus.

This information should come in addition to some statistical information on the Tracking Difference (difference between the performance of the fund and that of the index).

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

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)?

Yes we agree with the proposed definition.

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

Yes

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

No, we disagree, for various reasons:

1) The right place is the KIID, not the fund name

There is not enough space in the fund's name: the name of the ETF must already include "ETF", the name of the provider and the name of the index. The appropriate place for such information is the KIID or the prospectus (or both).

2) "Synthetic" or "physical" replications are difficult concepts that cannot be understood without explanations (the same applies to "actively managed"). The KIID and/or the prospectus have enough space to explain these concepts.

3) This distinction would not accommodate mixed situations, which often occur in practice:

a. ETFs can use several techniques and switch from one replication to another, or use a combination of them, in order to optimize the return of the fund. For example, an ETF could own physically 90% of the shares of the index, proportionally to the weighting of the index, but use synthetic replication only for the remaining 10% of the index, by purchasing some other shares and swapping them with the rest of the index. A threshold would be necessary to allocate a "mixed" ETF in one category or another.

b. Physical ETFs sometime invest in futures or in certificates on single stocks, instead of investing in the underlying stocks.

A physically replicated ETF engaged in stock lending activity and a swap based ETF present similar risks to investors (counterparty and collateral risk). We therefore consider that such a distinction must be explained in more detail, and is therefore inappropriate for a fund name.

Lastly, other UCITS funds which use derivatives as part of their investment policy do not have such requirements, and it is important to ensure consistency across all UCITS.

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

No, we believe that adding a second possible identifier may only bring confusion over the ETF brand name, and will bring no additional benefits (except maybe for English speaking clients).

On the other side, it is important that a UCIT which does not fall under the definition of UCITS ETF paragraph 1 of box 3 should not use the "Exchanged Traded Fund" in its name or in its fund rules or instrument incorporation, prospectus, KIID or any marketing communications.

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?

Although we agree that the greater the number of market maker the better, we think **there should not be stricter requirements on the minimum number of market makers**. Some underlying strategies are more complicate to market make and require specialized market makers, hence it is not always possible to find several market makers.

ESMA must keep in mind is that what matters is not the number of market makers, or their relationship with the ETF promoter that effectively matters: it is the realized liquidity of the ETF that should be regulated and monitored. The enforcement of the liquidity rules is under the responsibility of the exchange, indistinctively whether the market maker is affiliated to the ETF promoter or not.

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 either the prospectus, the KIID or any marketing communications of the UCITS ETF?

We do agree with the proposed guidelines. We would add that as ETFs are commonly assimilated to trackers (i.e. passive investment funds), **actively managed UCITS ETF should use an identifier**, in its name and in its fund rules or instrument of incorporation, prospectus, KIID and marketing documentations, which would identify it as an actively managed exchanged traded fund. The identifier could be “ACTIVE ETF” for example.

Secondary Market Investors

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

We believe option 1 is a suitable guideline for secondary market investors.

The unique creation redemption structure of ETFs is properly the innovation that made its success, allowing investors to benefit from optimal fund management and intraday liquidity. There are several reasons why we believe that **the primary market should be essentially reserved to Market Makers and APs:**

> a) The current creation redemption process limited to Authorized Participants, imposes large minimum size orders (usually around 1-3M€). If retail investors were allowed to create and redeem for small sizes, the fund manager will lose operational efficiency and it will greatly impact the tracking error of the funds, as small fractions of the index are not possible to trade;
> b) Authorized Participants are investment professionals who ensure the liquidity of the ETF on the secondary market. If retail investors could create and redeem on the primary market, the profitability of the Liquidity Providers would be impacted, which in return will impact the intraday market spreads;
> c) Creation and redemption costs may change as it corresponds to the actual execution costs, and are billed to the funds, so that existing shareholders are not impacted by new entrants or redeeming shareholders. This mechanism requires a good understanding of the underlying market to anticipate execution costs, and may sometimes lead to the payment of a separate invoice after the settlement of the ETF transaction when execution is delayed by a market disruption event. Such mechanism may not be implemented with retail investors, and the role of Authorized Participants as intermediaries simplifies the process for these investors.

Given these consideration, if option 2 was applied, the ETF providers will have to define in the prospectus dissuasive redemption fees on the primary market in order to direct investors towards the secondary market (unless the secondary market is disrupted).

We do agree **that UCITS ETF or its management company should take appropriate action to replace the market maker(s) if it is no longer able or willing to act in that capacit**y, including all specific investor protection measures described in paragraph 2 of option 1.

Please note that although the management company is responsible for appointing at least one market maker and ensure its replacement if the market maker is no longer able or willing to act in that capacity, **it is the responsibility of the exchange authority, not the management company, to ensure that the market maker offers redemption to secondary market investors** whenever the market is open for trading. Indeed, the market making agreement is a bilateral contract between the market maker and the exchange. **We hence do not agree with paragraph 1 of option 1.**

We believe that the warning provided by ESMA I paragraph 4 of option 1 can simplified as follows:

> "*UCITS ETF units / shares cannot usually be sold directly back to the fund. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so.* "

Indeed, the last sentence in ESMA's proposition ("*Investors may pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them")* is redundant with the previous sentence. Please note that if the market maker has inventory interests, secondary market investors may also pay less than the current NAV when buying unites/shares and may receive more than the current NAV when selling them.

ESMA should also consider defining a model specific for ETFs for the "Fees" section of the KIID, as there is different levels of fees depending if the investor trade on the primary or the secondary market and whether the investors on the primary market is an AP or not, and whether we are under the disruption conditions of option 1.

Q13: With respect to paragraph 2 of option 1, 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 can think of no further specific investor protection measures.

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.

N/A

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 a intermediary?

N/A

Efficient portfolio management techniques

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favor 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?

First and foremost, in order to answer properly this question, paragraph 48 of the consultation paper dealing with repo and reverse repo should be prior discussed. Anyway, an EPM technique should not necessarily aim to be a kind of "risk free management technique", otherwise, it has to be called as such. Indeed THEAM would like to highlight the fact that a clear distinction should be made between the different EPM techniques, since they do not have the same nature and do not involve the same level of risk. Each technique corresponds to a specific level of risk, therefore the rules applying to the collateral received should be set in light of each corresponding specific nature.

- Securities lending/borrowing are transactions involving **primarily exchange of securities**, where collateral is used to secure these assets. The profitability of such a deal is directly linked to the scarcity of the securities involved, which is the heart and the motivation of the deal.

- Repurchase agreements or reverse repurchase agreements are **primarily financing transactions**, where the point is to have an appropriate remuneration compared to the risk involved: more risk can be taken by accepting less perfect collateral, assuming that a higher remuneration is obtained.

Applying the same rules to different techniques would certainly affect their efficiency as portfolio management techniques and their role in the efficiency of the market. THEAM is thus of the view that securities lending/borrowing, repurchase agreements and reverse repurchase agreements should not be ruled in a single way and distinctions should be made, in light of their respective economic objective. As it is a basic principle to have collateral complying with some of the CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS in the context of securities lending/borrowing, THEAM is of the view that, **in case of repurchase agreements or reverse repurchase agreements**, the use of collateral complying to this late CESR guidelines should be reserved to maintain the deal into the limits of the risk incurred, in order to match the level of remuneration of the cash received or provided: so, not to the principal of the deal, but **to the variation of net value of the deal**.

Box 6 - Guideline 1) A UCITS should clearly inform investors in the prospectus of its intention to employ the techniques and instruments referred to in Article 51(2) of the UCITS Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS.

Box 6 - Guideline 2) The prospectus should also clearly inform investors of the UCITS' collateral policy. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks arising from the re-investment policy.

Box 6 - Guideline 4) Where the third party is the investment manager or a connected party to the UCITS management company / directors / investment manager / depositary, this should also be disclosed in the prospectus.

THEAM of course agrees with the type of disclosure requested (use of EPM techniques and risks involved, UCITS collateral policy, EPM counterparties), assuming the information are disclosed in the prospectus. However, THEAM wants to call ESMA's attention to the weight of such requests, if the information would be requested on a "live" basis. Moreover, the level of details has to be carefully determined in order to avoid inefficiency and operational burden and to prevent investors from being misled with irrelevant details, bearing in mind that information have to remain readable for investors.

Box 6 - Guideline 3) Fees arising from EPM techniques should be disclosed in the prospectus and, as a general rule, returned to the UCITS. Where a UCITS engages in fee-sharing arrangements in relation to EPM techniques, this should also be clearly disclosed, together with the maximum percentage of fees payable to the third party. Other fees that may be deducted to the return delivered to investors should also be disclosed in the prospectus.

Regarding fees, efficient portfolio management techniques should not be an exception. THEAM is therefore of the view that the fact that EPM techniques generate fees has to be disclosed in the prospectus. As a matter of principle, any fee-sharing arrangements should also be disclosed.

Nevertheless, securities lending is a complex and costly activity which is usually undertaken by a third party specialist (this may be the asset manager, the custodian or an independent third party) who has invested in specialized systems and expertise to manage the process in a risk controlled manner. It is usual for this third party to seek re-imbursement through a fee sharing arrangement rather than charging a flat fee. This ensures that the UCITS only incurs costs when revenues are generated and lines the interests of the third party up with those of the UCITS, assuring that the activity is profitable for the UCITS.

Box 6 - Guideline 5) A UCITS should ensure that it is able at any time to recall any security that has been lent or terminate any securities lending or repo agreement into which it has entered.

THEAM agrees with this guideline.

Box 6 - Guideline 6) Collateral received in the context of EPM techniques should comply with the criteria for collateral received in the case of OTC derivatives set out in Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

Please refer to the comments of the Box 6 above.

THEAM is of the view that depending on the context, EPM techniques should not have to comply with the criteria for collateral received in the case of OTC derivatives set out in Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. While securities lending/borrowing (especially lending) has to protect the securities ownership, and then needs collateral complying with Box 26 of the referred CESR's Guidelines, repurchase agreements and **reverse repurchase agreements are financing transactions**, which, like any financing transaction, involve a certain level of risk facing an adequate level of remuneration: collateral complying to the referred Box 26 of CESR's Guidelines should only concern the hedge of **the variation of the net value** of the deal.

> *Box 6 - Guideline 7) 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.*

Please refer to the introduction.

Here is the question of how to secure efficiently the saving of investors, especially retail investors. Clearly, the view of the proposed Guidelines is to fully secure these investors in case of extreme scenarios, whatever the cost, postulating that the use of "EPM" techniques should be totally transparent for retail investors in case of such scenarios occur.

THEAM is of the view that this philosophical position, unique over the whole economical activities, can't be really efficient.

To make this point sensible, it could be useful to switch to car industry and imagine the specifications of a new car. Not only, it has to have the usual protections (airbags wherever possible); but also, it has to guarantee that in case of crash, nobody would have any inconvenience, such as glasses broken or nose bleeding… Finally, the only way to match these requests is to curb the speediness of the car to 10 or 15 kilometers per an hour… By requesting some specifications relating to a very high level of security, one would have forgotten the main one of a car: allowing going from a point to another in a reasonable time and in a reasonable level of security.

Similarly, THEAM considers that requiring collateral received in the context of EPM techniques to comply with the UCITS diversification rules is demanding a too high level of security considering the objective of an EPM technique. In other words, the requirements on collateral received and securities purchased would substantially reduce the efficiency of the portfolio management techniques and would lead the UCITS to be less attractive to investors.

More precisely, the view of THEAM considering the diversification rules for UCITS can be split in two points:

1) These rules have been elaborated to ensure investors to have a reasonably diversified exposure when they go to collective investment: the aim is to allow retail investors to comply with some theory of efficiency of investment, although they have not enough savings to replicate it alone. These rules have absolutely not been designed to comply primarily with safety of such a portfolio.

2) Complying with such rules for collateral or repurchase agreement is not as simple as it could appear to someone knowing only the direct investment side. The investment and control system are, at first, not designed to such an aim. Moreover and principally, the functioning of both the collateral's world and the repurchase's world is to let the debtor to choose the securities given in a contractual universe: every time

the creditor has some supplementary requests concerning these securities, it has to be treated as an exception.

So then, having to comply with such non linear rules as “UCITS’s diversification rules”, with mixing direct investment (controlled by the UCITS Management Company), collateral given by OTC’s counterparties (chosen at first by each counterparty involved, which can be numerous) and securities bought through reverse repurchase agreement (chosen too by each counterparty involved, which can be numerous too), will be at least be very complex, bearing a lot of operational risks, without increasing fundamentally the safety of the investors.

Anyway, as a reasonable diversification of the collateral could be preferred, THEAM is of the view that a limit of 35% per security, that would lead to have generally 5 securities close to equally weighted if there is only one counterparty of EPM, and that would prevent from to having too many feedback effects when the UCITS is working using open architecture. Please refer to THEAM’s same view below concerning especially Total Return Swaps (especially Q32) to have more points about operational issues involved on this point.

Considering the collateral received in cash (to avoid any misunderstanding, the cash received in a financing operation, like repurchase agreement, is not considered as cash collateral), the holding of sight or on call deposit with the depositary may be justified to cover payments. Requiring that at **any time** a UCITS shall hold no more than 20 % of the portfolio composed of (i) cash received in ancillary liquid assets (ii) cash received as collateral and (iii) deposits with the depositary will finally lead to **transfer cash collateral to third party agents**. This will result in a credit exposure on these third party agents, unless the bankruptcy rules for UCITS’s depositary change to protect especially this kind of position.

Furthermore if received collateral fall in the scope of custody under UCITS V, THEAM believe that depositaries will not accept to have an obligation to return cash-reinvestment in assets held by a third party in case of loss of these assets by the third party.

Therefore THEAM strongly suggests that the review of UCITS V (or of any provision applying to depositaries) should lay down that UCITS are entitled to be preferred before other creditor of the depositary in case of its bankruptcy to enable the raise of the threshold of 20% for cash held by the depositary.

<u>Box 6 - Guideline 8)</u> Entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

Yes. Please refer to question 24 below.

<u>Box 6 - Guideline 9)</u> A UCITS should have in place a clear haircut policy for each class of assets received as collateral. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.

Please refer to discussion above.

THEAM is of the view that a clear haircut policy should be in place and documented.

<u>Box 6 - Guideline 10)</u> The UCITS' annual report should also contain details of the following:

a) *The underlying exposure obtained through EPM techniques;*
b) *The identity of the counterparty(ies) to these EPM techniques; and*
c) *The type and amount of collateral received by the UCITS to reduce counterparty exposure.*

THEAM understands that the objectives of the guidelines are to set rules in order to put efficient portfolio management techniques into a robust frame. Once this framework in place, one can question the relevancy of requesting additional information. Actually by providing more information on ordinary techniques, investors' attention may be diverted from more crucial topics.

Furthermore, if such information has to be disclosed in the annual report, THEAM wants to point out to ESMA the operational issues that this requirement would entail. The underlying exposure obtained through EPM techniques, as the identity of the counterparties and the type and amount of collateral received may change over time and appropriate tools should be set up in order to catch these data. The costs of such tools would have, one way or another, repercussions on the UCITS and thus, investors.

<u>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.</u>

As stated before, depending on the context, collateral received/provided or securities purchased/sold in the context of EPM techniques is not a straightforward concept. Where collateral is mainly to protect the fund, *i.e.* in the context of securities lending, THEAM considers that the proposed guidelines set standards that will ensure the collateral received to be of good quality.

However, as demonstrated, when it comes to securities involved in reverse repurchase agreements, quality (amongst which liquidity, level of haircut, credit appreciation) is **one of the parameters** of the deal **involved in the financial conditions** of the deal. In certain circumstances, according to the analysis of the UCITS's manager and to the documentation of the fund, the deal could be more secured and less rewarding for the investor; or less secured but more rewarding for the investor. In the context of reverse repurchase agreements, complying with the criteria applying to collateral limits such EPM as a kind of "risk-free" deal. Nevertheless, THEAM is of the view that **reverse repurchase agreement has to remain a way amongst others to invest in the profit of the investor**s.
Anyway, once a level of risk accepted for such an EPM, the increase of this risk should be covered by collateral, under the conditions set out in Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS.

<u>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)?</u>

Reinvestment of cash collateral, which has to be distinguishing from cash held within the UCITS, should be limited to non-risky assets. Cash collateral criteria as they are disclosed in Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS should be sufficient. Therefore THEAM cannot see any merit in the development of further guidelines in respect of the reinvestment of cash collateral.
However, the answers assume that cash received from a repurchase agreement is not considered as cash collateral but as financing cash. Therefore, the proposed guidelines have not to be applied to this cash.

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.

No. THEAM is of the view that request concerning any level of correlation is not useful to protect investors. Therefore, such a request will be misleading:

- In the event of a default by the counterparty, what really matters with collateral received or securities purchased is to be able to quickly resale the assets. A high correlation criterion would be useless. Furthermore, in many cases it would be very difficult to find enough correlated securities. Basically, the only collateral which would be totally correlated to the securities lent would be the securities themselves.

- A high correlation requirement may give rise to inefficiency, since any changes in the collateral or securities composition, required to ensure that the correlation criterion is enforced, would involve costs, ruining the initial purpose of securities lending/borrowing and repurchase agreements/reverse repurchase agreements as efficient portfolio management techniques and causing intermediaries to be paid with no upside for the investors.

In the end, bearing in mind that correlation is a non trivial input (as a market parameter, it can vary over time and over maturities), a high correlation requirement between the collateral received or provided, or the securities purchased or sold, and the composition of the UCITS underlying portfolio would lead to non efficiency. THEAM is thus of the view that a high correlation requirement should not be applied for EPM techniques.

More generally, THEAM warns about the fact, assuming a small gap is allowed between the risk and the collateral (from which comes a certain exposure to the counterparty), it is not consistent to want to be very tight on the collateral itself.

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?

Please refer to Q16, Guideline 7) above where this point has been detailed.

THEAM is of the view that the combination of the collateral received by the UCITS and the assets of the UCITS is not relevant, since the two aggregates do not have the same nature. Furthermore, what should comply with the diversification criteria is what actually creates the performance, now collateral received in the context of securities lending do not create any performance and, therefore, should not comply with the UCITS diversification rules.

THEAM is pleased to highlight again a crucial point concerning the organization of the global collateral system. This organization has as main purpose to prevent the financial markets from instability. The normal functioning is the debtor choosing collateral into its own assets complying with the contractual universe of collateral mutually agreed, and giving it to the creditor.
Practically, it would be very difficult to enable the creditor to choose the assets of the debtor for collateral.

By asking some requests upon diversification, including non public data (such as assets owned by the UCITS, choice of other counterparties as collateral into other EPM), the proposed Guidelines would have hazardous impact on the global collateral system itself.

- Especially, we can imagine a lot of difficulties to have both counterparties of one EPM to agree on the collateral of the day, the difficulties increasing as the square of the number of counterparties involved.
- So, the probability to have substantial lateness and delays to match the collateral will become major; the probability to have "domino's effects" on the whole market of collateral will grow too, through counterparties needing to recall some collateral somewhere to be able to give it back to a UCITS.

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?

The quality of the assets to be used as collateral is supposed to be assessed by the Management Company. Furthermore, where collateral should be received, *i.e.* in the context of securities lending, THEAM considers that the proposed guidelines set standards that will ensure that the collateral received is of good quality.

Moreover, an indicative list could be misleading and understood as a true reference, since the "indicative" feature is not lawfully defined.
Anyway, the list of Transferable Securities (T-bills, securities from sovereign agencies, etc., and not only Bonds) as eligible assets maintained and published by the ECB should be added in the list proposed by ESMA to enable sufficient flexibility, if such a list is recognized to be necessary despite the view of THEAM.

But definitely, THEAM believes that defining qualitative criteria for eligible collateral without further expansion to be the best approach. This allows a level of flexibility for the UCITS to react to changes in market conditions without the need to amend regulation whilst ensuring that the quality of collateral is always maintained.

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.

An exhaustive list of eligible assets would be useless and may lead to confusion. However, should an eligible list of assets for use as collateral received be maintained, THEAM is of the view that the list should be more exhaustive (please refer to our above comments Q21).

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, we do. Where an EPM technique is involved, counterparty risk is calculated taking into account any collateral as a reduction of risk. Therefore counterparty risk arising from EPM techniques is supposed to be offset. Nevertheless, THEAM is of the view that the resulting counterparty risk (*i.e.* net of collateral received) 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. To be exhaustive, THEAM assumes that a negative net exposure on a given instrument with a given counterparty should always reduce a positive net exposure on another transaction with the same counterparty.

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

THEAM is of the view that cash collateral has to be deposited with credit institutions complying with the criteria stated in the Article 50(f) of the UCITS Directive, as far as the bankruptcy rules do not make any difference between cash held on behalf of a UCITS and cash held for other creditors of a depositary.

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 do not. THEAM cannot see any merit in limiting the proportion of the portfolio subject to securities lending. Provided the risk management techniques are robust and appropriate collateral and haircuts are applied limits are not necessary and will be detrimental to the UCITS ability to ensure best pricing and to maximize returns for the investors. What should rather be limited is the risk taken through these operations.

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

THEAM is of the view that where securities lending is employed, 100% of the portfolio could be lent. To complete, with regards to reverse repurchase agreement, depending on the objective of the UCITS, the whole cash available may be employed to purchase securities. The approach that is made concerns the net exposure, which is the relevant one, not the gross one.

Q27: For the purposes of Q25 above, should other elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

As stated before, the proportion of the UCITS portfolio that can be subject to securities lending activity should not be limited.
Anyway, THEAM wishes to remind ESMA that a UCITS Management Company is supposed to work in the interest of the investors and to disclose its politics of vote in general assembly. Therefore, a UCITS Management Company is not supposed to lend, on purpose or knowing it, securities to counterpart that will use them to vote in another way, or in a way that will deserve UCITS's investors interests.

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?

Yes, we do.

<u>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?</u>

THEAM does not see any merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis. Furthermore, even if annual reports of UCITS appear as a relevant medium to communicate changes, if any, regarding EPM counterparties, one should bear in mind the costs incurred by the follow-up of such data. As stated before, such costs would be passed on the UCITS and thus, on investors.

<u>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.</u>

THEAM wishes to underline that it is already into the basic assignments of the UCITS Management Company to be able to value or control the value of any asset owned by any of its portfolio, through any way (directly owned, reverse repurchase agreement, total return swap, collateral of any transaction…).

Concerning the role of the depositary regarding valuation of collateral, a solution could be to retain rules similar to those developed under the AIFM Directive according to which, provided it has functionally and hierarchically separated functions, the depositary may also provide:

- services to finance or execute transactions in financial instruments as counterparty, securities lending, customized technology and operational support facilities if potential conflicts of interest are identified, managed, monitored and disclosed to the investors in the fund;
- Monitoring of net asset value calculation and valuation of individual assets (including collateral).

It is recognized that the AIFM Directive establishes a stringent regulatory framework addressing risks in relation to investors.

THEAM is of the view that rules similar to those of the AIMF Directive should be sufficient to mitigate these risks.

<u>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.</u>

THEAM is of the view that a UCITS Management Company is due to control the value of any of the assets held, at any time and through any technique or any contract (direct ownership, collateral and so on – see above) and whatever the way of entering into ownership (discretionary management, automation, etc.).

ESMA should primarily address this basic responsibility of the UCITS Management Company and should rather organize adequate controls from local regulator, than avoiding investors to benefit from some useful techniques.

Total Return Swaps

Q32: Do you agree with the proposed guidelines in Box 7?

> *Guideline 1 In the case of an unfunded swap, both the UCITS' investment portfolio, the return of which is swapped, and the underlying to the swap, to which the UCITS obtains exposure, must comply with the relevant UCITS diversification rules. If collateral is posted by the swap counterparty to mitigate the counterparty risk, this collateral should be sufficiently diversified over the course of the swap in order that at any time, the portfolio composed of collateral and the other investments made by the UCITS comply with the UCITS diversification rules.*
> *Guideline 2 In the case of a funded swap, the collateral posted by the swap counterparty to mitigate the counterparty risk should be sufficiently diversified to comply with the UCITS diversification rules, taking into account both the investments made by the UCITS and the collateral. 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.*

THEAM draws ESMA's attention on the fact that the **UCITS diversification rules were originally implemented in order to mitigate investment risk, not counterparty risk,** and that the current regulation already specifies that collateral should be diversified as a matter of principal and monitored by the Management Company (box 26 of CESR guidelines),

It seems that the credit crisis has pushed investors and regulators to focus all their attention on counterparty risk, to a point that they may sometimes disregard market risk.

THEAM firmly encourages, supports, and follows, rigorous risk management techniques in order to mitigate counterparty risk (thorough counterparty analysis for rigorous selection and monitoring, efficient collateral management, multi-counterparty exposure, etc). **We do not believe that applying the UCITS diversification rule to the combination of the collateral and investment made by the UCITS is the best way to protect investors from counterparty risk.**

Portfolio investments and collateral are **not of the same nature**, and should therefore be treated separately.

Beyond the economical relevance of these guidelines, ESMA should **also measure the operational impact of such requirements.** Collateral is not managed directly within the funds but on segregated accounts (one per each counterparty) and involves different collateral agreement contracts. **Such guidelines would hence lead fund management companies to trade with single counterparties to reduce complexity**. This is contrary to a counterparty risk limitation policy. Fund managers would have to develop cross account monitoring systems and teams, and this would **heavily impact operational costs**. At the end of the day, this will ultimately be **reflected in the fund performance.** If ESMA wishes to clarify through quantitative guidelines the already existing collateral diversification requirements, (box 26 of CESR guidelines), we believe that ESMA should develop a rule designed specifically for this purpose, instead of using a rule that applies for a different source of risk. **This rule should be applied specifically to the collateral**, and should not combine two aggregates of separate nature: the portfolio investments and the collateral**.**

For example, we suggest ESMA to apply the following rule: no portfolio line (single issuer) should ever exceed 35% of the total portfolio value, whether this line is an investment made by the UCITS or a posted collateral. This rule would come in addition to the existing UCITS diversification rule which applies to the portfolio exposure only.

This rule would directly address the collateral diversification issue, based on real economical insight, while avoiding too heavy operational burdens and costs.

Guideline 3 Entities at which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

THEAM agrees.

Guideline 4 A UCITS should have in place a clear haircut policy for each class of assets received as collateral of a funded swap. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.

THEAM agrees.

Guideline 5 a) Information provided to investors in the prospectus of UCITS using total return swaps should include information on the underlying strategy and composition of the investment portfolio or index, the counterparty(ies) and, where relevant, the type and level of collateral required and, in the case of cash collateral, reinvestment policy, including the risks arising from the re-investment policy.

THEAM agrees that static information such as information on the underlying strategy and composition of the investment portfolio or index, general type and level of collateral required, reinvestment policy, etc, should be including in the prospectus of UCITS. **However, the prospectus should not specify dynamic information such as counterparties or collateral received, as it would lead to inefficient management, as investment decision will be driven by operational considerations (as the management company will have to undergo a modification of prospectus in order to switch counterparty for example).**

Within THEAM, counterparties are selected according to tight selection rules defined by the risk management department, and the eligible counterparties list is closely monitored. A **fund should not be tied to one or more counterparties through its prospectus as counterparty risks evolve over time**.

Guideline 5 b) Information provided to investors in the prospectus of UCITS using total return swaps should include the risk of counterparty default and the effect on investor returns.

THEAM agrees.

Guideline 5 c) Where the swap counterparty assumes any discretion over the UCITS portfolio the extent to which the counterparty has control over the investment policy and the limitations imposed in the management of the UCITS should be disclosed to investors in the prospectus.

THEAM considers that the swap counterparty could not have control over the investment policy of the UCITS which remains the responsibility of the UCITS/management company as such we do not consider necessary useful to mention this point in the prospectus.

Guideline 5 d) 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.

THEAM considers that the UCITS and/or its management company is the right entity to have discretion over the UCITS portfolio and if this could not be delegated to the swap counterparty.

The swap counterparty could not from our perspective be appointed as investment manager if this will be the case it will necessarily face huge conflict of interests in the management of assets of a third party and its own account positions according to its hedging policy. ESMA should provide explanations regarding the way a swap counterparty could be deem to act according to these two roles.

Furthermore, UCITS have very often several swap counterparty, it will be also impracticable to consider that each swap counterparty is deemed as an investment manager. We consider that the appointment of an investment manager is made to benefit from a specific expertise according to a management style and this won't be the case through the conclusion of a swap.

From our perspective it is the role of the UCITS/management company to ensure that the UCITS comply with the directive and as such the swap documentation should necessarily include provision according to which any change of assets, if any, shall be made with the approval of the UCITS and in compliance with the UCITS directive.

Guideline 5 e) Where the approval of the counterparty is required in relation to any portfolio transaction this must be disclosed in the prospectus.

We do not consider necessary to insert this kind of reference in the prospectus as this is made under the control and responsibility of the UCITS/management company.

<u>*Guideline 6*</u> *The UCITS' annual report should also contain details of the following:*

a) The underlying exposure obtained through financial derivatives instruments;
b) The identity of the counterparty(ies) to these financial derivative transactions; and
c) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

THEAM agrees that the UCITS annual report should contain details on the underlying exposure obtained through financial derivatives instruments.

THEAM does not support the disclosure of counterparties as it can encourage industrial espionage on funds that use complex and innovative strategies. Moreover, this information is dynamic and provides no guarantee to the investors that the same counterparties would be used in the future. We understand ESMA's concerns over credit risk transparency, and agree that investors must be ensured that the risk policy described in the prospectus is effectively applied. For this reason we would suggest ESMA to require that the auditor checks the identity of the counterparties, and we believe that the number and the ratings category of the counterparties used should be disclosed in the annual report. In this way, clients will receive the relevant information in terms of counterparty risk, without potentially harming the intellectual property rights of the fund management company.

THEAM agrees that the type of collateral received by the UCITS should be disclosed, yet the disclosure of the amount of collateral is not relevant, heavy to produce, and may drawn investors with data.

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.

As mentioned above, **we do not believe that applying the UCITS diversification rule to the combination of the collateral and investment made by the UCITS is the best way to protect investors from counterparty risk.**

Portfolio investments and collateral are **not of the same nature**, and should therefore be treated separately.

Beyond the economical relevance of these guidelines, ESMA should **also measure the operational impact of such requirements.** Collateral is not managed directly within the funds but on segregated accounts (one per each counterparty) and involves different collateral agreement contracts. **Such guidelines would hence lead fund management companies to trade with single counterparties to reduce complexity**. This is contrary to a counterparty risk limitation policy. Fund managers would have to develop cross account monitoring systems and teams, and this would **heavily impact operational costs**. At the end of the day, this will ultimately be **reflected in the fund performance.** If ESMA wishes to clarify through quantitative guidelines the already existing collateral diversification requirements, (box 26 of CESR guidelines), we believe that ESMA should develop a rule designed specifically for this purpose, instead of using a rule that applies for a different source of risk. **This rule should be applied specifically to the collateral**, and should not combine two aggregates of separate nature: the portfolio investments and the collateral**.**

For example, we suggest ESMA to apply the following rule: no portfolio line (single issuer) should ever exceed 35% of the total portfolio value, whether this line is an investment made by the UCITS or a posted collateral.

This rule would come in addition to the existing UCITS diversification rule which applies to the portfolio exposure only.

This rule would directly address the collateral diversification issue, based on real economical insight, while avoiding too heavy operational burdens and costs.

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?

See above comments

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 encourage ESMA to define an indicative list of eligible assets to ensure the liquidity quality. For example, ESMA could impose securities which are components of the broad recognized equity index for equities, transferable securities eligible to ECB for bond instruments, and cash.

<u>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.</u>

We believe that an indicative list is more suitable than a fixed exhaustive list, as markets evolve over time, and it is important to leave room for adaptation. For example, ESMA could impose securities which are components of a broad recognized equity index for equities, transferable securities eligible to ECB for bond instruments, and cash.

<u>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?</u>

As mentioned above, **we do not believe that applying the UCITS diversification rule to the combination of the collateral and investment made by the UCITS is the best way to protect investors from counterparty risk.**

Portfolio investments and collateral are **not of the same nature**, and should therefore be treated separately.

Beyond the economical relevance of these guidelines, ESMA should **also measure the operational impact of such requirements.** Collateral is not managed directly within the funds but on segregated accounts (one per each counterparty) and involves different collateral agreement contracts. **Such guidelines would hence lead fund management companies to trade with single counterparties to reduce complexity**. This is contrary to a counterparty risk limitation policy. Fund managers would have to develop cross account monitoring systems and teams, and this would **heavily impact operational costs**. At the end of the day, this will ultimately be **reflected in the fund performance**. If ESMA wishes to clarify through quantitative guidelines the already existing collateral diversification requirements, (box 26 of CESR guidelines), we believe that ESMA should develop a rule designed specifically for this purpose, instead of using a rule that applies for a different source of risk. **This rule should be applied specifically to the collateral**, and should not combine two aggregates of separate nature: the portfolio investments and the collateral**.**

For example, we suggest ESMA to apply the following rule: no portfolio line (single issuer) should ever exceed 35% of the total portfolio value, whether this line is an investment made by the UCITS or a posted collateral.

This rule would come in addition to the existing UCITS diversification rule which applies to the portfolio exposure only.

This rule would directly address the collateral diversification issue, based on real economical insight, while avoiding too heavy operational burdens and costs.

<u>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?</u>

THEAM believes that there should be harmonization of UCITS rules among all OTC derivatives transactions.

Strategies indices

Q39: Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.

Guideline 1:
The prospectus for an index replicating UCITS must, where relevant, inform investors of the intention to make use of the increased diversification limits together with a description of the exceptional market conditions which justify this investment:

THEAM agrees with this proposed guideline, to the extent that the proposed diversification rules are those described in the 1st bullet point of the paragraph 79.

Guideline 2:
A single component of an index must not have an impact on the overall index which exceeds the relevant diversification requirement i.e. 20%/35%. In the case of a leveraged index, the impact of one component of the overall return of the index, after taking into account the leverage should respect the same limits.

THEAM agrees on the fact that the diversification criteria within the strategy index should be always consistent with respect to the leverage embedded within the index.

THEAM agrees with the guideline in general and that the diversification criteria within the strategy index should always be consistent with respect to the leverage embedded within the index. For the avoidance of doubt, THEAM strongly recommends that ESMA clearly confirms that diversification of indices of indices and indices based on futures can be assessed by looking through each index component or future component.
As an example, an index based on a diversified equity index and EONIA, balancing its exposure on cash versus equity according to market conditions with a resulting exposure on equity between 0 and 100%, needs to be eligible.

Guideline 3:
Commodity indices must consist of different commodities which respect the 20%/35% limit in order to be considered an eligible index.

THEAM would like to remind that the UCITS regulation doesn't allow any investment in the physical commodities but only in indices of systematically rolled futures. As a matter of consequences, specificity of each index/commodity should be treated independently in respect of diversification.
THEAM agrees with this guideline if by "commodity" (i) each single-commodity is taken into account separately, if (ii) a related product of a given commodity is considered as a separate commodity and if (iii) a given future of a commodity is not aggregated with the other existing futures.

As a matter of illustration,
- case (i), Brent and WTI shouldn't be considered as the same commodity
- case (ii), "soybeans" and "soybeans oil" shouldn't be considered as the same commodity.
- case (iii), the 3 month WTI sub index versus front month WTI sub index shouldn't be considered as the same commodity

THEAM considers for all the above illustrations, performances and market behaviours are different. Thus treatment should be different.

Guideline 4:
A strategy Index must be able to demonstrate that it satisfies the index criteria, including that of being a benchmark for the market to which it refers. For that purpose:

- *An index must have a clear, single objective in order to represent an adequate benchmark for the market;*

- *The universe of index components and the basis on which these components are selected for the strategy should be clear to investors and competent authorities;*

- *If cash management is included as part of the index strategy, the UCITS must demonstrate that this doesn't affect the objective nature of the index calculation methodology.*

THEAM agrees with this guideline.

Guideline 5:
The UCITS prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.

THEAM considers important to distinguish between the two following cases:

- Case 1: the fund is exposed to an actively managed set of strategy indices;
- Case 2: the fund is exposed to a strategy index.

THEAM would like to make clear that in the case of a fund using various strategy indices, the various rebalancing between the strategy indices should be disclosed in the usual reporting materials and not in the statutory document of the UCITS.

<u>Disclosure of the rebalancing frequency:</u>

THEAM agrees to make this disclosure when the rebalancing mechanism embedded within the index makes it possible. Indeed and for some indexes, the rebalancing mechanism depends on the fulfilment of certain conditions. For example for CPPI and/or 'isovol' indices, the rebalancing frequency can vary in time and thus, cannot be subject to a defined periodicity as it will depend on market conditions.

<u>Disclosure of the effects of the rebalancing frequency on the costs within the strategy:</u>

THEAM would like to point out that there is no major interest to disclose this kind of information in the prospectus. Actually, THEAM considers that the management company's role is to perform the necessary due diligences in order to determine if an index is suitable for a UCITS, to assess the rebalancing frequency, to analyze whether or not these rebalancing will negatively impact the costs' structure, the index performances. If this should be the case, investors should be informed through usual reporting materials of the costs of the rebalancing frequency of a strategy index.
Therefore, for case 1, as the allocation between the indices is actively managed, it is difficult to identify the costs' impacts: the indices can vary in time, the rebalancing frequency can also evolve in time….
However, in respect of case 2: THEAM would agrees with the principle of a broad disclosure in the prospectus of details about the nature of the various costs (replication costs, brokerage costs…..) and their potential impacts on the strategy according to circumstances.

Guideline 6:
The rebalancing frequency should not prevent investors from being able to replicate the financial index. Indices which rebalance on intra-day or daily basis do not satisfy this criterion.

THEAM doesn't understand the reasons behind forbidding daily basis rebalancing for eligible indices. From our point of view, this guideline should be applied exclusively for high frequency trading indices. For daily rebalancing or even low intra-day rebalancing frequency (two per day for example), THEAM doesn't see any problem preventing investors from an appropriate replication. Moreover, THEAM would like to draw ESMA's attention that the daily rebalancing can be done within a strategy index for the investor' benefit, especially in case of rebalancing due to an 'isovol' mechanism within the index.

Guideline 7:
The index provider should disclose the full calculation methodology to, inter alia, enable investors to replicate the strategy. This includes information on index constituents, index calculation (including effect of the leverage within the index), re-balancing methodologies, index changes and information on any operational difficulties on providing timely or accurate information. This information should be easily accessible by investors, for example, via the internet. Information on the performance of the index should be freely available to investors.

Guideline 8:
A financial index must publish the constituents of the index together with their respective weightings. Weightings may be published after each rebalancing on a retrospective basis. This information should cover the previous period since the last rebalancing and include all levels of the index.

THEAM doesn't agree with this proposed guideline for the main following reason:
Intellectual property & innovation: the fact to disclose all the proprietary information stated above will prevent management companies from providing innovative index to our investors which can harm the "UCITS" brand. Indeed, THEAM thinks that the index providers will not accept such disclosure as it will affect their intellectual property and competition advantage. In addition, qualified investors, wishing to invest in a dedicated fund with the UCITS branding exposed to a strategy index, have all the required skills to analyze the index and to understand its mechanisms. Thus, THEAM considers that index provider will not appreciate the disclosure of the information related to the index at a large scale since it can harm their competitive and innovative power.
It seems to us that the aim of this guideline as the previous one (guideline 6) is to enable the investor to fully replicate the index for a better understanding of the mechanisms. THEAM doesn't agree with such approach. Indeed, THEAM considers that the management company has the full responsibility to make the necessary due diligences on the index, to determine for which category of investors this index can be used, to assess the complexity level of the index and this is finally submitted to the UCITS supervisory body for approval. THEAM thinks that the important information from an investor point of view is more the index behaviour in various markets conditions (bearish or bullish….) rather than its calculation methodology one in order to decide the suitability of the index strategy with its target investment.
However, THEAM is of the view that the index mechanism should be for instance described in the prospectus. A UCITS should especially highlight the portfolio construction or the different constraints embedded within the index.

Guideline 9:
The methodology of the index for the selection and re-balancing of the components of the index must be based on a set of pre-determined rules and objective criteria.

THEAM agrees with this proposal.

> *Guideline 10:*
> *The index provider may not accept payments from potential index components for inclusion in the index.*

THEAM agrees with this proposal.

> *Guideline 11:*
> *The index methodology must not permit retrospective changes to previously published index values (backfilling)*

THEAM agrees with this proposal.

> *Guideline 12:*
> *The UCITS must carry out appropriate documented due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark. The UCITS must also assess the availability of information on the index including whether there is a clear narrative description of the benchmark, whether there is an independent audit and the scope of such audit, the frequency of index publication and whether this will affect the ability of the UCITS to calculate its NAV. The due diligence should also cover matters relating to the index components.*

In all cases, THEAM thinks that the management company's role is to carry out the necessary diligences in order to determine the index suitability with the UCITS guidelines.

Nevertheless and regarding funds dedicated to qualified investors, THEAM considers that an exception can be made (please refer to Answer 13 & 14 for more details).

For the avoidance of doubt and in order to fully understand this guideline, THEAM would like to stress the need to get a clarification of the meaning of 'independent audit' and the scope of such audit in the context of a strategy index is it process valuation audit, operational audit on the index provider…? THEAM thinks that is should be clarified that the audit can be done by any entity that is arm's length with the index calculation agent.

> *Guideline 13 & 14:*
> *UCITS must ensure that any valuation of the swap includes an independent assessment of the underlying index.*
> *The financial index should be subject to independent valuation.*

THEAM would like to highlight the fact that in making any calculation of a financial index, an 'independent agent' would in practice only make the calculation of the index following the rules of the index established by the index provider as set out in the relevant rulebook. It would be very unusual for this 'independent agent' to perform some type of audit role regarding the valuation of the index that extends beyond calculation according to the existing rules.

With this in mind and to reduce potentially unnecessary costs arising from third party calculation of a provider's index which is likely to have a pricing impact for a UCITS, some index providers have put in place an organizational infrastructure which ensures total independence between the teams in charge of marketing, negotiating and closing transactions with UCITS linked to the indices and the teams in charge of the calculation of these indices. Provided that the management company has performed its own due diligence to assess the independence or the robustness of the organization of the index provider, THEAM is of the view that that the independent valuation is achieved.

Moreover and if we take into account the practice of UCITS dedicated to institutional investors, THEAM thinks that the independent valuation isn't necessary for the same reasons stated above. THEAM considers however that the prospectus should contain appropriate disclosure regarding the various entities involved for a given strategy index as well as the potential interest conflict of interest that may arose in respect of the use of an index.

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?

THEAM doesn't see any conflict of interest when the index provider is an affiliated firm of the management company itself as far as the affiliated firm is able to prove that it has the means to handle properly the calculation and the controls linked.

Moreover THEAM thinks that the asset manager itself could be under certain circumstances the index provider. Indeed as a specialist of the investment decisions, the management company is one of the best entities to handle such a role and it thus should be encouraged to develop new indices.

Transitional provisions

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

THEAM welcomes the fact that ESMA is recognizing the need for transitional provisions for the entry into force of the guidelines.

As a general remark, however, we wish to underline that the appropriateness of the transitional provisions can only be assessed once the extent of the changes to the regulatory framework will be clearly established. Indeed, since ESMA is seeking to harmonize issues which are currently regulated at national level, it may well be that national laws or regulations have conflicting requirements and would therefore need to be amended to be aligned on ESMA's guidelines. In such cases, there should first be sufficient time to adopt national laws/regulations and second appropriate time for market participants to adapt to such changes. Otherwise, market participants may be facing an uncomfortable situation in which they would have to choose between violating ESMA's recommendations or national regulations.

As a first step, we would therefore urge ESMA to check with national supervisors whether changes in national laws or regulations are needed to comply with ESMA's proposed guidelines and, as the case may be, how much time would be required for these changes to become effective. On the basis of that information, ESMA should then define accordingly the date of entry into effect of the proposed guidelines.

In addition to that, whilst THEAM agrees with many of the proposals and general direction of ESMA's guidelines, it is very important to recognize that the envisaged guidelines require implementation of several policies such as collateral policy, haircut policy, reinvestment policy or policy in relation to tracking error which need considerable preparation in order to become operational.

Therefore, **THEAM believes that it is not reasonable or practicable to bring the guidelines into effect in 2012**.

As a result, **the guidelines should generally come into effect not less than twelve months after their final publication**. Additional time should be available in order to reflect the content of the new policies in the marketing materials and fund documents.

Moreover, THEAM believes that it would be very important to clarify the meaning of “new investments” in paragraph 2 of Box 9.

In this respect, we believe in particular that **a grandfathering clause should be granted to contracts already in place when guidelines will set in force**, or, in any case, **to Structured UCITS** (within the meaning of Regulation 583/10 (KIID)) which do not accept any new subscriptions from the public. This type of grand-fathering clause has already been accepted by ESMA for the calculation of global exposure (see ESMA 2011/112 - Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS).

Under such a grand-fathering clause, structured UCITS authorized prior to the implementation of the new guidelines would not need to comply with paragraph 7 of Box 6 and paragraphs 1 and 2 of Box 7.

Such grand-fathering clause would be granted in recognition of the fact that these new guidelines were not in place when these UCITS where launched and if the UCITS portfolio were adjusted to comply with the new guidelines, this would affect the pre-defined payoff to investors at maturity. This would not be in the best interests of investors as they invested in the UCITS on the basis of the pre-defined payoff. While these existing structured UCITS may continue to accept new subscriptions, they cannot actively market their units. Structured UCITS can only benefit from this grandfathering provision using their current payoff profile; where a UCITS makes any changes to the derivative which results in a new payoff profile or scenario it must comply in full with the guidelines.