

## SECURITIES AND MARKETS STAKEHOLDER GROUP

### Advice on ESMA's public consultation on UCITS Exchange-traded funds in the European Union

#### I. Executive Summary

The Group generally agrees with the concerns raised by ESMA in its Consultation Paper, which relate mainly to the fact that ETFs have become increasingly complex, and may raise significant issues both in respect to investor protection and to systemic risk. However, ETFs are a low cost and straightforward investment proposition for investors, and as such, ESMA should investigate how to make indexed ETFs more offered to retail investors. In respect to the prevention and mitigation of the risks that may arise from ETFs, while the whole Group agrees that greater disclosures are required, the majority of the Group members believes that, in addition to these disclosure requirements, regulators should adopt a more interventionist approach. The Group also believes it necessary to avoid any type of regulatory arbitrage, by subjecting all UCITS products and exchange-traded products to similar rules.

The Group generally supports the recommendations made by ESMA, and agrees that:

UCITS ETFs should use an identifier in their titles, fund rules, Key Investor Document, prospectus and marketing material;

investors should be provided with sufficient details to understand the index tracking policy used;

there is a need for greater disclosures in respect to synthetic ETFs, notably in relation to underlying exposure, counterparty(ies) and the portfolio fund, as well as for stricter requirements in respect to the quality of the collateral, in the form of quantitative requirements on the quality (notably the liquidity) of the collateral, over-collateralisation requirements in specific circumstances, the regulators (and potentially ESMA) being responsible for regularly controlling the quality of the collateral. In addition, risks of conflicts of interests should be limited by prohibiting entities from the same group from acting at the same time as the ETF provider and the derivative counterparty;

securities lending should be made more transparent to investors, should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, and the lending agent must be required to indemnify the UCITS when a counterparty defaults for all types of ETFs (synthetic and physical);

actively-managed UCITS ETFs should be subject to greater disclosure requirements;



it is necessary to specify, in the product title of leveraged UCITS ETFs, that they constitute leveraged ETFs, as well as the level of leverage;

greater protection of secondary investors would be achieved by informing investors of their redemption rights, the ETF manager being made responsible for paying the difference between the collateral and the index underlying the swap if a counterparty defaults;

total return swaps and strategy indices need to be better regulated.

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## **II. Explanatory remarks**

1. The members of the Group welcome the opportunity to comment on the public consultation on UCITS Exchange-traded funds in the European Union (hereafter the “Discussion Paper”). However, before commenting ESMA’s Discussion Paper, the Group believes it necessary to place the key issues around UCITS Exchange-traded funds (hereafter “ETFs”) in the wider context. ETFs are one of the fastest growing investment products in the world, combining the trading characteristics of stocks with the diversified risk of investment funds. However, ETFs are still very small in comparison to the overall size of the fund market and their impact on secondary markets and their stability should be put into perspective: only 2.6% of all European funds are ETFs (3.5% of UCITS funds), and high growth rates are due to a low starting base. A large majority of ETFs in the European Union are already subject to one of the most respected and widely recognized fund regulatory frameworks: the UCITS Directive. Nonetheless, the Group believes that adapted regulation and its efficient enforcement can address some of the characteristics of ETFs, in order to ensure better protection of investors and a level playing field across Europe. The Group would therefore like to subscribe to the efforts of ESMA to provide guidelines on safeguards and controls in a proactive manner.
2. It is important to point out some key points for retail investors when discussing index-tracking ETF regulation: ETFs are a very low cost alternative to other UCITS funds for private investors but unfortunately most of them are very rarely, if at all, marketed for European individual investors. The main cause is due to differences in remuneration of the distribution channels and seems unrelated to the relative performance of index-tracking ETFs vis-à-vis other UCITS funds. This points to potential problems regarding ETF distribution.
3. In addition, the Group believes it important to distinguish between “index-tracking” ETFs (the bigger share of the ETFs market, simple and easy to understand investment objective, providing the performance of the market) and other ETFs (much less important in market share: leveraged ETFs and “active” ETFs, with less clear and more complex investment objectives).
4. The Group believes that issues around UCITS ETF should not be treated differently from other UCITS, and more importantly, from other exchange-traded products (“ETPs”) such as notes and certificates that are distributed to retail investors, in order to avoid the creation of regulatory loopholes, and to establish a level playing field between similar products.
5. Two options are possible in order to address the issues raised by ESMA in its Consultation paper. First, some argue that only transparency needs to be addressed by regulation creating

more disclosure and information given to investors. Second, others argue that this regulation needs to go further by addressing not only transparency measures but also control and/or intervention on the products design, sale and governance.

6. This report will therefore present general observations of the Group and more specific comments relating to the different sections of the Consultation paper. In the General observations section, we will analyse the risks and benefits related to UCITS ETFs. In section two, we will broadly address the questions presented in the Consultation paper and analyse the different options for regulating UCITS ETFs in light of these different elements and ESMA's propositions.

### **III. GENERAL COMMENTS OF THE GROUP ON UCITS EXCHANGE-TRADED FUNDS IN THE EUROPEAN UNION**

#### **III.I. Complexity**

7. Some financial instruments are currently defined as automatically non-complex in Art. 19 of the MiFID Directive. For other instruments, criteria to identify non-complex financial instruments (set out in Article 38 of the MiFID implementing Directive 1) focus on the ease with which the product can be understood by an investor, and not to the potential risk(s) it gives rise to<sup>2</sup>. All UCITS are currently classified as automatically non-complex.
8. ESMA's consultation raises the question as to how ETFs have evolved and whether some forms of ETFs should be considered "complex". If an ETF is created under the UCITS regime, there are already certain restrictions on the investment policy of the fund<sup>3</sup>. A number of regulators and policy-makers, along ESMA's line, are concerned by the potential complexity of ETFs, and the fact that, given the high level of innovation that has been observed lately, retail investors may not understand the products at stake, as illustrated by the FSA's 2011 Retail Conduct Risk Outlook.
9. In its proposal regarding the review of MiFID, released in October 2011, the European Commission suggests introducing some important changes in respect to UCITS products. It suggests excluding from the scope of "execution only" services (that is to say the services that an investment firm can provide without the need to obtain information regarding the knowledge and experience of the clients) the financial instruments including collective investment in transferable securities (UCITS), which embed a derivative or incorporate a structure for which it may make it difficult for the client to understand the risk involved. The proposal excludes explicitly structured UCITS (as defined in Commission Regulation 583/1020 at Level

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<sup>2</sup> The central aim of the MiFID appropriateness test is to prevent complex products from being sold on an "execution-only" basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products. The MiFID Level 2 Directive allows a firm to assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those investment services or types of transactions or products for which the client is classified as a professional client.

<sup>3</sup> Risk diversification is the strength of UCITS, with a ceiling of 10 percent of the overall assets for any individual investment, with any holdings representing more than 5 percent of the overall assets capped collectively at 40% of the fund. The UCITS directive does, however, contain a special allowance for trackers, whereby the ceiling for an individual holding can reach 20 percent, and in exceptional circumstances 35 percent, provided the index is sufficiently diversified, is an adequate benchmark for the market it replicates, and is published in an "appropriate" manner (Art 53).

2 of the UCITS Directive<sup>4</sup>) from the scope of the instruments that can be provided on an "execution only" basis. However, some the Group members believe there is still a scope for interpretation over whether swap-based ETFs (which embed a derivative) would also be excluded from the scope of the instruments that can be provided on an "execution-only" basis.<sup>5</sup>

### III.II. Main risks and benefits

10. UCITS ETFs' intrinsic advantage relates to the fact that these products combine the benefits of exchange-traded products (namely trading flexibility and cost-efficiency) with those of mutual funds (namely diversification). In addition, ETFs offer tax advantages in certain member states and cover different types of asset classes such as equities, commodities and fixed income.
11. Despite these benefits, UCITS ETFs also present significant risks:
  - A. Increased complexity and opacity
    - Complexity as a result of synthetic ETFs and a wide range of asset classes covered
    - Transparency issues related to the composition of the underlying assets, replication mechanism used (physical, synthetic, sampling), composition of the collateral and on the lending and borrowing arrangements
  - B. Counterparty risk and collateral
    - Composition of the collateral is not yet sufficiently regulated
    - The level of haircut on collateral is not yet regulated
    - Limit on swap counterparty risk (10% swap counterparty risk maximum)
    - Low liquidity of the assets held as collateral (risk to investors, bank and systemic risk)
    - Risk of default of the swap counterparty (borne by investors and/or bank)
    - Weaknesses of the enforcement procedure on swap counterparty risk
  - C. Securities lending and liquidity risks
    - Counterparty risk borne by fund investors
    - Many fund managers keep part of the benefits of security lending; there is no clear rule about passing on these benefits to the investors of the UCITS ETF
    - Collateral rules
    - Risk of market squeeze in the underlying securities
    - But securities lending is not specific to ETF UCITS funds
  - D. Risk implications for authorities and ETF investors
    - Regulatory arbitrage and unlevel playing field

## IV. SPECIFIC COMMENTS RELATED TO THE CONSULTATION

### IV.I. Scope

12. Regulation should be harmonised at European level. In this respect, ESMA should have a particular role, through, notably, the adoption of legally binding standards, and, potentially, a greater direct supervision role. The majority of the Group members therefore support the introduction of guidelines on UCITS ETFs. Some members insist on the need to extend the

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<sup>4</sup> See article 19 (6) of MiFID1 and new proposed art 25(3)a)iv) of October 2011 MiFID proposal.

<sup>5</sup> See article 19 (6) of MiFID1 and new proposed art 25(3)a)iv) of October 2011 MiFID proposal.

scope of these guidelines to all ETFs and - depending on the concern to be addressed - also other ETPs. The MiFID review and the Package Retail Investment Products legislation (“PRIPs”) appear to them as more appropriate as policy instruments than guidelines only for UCITS ETFs and/or modifications to the UCITS Directive, in order to reduce regulatory arbitrage, and to provide comprehensive investor protection.

13. Regulators should be adopting an evidence-based approach to regulation and should seek to apply equal treatment for similar financial instruments. They must be wary of the unintended consequences of developing regulation that would have the effect of creating potential incentives for investors and issuers to move similar products off-exchange, where they are not subject to the same transparency and regulatory requirements as exchange-traded products.

#### IV.II. Potential requirements

14. Greater transparency relating to UCITS ETFs is beneficial to foster investor protection and confidence.
15. However, the Group believes that transparency is not enough to truly protect retail investors. Considering the difficulty that the average investor may have in respect to understanding disclosed information related to characteristics and the significant systemic risks that may derive from some UCITS ETFs, the Group believes that disclosure requirements are not sufficient. Whilst disclosure about ETFs is important, it does not provide an appropriate substitute for action to eliminate conflicts of interest and set clear product-standards. Therefore, on top of greater transparency rules, according to the majority of the Group members, UCITS ETFs should also be subject to stricter regulation related to product control. Such more “interventionist” regulatory policies are currently contemplated in some of the European Union member state, as illustrated by the FSA’s new product intervention policy reflecting its willingness to intervene during the product development cycle.
16. A minority of the Group members considers that the existing UCITS Directive already provides a very robust framework to mitigate the potential risks and manage conflicts of interest raised by some ETFs. They consider that existing rules are sufficient, notably in respect to the prevention and management of conflicts of interests that may arise when entities from the same group are at the same time the provider of a synthetic ETF and acts as the derivative counterparty. In addition, they believe that the potential risks related to collateral and securities lending are already well regulated – although some improvements may be appropriate – and ESMA’s focus should be on establishing a level playing field with ETPs.

#### IV.III. Retailisation of complex products (Questions 1 to 7)

17. The Group believes that the issue of marketing and sale of UCITS ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors could be solved by a common approach to these issues.
18. In general, the Group members believe that the UCITS disclosure rules and exchange listing requirements promote transparency in UCITS ETFs, but that additional disclosure is positive. However, the majority of the Group members is in favour of restrictions on the distribution even if investors understand the inherent risks by reading standardized disclosure and annual reporting of the fund.

19. Given the increasing familiarity and use of a range of investment products from structured UCITS, ETFs, CFDs, Warrants and Certificates – all of which have investment profiles which can be similar on certain dimensions, the Group suggests that any approach to marketing and solicitation rules must consider the unintended consequences of creating an unlevel playing field among all ETPs and similar financial instruments. This can be avoided if similar approaches including transparency requirements are proposed in the guidelines agreed for UCITS and those applied to regulated non-UCITS funds established or sold within the EU. However, the Group considers that such requirements should be extended to all ETPs in order to provide an appropriate level of investor protection.
20. In addition to these requirements in terms of transparency, some Group members believe it necessary to give regulators, and potentially to ESMA, increased powers in respect to the authorisation, banning<sup>6</sup> and regular controls of ETFs. Throughout the life of a product, regulators should continue monitoring the information that had been announced in the product's prospectus. Regulators could also, based on the assessment of the risks presented by certain ETFs, decide to ban their distribution to retail clients.
21. In order to guarantee consistency throughout the European Union, the actions taken by national regulators should be coordinated, notably through the powers of ESMA in respect to the harmonised application of the European regulations<sup>7</sup>, and, ESMA, in addition to its own powers of intervention for banning or restricting certain financial activities<sup>8</sup>, should also ensure a greater consistency of the bans / restrictions adopted by national regulators through the adoption of standards.
22. Other Group members support stronger powers for ESMA in relation to bans or restrictions on the distribution of products, in order to harmonise intervention in the European Union and preserve benefits of the Single Market for financial products. Consistency with other regulation (UCITS, Prospectus Directive) should also be closely considered. Above all, however, any restrictions or bans to distribution should not apply only to narrow categories of financial instruments (ETFs or subcategories of ETFs, UCITS), but be principle-based and apply to all instruments under MiFID.
23. In addition, the Group also discussed the appropriateness for regulators to forbid the distribution of synthetic ETFs to retail investors, but no definitive recommendation was reached.

#### IV.IV. Title (Questions 8 to 10)

24. The Group agrees that UCITS ETFs should use an identifier in their names, fund rules, prospectus and marketing material as it will help investors' investment decisions. The Group also agrees that the identifier be used in the Key Investor Document as it will be a core support in the investment decision process. Some Group members supports the suggestion according to which the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs.

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<sup>6</sup> In the regulation setting up ESMA (regulation n°1095/2010), ESMA is entitled to ban financial activities, under certain conditions, and for a 3-month period, but with an unlimited renewal possibility (article 9). ESMA is generally required to consult the recipients of its intended decisions, but only in the case where ESMA's decisions explicitly mention a recipient (article 39), which would not apply to any generic ban or restriction of financial activities.

<sup>7</sup> Articles 8.1.b and 9.5 of Regulation 1095/2010

<sup>8</sup> Article 9 Regulation 1095/2010

25. In addition, the Group believes that with respect to ETFs there should be clearer labelling in the prospectus that in the event of default, consumers do not have recourse to a guarantee scheme. Similar warnings are considered important by other Group members for other ETPs and UCITS products.

#### IV.V. Index tracking issues (Questions 11 to 15)

26. The Group agrees with ESMA's analysis of index-tracking issues, as it contributes to better transparency. A summary of the « index tracking issues » being present in the Key Investor Document (KID); or in the prospectus together with a clear reference in the KID that information on index tracking issues can be found in the prospectus can also be a beneficial disclosure transparency measure.
27. Full replication of an index can be difficult to achieve and issues relating to tracking error can be present. Synthetic or swap-based index-tracking ETFs can avoid the rebalancing costs and tracking error associated with physical replication but introduce other risks including counterparty risk. Tracking error is higher for physical replicating ETFs due to transaction costs and difficulties in buying and selling small illiquid components of the index. But although synthetic replication reduces tracking error, it does not eliminate this problem entirely. Index return swaps may not always be based on the same assumptions and calculations as the main version of an index.
28. The Group believes that it is important that investors be provided with sufficient detail to understand the index tracking policy used and the types of underlying assets and strategies they are gaining exposure to. The Group fully supports ESMA's policy recommendation as to ensure that the prospectus for index-tracking UCITS ETFs contain a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index, as well as the mechanism and frequency for posting over-collateralisation.
29. Some Group members, however, would like to draw ESMA's attention on the necessity to adopt similar rules for all UCITS products, so as to avoid any kind of regulatory arbitrage.
30. Furthermore, the definition of tracking error in the 21st paragraph (page 10) of ESMA's discussion paper needs to be refined, since, according to some Group members, the tracking error is, in fact, the volatility of the difference of the returns of the fund and of the returns of the index.
31. In addition, while some Group members believe that greater disclosure requirements are sufficient to ensure a high level of investor protection, others believe the contrary. These members believe that a clear distinction should be made between the "theoretical" tracking error (determined at the moment of the creation of the product) and the "real" tracking error (related to the management of the product). The difference between these two types of tracking errors should be regularly compiled, so as to enable investors to have an accurate picture of the actual tracking error risk, throughout the life of the product.
32. In addition, regulators (and potentially ESMA) could be empowered to regularly control that the ETF adequately complies with what has been announced in its prospectus. A minority of the Group members considers that control mechanisms already exist for national regulators for ETFs but should be extended to all ETPs.

#### IV.VI. Synthetic ETFs – counterparty risk (Questions 16 to 18)

33. The Group supports the disclosure proposals in relation to underlying exposure, counterparty(ies) and the portfolio fund.
34. The Group has diverging opinions in respect to the requirements in terms of the composition of the collateral. A minority of the Group members believe that the existing CESR's Guidelines on Risk Measurement for UCITS are sufficient, and that it is important to leave a level of flexibility to the managers of the funds. Also, some members raised the question of the interest and the benefit for the investor in the synthetic approach when the portfolio held by the synthetic ETF (or a part of it) is less liquid than that of the index tracked.
35. The majority of the Group members fully support ESMA's suggestions regarding stricter requirements in respect to the quality of the collateral. The Group agrees that liquidity is an essential factor for the quality of the collateral. The majority of the Group members believes that an appropriate way to ensure that the collateral is sufficiently liquid would be to set qualitative as well as quantitative requirements on the quality of the collateral. The Group suggests that 70% of the collateral should consist in liquid assets, that is to say listed assets such as large caps. In requiring that the majority of the collateral be made out of listed assets, the valuation issues arising in respect to the collateral will be solved, since the valuation of 70% of the collateral will correspond to stock market prices. Furthermore, an over-collateralisation is necessary when the ETF index type and the collateral posted are not significantly correlated (for instance, are not from the same asset class). The minimum level of over-collateralisation should be explicitly stated in the prospectus. It should not be less than 5x when asset and liability match and not less than 10x when asset and liability do not match. Also collateral should be posted on a daily basis. The level of haircut should also be revised in function of market volatility.
36. In addition, the majority of the Group members believes that regulators (and potentially ESMA) should regularly control the quality of the collateral used throughout the life of the product. A minority of the Group members consider that enforcement powers already exist for national regulators for ETFs but should be extended to other ETPs.
37. Finally, the majority of the Group members believes it necessary to better regulate the risks of conflicts of interest that may arise from the dual role that entities from the same group may have as the synthetic ETF provider and as a derivative counterparty. Such a dual role should be prohibited. A minority of the Group members considers that for UCITS ETFs conflicts of interest involving the management company and other members of the same financial group are already well regulated and appropriately mitigated.

#### IV.VII. Securities lending activities (Questions 19 to 25)

38. The majority of the Group members believe that securities lending activities are among the most critical issues in respect to ETFs (although they are not specific to UCITS ETFs). They exacerbate the risks that may derive from these products, since they add-up to the collateral risk. In fact, the securities and lending risks in respect to ETFs is particularly high because for these products the collateral and the underlying do not necessarily match. Therefore, these members suggest that lending and borrowing should be forbidden in respect to the

collateral received in exchange for the swap in the case of synthetic ETFs, because the risks is heightened and the tracking of the underlying is made more difficult.

39. Furthermore, they believe that the lending agent should be required to indemnify the UCITS in the case of a default of a counterparty. This indemnification requirement could also be requested in the case of physical replication ETFs.
40. However, a minority of the Group members believes that securities lending is not risky by itself, but should, nonetheless, be made more transparent to investors, through greater disclosure requirements. Securities lending is a well established part of the investment management industry. It plays a key role in increasing liquidity in equities markets throughout the EU. That said, the level of stock lending in most markets is relatively low. For example, in the UK in June 2010, less than 5% of stock in the FTSE 100 index was out on loan. If indeed securities lending is an issue to be addressed, it should be done in a broader context and not solely around ETFs.
41. Also, some members raise a fund governance issue regarding the disclosure and the profits allocation of the securities lending activities, as the fund investors provide the funding and bear the risks.

#### IV.VIII. Actively-managed UCITS ETFs (Questions 26 to 28)

42. The Group agrees with ESMA's proposed policy orientations. In particular, the Group believes it is important to inform investors through an explicit statement that actively-managed ETFs are not aiming to track an index, and the investment policy is under the sole discretion of the fund manager.

#### IV.IX. Leveraged UCITS ETFs (Questions 29 to 32)

43. The Group believes that leveraged UCITS ETFs are not as easy to understand for retail investors as other forms of ETFs, and should be subject to additional disclosure requirements. In particular, some Group members consider that their title should specify that they constitute leveraged UCITS ETFs, and the level of leverage should also be disclosed, so as to ensure that investors have a real understanding of the product at stake. The word "daily" or "monthly" should also be included, as appropriate, in the identifier.

#### IV.X. Secondary market investors (Questions 33 to 38)

44. End investors buying individual units of a UCITS ETF from a market participant on the secondary market may not be informed of the possibility to redeem directly the units (not on an individual basis from the fund, but through their regular intermediary, that is to say without having to go through a limited number of market participants selected but the UCITS ETF's issuer). Investors should be better informed of the possibility to redeem any amounts against the fund, although fees would apply.
45. In addition, in order to reinforce investor protection in case of default of the counterparty, some Group members suggests that the UCITS ETF manager should be required to pay for the difference between the collateral and the index underlying the swap. In order to enforce this requirement, it is necessary to apply a haircut on the collateral, and, as previously stated, the swap counterparty should not be from the same group as, the UCITS manager.

46. Furthermore, some Group members consider that the iNAV of an ETF should be made accessible to the retail investors, along with its order book, so that private investors have a sense of the magnitude of the difference between the ETF market bid and offer and its iNAV. Also, investors - especially retail ones who are only trading on the secondary market – should have access to information on the average and maximum bid/offer spreads, as they are an important cost element in buying or selling ETFs.

#### IV.XI. Structured UCITS

##### **a) Total Return Swaps (Questions 39 to 42)**

47. The Group believes that policy recommendations as submitted by ESMA are adequate, as long as they respect UCITS diversification rules, and the majority of the Group members consider that the TRSwap should be over-collateralised and the collateral should be posted daily. However, a minority of the Group members has reservations regarding the ESMA's proposal to treat discretionary decisions relating to the underlying swap as delegation of investment management, and regarding the imposition of diversification rules to the swap underlying.

##### **b) Strategy indices (Questions 43 to 46)**

48. The Group broadly supports the proposed policy orientations on strategy indices as they reflect most current standards already applied and relating to, amongst others, standards applying to sufficient diversification, adequate benchmarking, transparent methodology, transparent portfolio and the right level of independence between the index provider and the asset manager. Such requirements are particularly important considering the potential complexity and risk of the model or strategy tracking the “index” on which the UCITS ETF has been built on. However, diversification rules might be difficult to implement on some benchmarks (especially bond ones representing a thin bucket of maturity) and a minority of the Group members have concerns on some details of ESMA's proposals.

This advice will be published on the Securities and Markets Stakeholder Group section of ESMA's website.

Adopted on 30 November 2011

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