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103 Rue de Grenelle
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23 March 2012

Re: ESMA Consultation Paper on Guidelines on ETFs and other UCITS issues

Dear Sir/Madam,

UBS would like to thank ESMA for the opportunity to comment on the Consultation Paper on Guidelines on ETFs and other UCITS issues. Please find attached our response to the questionnaire.

We would be happy to discuss with you, in further detail, any comments you may have. Please do not hesitate to contact Gabriele Holstein on +41 44 234 4486.

Yours sincerely,
UBS AG

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UBS Response to the ESMA Consultation Paper on
Guidelines on ETFs and other UCITS issues

INTRODUCTION

UBS would like to thank ESMA for the opportunity to comment on the Consultation Paper on guidelines on ETFs and other UCITS issues (the “Paper”) . Please find below our response to the overall content, as well as the specific questions set out in the Paper.

UBS’s detailed responses to the specific questions posed in the Paper follow below.

III. INDEX-TRACKING UCITS

Many index-tracking UCITS take the form of ETFs but some of them are non-listed. This can be done physically or synthetically or by a combination of both. In the paper ESMA distinguishes between *“physical replicating” or cash based index tracking UCITS* versus *“synthetic” or swap-based index-tracking UCITS.* The former replicates the performance of an underlying index by investing in all the securities of that index or a representative sample of those securities, whilst the latter transacts a swap with a counterparty in return for the performance of the index. For cash based UCITS, full replication of an index can be difficult to achieve and can involve significant rebalancing, transaction costs. Swap-based index-tracking UCITS avoid high rebalancing costs and tracking error associated with physical replication but introduce other risks including counterparty risk.

ESMA sets out the disclosures that index-tracking UCITS should make in their prospectuses, annual and half-yearly reports regarding the way they track the relevant index. According to ESMA the prospectus of an index-tracking UCITS should include:

i) a clear description of the index including details of its underlying components, (ii) 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, (iii) the policy of the index-tracking UCITS regarding the ex-ante tracking error including its target level, (iv) a description of factors that are likely to affect the index-tracking UCITS' ability to track the performance of the index, (v) details of whether the index-tracking UCITS will follow a full replication model or use, for example, a sampling policy.

The annual and half-yearly reports should state the size of the tracking error as at the end of the period under review. The annual report should furthermore provide an explanation of any divergence between the target and actual tracking error for the relevant period.

Q1: Do you agree with the proposed guidelines?

While we are in broad agreement with the guidelines, we would like to raise the following comments.

First we would advocate for the proposed guidelines to be sufficiently high-level so as not to require frequent updating. In our view, consideration should be given to (i) whether index providers would be willing to provide the necessary data and (ii) what the necessary steps would be in the event of an index disruption. On (i), the exact composition of an index is often viewed as the proprietary information of the index provider (and the basis for their license fees) and it is difficult to envisage circumstances in which they would be willing to share that information publicly without being paid a fee.

Second, we would emphasise that we are not in agreement with ESMA's comment that index return swap ETFs do not always track indices that are a main version of an index. We do not believe this to be a fair statement.

Third we have the impression that there is a desire to put synthetic index tracking under greater regulatory scrutiny. Subject to credit exposure and liquidity risk being properly managed within a UCITS framework, we would underscore the importance not to put synthetic index tracking at a regulatory disadvantage compared to replicating UCITS. Synthetic index tracking has allowed the development of a wide offering of index UCITS on broadly diversified indices, where replication would come with a substantial tracking error and hence be less attractive to clients. Placing regulatory restrictions on synthetic index tracking UCITS is likely to lead to a reduced offering of UCITS that track broadly diversified indices and as such to a higher concentration on narrow indices. This in turn is likely to lead to an increased price volatility for stocks contained in such indexes and reduce investor diversification.

Finally, we would stress that the Management Company has the role to act in the best interest of the investors. As such it is its role to determine, depending on the circumstances, what the best index tracking strategy is: replication or synthetic tracking, or a mix of both. It is important to note that for a given UCITS, this conclusion may change over time. Therefore, whilst we support transparency and increased disclosure to investors, the Guidelines should not restrict the flexibility of Management Company to deploy both techniques to track an index where the possibility of utilizing both techniques is disclosed to investors in the fund offering documents. As such they should not include an obligation to commit ex ante to a replication or synthetic tracking strategy.

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.

Yes, we see a merit in ESMA developing further guidelines. The tracking error should not only be clearly defined, but calculable and consistent between swap and replicating UCITS, particularly for distributing funds. We would stress our view that we do not agree with the inclusion of a target tracking error and only support the calculation of a tracking error on an ex post basis. This is because a target tracking error has the possibility to become a de-facto limit while the actual tracking error will depend on market circumstances. Disclosure of tracking error in the annual reports should be sufficient disclosure for investors.

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?

Yes, this should be in the form of a realised tracking difference (the tracking difference of the fund share class versus the benchmark performance) and tracking error (volatility of tracking difference) to be published on a semi-annual and annual basis.

IV. INDEX-TRACKING LEVERAGED UCITS

According to ESMA the use of leverage by index-tracking UCITS should not be used as a means to circumvent the relevant limits on UCITS global exposure. As such, an index-tracking leveraged UCITS should comply with UCITS global exposure requirements and calculate its global exposure using either the Commitment Approach or the Value at Risk (VaR) Approach according to the rules set out in CESR's Guidelines. [1]

The prospectus for index-tracking leveraged UCITS is to include (i) a disclosure on the leverage policy i.e. how this is achieved (e.g. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage and the risks associated with this policy; (ii) a disclosure on the impact of any reverse leverage (i.e. short exposure); (iii) a description of how the frequency of calculation of leverage impacts on investors' returns over the medium to long term.

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

Yes, we agree with the proposed guidelines although we would request further clarification with regards to the disclosure of the cost of leverage.

[1] Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788).

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

No, we do not believe that additional guidelines are necessary. Whilst the prospectus should contain all relevant information, it is important to strike the right balance between informing the investor and the portfolio manager retaining sufficient flexibility to act in the best interest of the investors. A leverage solution that is attractive today may actually turn out to be expensive or no longer attractive in a different market environment.

V. UCITS EXCHANGE TRADED FUNDS

According to ESMA, ETFs are also often confused with other types of exchange-traded products such as exchange-traded notes ("ETNs"), exchange-traded commodities and listed closed-ended funds. UCITS ETFs can be established under different forms, specifically when intending to replicate the performance of an index they may do this either physically or synthetically or a combination of both. Some UCITS ETFs could also aim at outperforming an index and be actively managed. Under the UCITS Directive, a UCITS which replicates a stock or debt securities index must include a statement to this effect in the prospectus and any other promotional literature.

V.II. Definition of UCITS ETFs and Identifier

ESMA provides a definition of ETFs which is broadly consistent with the MiFIR review. As such a UCITS ETF is defined as a UCITS of which at least one unit or share class is continuously tradeable on at least one regulated market or MTF with at least one market maker.

ESMA furthermore proposes that UCITS ETF should use an identifier, in its name and in its fund rules or instrument of incorporation, prospectus, KIID and marketing communications, which identifies it as an ETF. The identifier should be 'ETF'. A UCITS not falling under the provided definition should not use the 'ETF' identifier in its name or in its fund rules or instrument of incorporation, prospectus, KIID or any marketing communications.

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 ETF 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 as long as it does not restrict the use of "ETF" for non-UCITS ETFs and is defined as "UCITS ETF". It is in our view not practicable to attempt to reserve the term "ETF" for UCITS funds.

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

We refer to our response to Q6. We would also welcome further clarity on where the identifier would be used i.e. for umbrella funds with a number of sub-funds.

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

The UCITS brand must be protected and remain a clear mark of quality for investors. UCITS guidelines should therefore be applied in a manner that investors can benefit from a standard level of protection. For this reason we only support actions that further strengthen the UCITS brand. Sub-brands or labels may not achieve this objective.

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

We refer to our response to Q6.

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 see clear advantages to having more than one market maker as this can improve liquidity and spreads on exchange. There are no similar benefits associated with having more than one authorised participant and so we would not support such an interpretation.

We would, however, question whether this should be a regulatory requirement as it is likely to be difficult for small ETFs to implement, in particular where an ETF with two market makers wished to replace one of them. In addition, we would not view this as being a matter to be dealt with at the product regulation level. The relevant exchange on which the fund is listed should determine any minimum number of market makers that it requires.

V.III. Actively-managed UCITS ETFs

ESMA sets out specific disclosure requirements for actively-managed UCITS ETFs in that it should in its prospectus, KIID and marketing communications (i) clearly inform investors that it is not an index tracker, (ii) clearly disclose how it will meet the stated investment policy including any intention to outperform an index and without prejudice to the rules of the relevant regulated market or MTF, the policy regarding portfolio transparency and where this information may be obtained (including where the iNAV, if applicable, is published). An actively-managed UCITS ETF should furthermore in its prospectus clearly disclose how the iNAV is calculated, if applicable, and the frequency of its calculation.

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 with the proposed guidelines. There are no other matters which in our view should be disclosed.

V.IV. Secondary market investors

ESMA sets out two options for defining rules for the protection of investors dealing on the secondary markets.

Option 1 addresses the fact that market participants who acquire creation units may be the only recognised investors in the UCITS ETF to which UCITS rules designed to protect unit holders will not necessarily apply. It is considered important, at a minimum, that the prospectus and marketing material inform the secondary market investors of their status and rights. Specifically a UCITS ETF or its management company should (i) ensure that the market maker(s) of the listed units or shares of the UCITS ETF continue(s) to offer redemption to secondary market investors whenever the market is open for trading, (ii) make adequate contractual arrangements with each market maker, so that the market maker may not withdraw from its activities in the secondary market until a replacement has been appointed.

The prospectus should explain that ETF units are generally not redeemable from the fund other than by authorised participants holding creation units, furthermore the prospectus and marketing communications should include a warning text.

Option 2 provides for the right of investors acquiring their units or shares on the secondary market to ask for the redemption of their holding directly from the UCITS ETF. In such circumstances, the UCITS ETF should be able to set and disclose higher redemption fees to be paid by such investors in order to recover the additional costs it has incurred to satisfy such direct redemption requests.

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

We prefer Option 1. This is because in normal circumstances shares of an ETF should be traded over an exchange as this is a first principle of an ETF. Investors who wish to trade directly with a fund and not via an exchange should not be encouraged to invest in an ETF as they will be paying for a functionality that they do not require. We would emphasise that it is impossible for an ETF to ensure that there is always a market maker, as they do not have the appropriate permissions to perform the duties themselves.

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 consider the measures proposed in Option 1 to be sufficient and do not believe that further investor protection measures are required.

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.

It should be made very clear in our view that the instrument is a certificate and as such contains significant issuer risk. It is important to eliminate any potential confusion by the investor between an ETF and a certificate issued on the ETF.

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?

The ETF's register of unit holders provides the holdings of the authorised participant(s). The ETF's central depository manages the number of Global Share Certificates (shares traded on exchange) issued to the authorised participants, ensuring that the number of fund shares issued are the same as the number reflected by the Global Shares Certificates.

Overall the relationship between the ETF's register of unit-holders, the sub-register held by the CSDs and any other sub-registers is a complex matter and impacts the transparency and cost efficiency of the UCITS market.

VI. EFFICIENT PORTFOLIO MANAGEMENT TECHNIQUES

According to ESMA, efficient portfolio management techniques ("EPM") include sale and repurchase agreements (repo), purchase and resale agreements (reverse repo) and securities lending. ESMA considers it important to impose additional requirements on UCITS that make use of such techniques, in particular with respect to the collateral that the UCITS receives from the relevant third party.

Specifically ESMA proposes that

1. a UCITS should clearly inform investors in the prospectus of its intention to employ such techniques including a detailed description of risks involved and the impact they will have on the performance.
2. the prospectus should clearly inform investors of the UCITS' collateral policy including permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including associated risks.
3. fees from such 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.

4. Where the third party is the investment manager or a connected party to the UCITS management company / directors / investment manager / depositary, this should be disclosed in the prospectus.
5. A UCITS should ensure that it is able at any time to recall any security that has been lent or terminate any sec lending or repo agreement into which it has entered.
6. Collateral received in the context of EPM techniques should comply with the criteria for collateral received for OTC derivatives according to CESR's Guidelines
7. 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.
8. Entities at which cash collateral is deposited should comply with Art 50(f) of UCITS Directive.
9. 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.
10. The UCITS' annual report should also contain details of the (i) underlying exposure obtained through EPM techniques; (ii) identity of the counterparty(ies) to these EPM techniques; and (iii) The type and amount of collateral received by the UCITS to reduce counterparty exposure.

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?

While we broadly agree with the proposed guidelines, we have the following comments to offer.

On a general note, we would emphasise our view that disclosure should be proportionate. In regards to securities lending we would like to bring two aspects to ESMA's attention. First, securities lending generates extra income for the fund and allows investors to benefit from a better fund performance. Second if fees which are currently paid to parties connected with stock lending activities are in the future paid to the fund, such parties may no longer be in a position to undertake the duties connected to stock lending. This may in turn result in a real loss to the funds and investors. Where management fees are increased to cover for associated costs this could lead to an unfair competitive advantage for swap based funds.

Point 3 – disclosure and return of fees: Fees arising from EPM, particularly from Securities Lending (SL), typically are a percentage of total SL revenues which depend on the amount of assets lent and the fee received on the assets lent. As both factors vary across time and are unknown in advance they cannot be disclosed as a fee in the prospectus like e.g. the management fee of the fund. Furthermore, we are not in agreement with a general rule stating that SL revenues should be returned to the UCITS. The consequence of such a rule would be multifold. Numerous providers may choose to no longer offer securities lending as they would be unwilling to offer the service for free. As a consequence the performance of UCITS wishing to engage in SL activities can be expected to diminish. In this context it is important to bear in mind that SL generates extra income for the fund and allows investors to benefit from a better fund performance. While the impact on the performance varies across time and funds, we would estimate an average decline of about 5 to 10 bps p.a. We would also seek greater clarification on the term third party in particular if this is related only to the lending agent. We are of the opinion that not all information on collateral should be disclosed within the prospectus as such information is better suited for publication on the provider's website.

Point 5 – Ability to recall security lent / terminate agreement: While we agree in principle to a UCITS having to ensure that it is able at any time to recall a security, the critical question relates to the time frame. During normal times, 95% of securities lent should be recallable within 48 or even 24 hours. In times of market stress, however, this measure realistically falls to 3 or even 4 days. We hence believe it is important for ESMA to determine not only clear, but also realistic and measurable targets. In addition, the current proposed ESMA guidelines specify the right to recall "any security that has been lent". Normal practice is that it is the security **or equivalent securities** that must be returned – it is important that such practice remains in place to ensure efficient operation the relevant programmes.

Point 10 – Elements for inclusion in the UCITS annual report: With regards to the disclosure of the type and amount of collateral received by the UCITS to reduce counterparty exposure we would argue that in addition to the type/quality and amount of collateral as well as statistics of securities recall time (we refer to our comments to point 5 above), the value of the collateral received relative to the value of the securities lent (as an average over the fiscal year) is an important information for the investor. We would also consider the net SL revenues to the UCITS to be important.

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 do not agree with the statement. Whilst we fully support the clarification of the existing guidelines, we do not support the use of the word "ensure" as the level of prescription required to deliver such assurance is too detailed and may not be feasible.

In addition, we would have concerns around the proposals to require that collateral would be combined with the fund's portfolio for the purposes of risk management, global exposure or counterparty risk. This would be operationally complex for the fund service providers and result in increased costs (ultimately borne by investors) with no appreciable economic benefit. The purpose of collateral is to mitigate risks involved in the default of a counterparty. As such, it does not seem reasonable, in our view, to impose a potentially significant cost for a process that is ultimately irrelevant until an unlikely event such as a default occurs.

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

Yes, we support increased clarification.

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, not at all. Collateral is only functional in the funds/investors hands when there is a counterparty default. If such an event occurs the primary concern must be capital preservation and liquidity, as in the first instance the investors should be able to access their money as quickly as possible with minimal loss. The correlation argument implies that the fund/investor remains exposed to the collateral holdings over an extended time period. This is unrealistic as the most likely scenario is that the investor will redeem, or that the portfolio manager will identify an alternative counterparty, both of which will require liquidity as a primary concern. High quality collateral may also not be correlated with a portfolio.

We reemphasize the importance that collateral is of good quality and has good liquidity. Imposing correlation with the fund assets could actually be counterproductive. As an example, if it were necessary to correlate collateral with the fund's portfolio, you could end up having in place collateral of a lesser quality than might previously have been the case simply to meet such correlation requirements. For example, for an emerging market equity fund, a requirement to correlate collateral might result in a high proportion of emerging markets equities being held as collateral by a fund that would typically have taken government bonds as its collateral which might traditionally be viewed as being of better quality with better liquidity.

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?

We do not agree with the above proposal. The assets of the UCITS (whether lent or not) and the collateral received must be viewed and treated separately as the collateral is not 'part of the UCITS' asset portfolio'. Rather, the collateral is the insurance against the likelihood that the securities lending counterparty defaults.

If ESMA mandates that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan comply with the UCITS diversification rules, it would impose significant additional costs on the industry, which would ultimately be borne by fund investors. The additional costs are not justified by the possible benefit of applying the diversification rules in such a manner, which is not clear given the primary function of collateral as outlined in our response to Q19. This also sets a difficult precedent in that collateral has never been considered part of the investment rules as it does not have to be in agreement with the investment objective of the fund.

We reiterate our view that the overriding requirement for collateral is that it is of sufficient good quality/liquidity. Such standards have already been addressed by the recent CESR Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (CESR 10-788).

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?

We would prefer the former. The concern we have with an indicative list is the way in which regulators would interpret such a list, which most likely would become static and as a result easily outdated.

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.

We refer to our comments in Q21. An exhaustive list will become increasingly restrictive over time and in a dynamic market may in time include assets that are no longer capable of preserving capital and maintaining liquidity. In reality it would most likely lead to cross-jurisdictional inconsistencies.

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?

We do not believe that they should be added as the two counterparty risks stem from completely different businesses.

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

We agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

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?

We do not believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited provided sufficient collateral is posted and it is of a sufficiently good quality as this would only serve to limit the benefits of EPM and hence performance in the hands of investors.

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

It is not possible to outline what is current market practice as this will depend on the stocks held by the fund, the fund's domicile and the period over which stocks held pay dividends.

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, we do not believe that specific elements should be taken into account.

The UCITS should be concerned about the risks and rewards of securities lending rather than what the counterparty does with the securities lent. We would stress our view that the UCITS should not be held responsible with actions undertaken by the counterparty in relation to the securities lent.

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?

We are not clear on what is being referred to by "Fund Rules" and would welcome clarification.If this is a reference to the constitutional documents of the relevant fund (e.g trust deed or articles of association) then we would not be in favour of a requirement to include such disclosure. In our view disclosure in the prospectus is sufficient and we do not see any additional benefit to including also in the trust deed/articles of association.

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

No, we do not see a merit. Provided that collateral is of a sufficiently good quality there is no additional benefit of a more frequent identification of EPM counterparties Counterparties need to monitored on a regular basis by compliance and credit risk and actions need to be taken on an ad-hoc basis if requirements of the credit risk policy are no longer fulfilled.

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

This risk is already dealt with by the conflicts of interest policy, and should in any case be fully disclosed to investors within the prospectus

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

We strongly believe in the necessity for an active and diligent portfolio manager with a clear focus on their fiduciary duty as this is essential for investor protection. This is true whether a funds exposure is delivered via a Total Return Swap, or a Fully Funded Swap.

VII. TOTAL RETURN SWAPS

Q32: Do you agree with the proposed guidelines?

We are in broad agreement with the direction of the guidelines, but refer to our response to Q20 with regards to collateral diversification.

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.

Please see our response to question 19.

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?

We would like ESMA to set out what it means by "Fund Rules". We refer to our response to Q28.

We would emphasise that some information may not be known prior to the launch of the UCITS such as the swap counterparty and as such some of the collateral arrangements may also be open prior to launch.

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 refer to our response to Q21.

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.

We refer to our response to Q22.

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

No, this is not practicable. We refer to our response to Q20.

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?

While we generally agree with the direction of the guidelines, we have reservations with regards to the application of diversification requirements to all OTC derivatives and the imposition of limits on government bonds and cash. Please also refer to our response to Q20 with regards to collateral diversification.

VIII. STRATEGY INDICES

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

As a general comment we would suggest that "index replicating" UCITS is defined. We are in agreement with the guidelines 1, 2, 3, 7, 8 and 10 to 14. We have specific comments in regards to guidelines 4, 5, 6 and 9 as outlined below.

Guideline 4: We would query as to who would decide on what would be an adequate benchmark. Specifically was the Eurostoxx 50 with its massive overweight in financials prior to the financial crisis an adequate benchmark for the euro-zone based equity markets? We also question why it should it relate to a "market" and not to a market segment or securities pool.

Guideline 5: We are not in agreement with this guideline as it comes down to imposing a requirement on index providers to estimate what the tracking error would be. We refer to our earlier comments.

Guideline 6: We believe that in the interest of investor protection it should be possible for a third party to recalculate an index to check the index value. However, we would question why this would not be possible for indices that rebalance once a day.

Guideline 9: We would be concerned that if this guideline is applied in a narrow sense that it would harm the ETF business fundamentally as it would exclude most popular market indices.

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?

Provided that the index is calculated by an independent party, there should be no potential for a conflict of interest.

IX. Transitional provisions

ESMA recognises that it may not be in the interest of unit-holders if UCITS that have already made investments to unwind those investments. It therefore proposes that the guidelines only apply to new investments made after the guidelines come into effect.

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

The statement "Any new investment made by a UCITS or any new collateral received after XX 2012, and the content of any new document or marketing communication issued by or in respect of the UCITS after XX 2012 will have to comply with these guidelines immediately" appears to be a contradiction in terms. It is our understanding that these are guidelines and not rules.

We would advocate for point 6. to be changed to XX 2013 allowing firms sufficient time to set up systems to capture all requisite information over 2012 before these rules/guidelines are confirmed.