European Securities and Markets Authority

Discussion paper

ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

July 2011 | ESMA/2011/220

European Securities and Markets Authority

Date: 22 July 2011
ESMA/2011/220

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by Thursday 22 September.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'. Contributors should identify themselves and indicate the industry sector in which they operate or in which they are interested and the extent to which that sector is already subject to regulation at a national level. Contributors are also asked to consider the costs or benefits attached to the various options and quantify these costs to the extent possible.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publically disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response, is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper?

This document will be of interest to asset management companies and trade associations of asset management companies managing UCITS ETFs and structured UCITS, as well as to associations of retail investors.

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Acronyms used

AIFMD	Alternative Investment Fund Managers Directive
BIS	Bank for International Settlements
CESR	Committee of European Securities Regulators
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
FSB	Financial Stability Board
iNAV	Indicative Net Asset Value
TRS	Total Return Swap
UCITS	Undertaking for Collective Investment in Transferable Securities

I. Executive Summary

Reasons for publication

Following the entry into force of the broader investment freedoms for UCITS under UCITS III and their further extension in the Eligible Assets Directive (2007/16/EC), UCITS funds started to implement new strategies which are considered by some external stakeholders as innovative. It has often been suggested that by exploiting the new investment criteria and limits introduced by UCITS III, such funds pursue management strategies previously prohibited to them and more often associated with hedge funds (references have also been made to the so-called retailisation of hedge funds). In certain cases such funds may also be admitted to trading on some European regulated markets in the form of ETFs (exchange-traded funds).

ESMA has started looking into the operation of such funds and, particularly, at the industry practice following the implementation of UCITS III in order to identify the possible impact on investor protection and market integrity. It is worth recalling that UCITS products by definition (see MiFID Article 19(6)) are deemed to be non-complex products.

Achieving a co-ordinated approach to the regulatory and supervisory treatment of new or innovative financial activities is one of ESMA's tasks pursuant to Article 9 of the ESMA Regulation.

In April 2011 both the Financial Stability Board (FSB)[1] and the Bank for International Settlements (BIS)[2] published papers on Exchange-Traded Funds (ETFs) and the potential implications for the stability of the financial system. These papers focus on the move away from traditional ETFs into synthetic and more complex structures and their impact on investor protection and financial stability.

ESMA has reviewed the current regulatory regime applicable to UCITS ETFs and structured UCITS and considered that the existing requirements are not sufficient to take account of the specific features and risks associated with these types of funds.

Therefore, ESMA has decided to start working on the development of guidelines applicable to UCITS ETFs and structured UCITS as well as to examine possible measures that could be introduced to mitigate the risk that particularly complex products, which may be difficult to understand and evaluate, are made available to retail investors.

Contents

This discussion paper sets out ESMA's policy orientations on possible guidelines on UCITS ETFs and structured UCITS.

For UCITS ETFs, ESMA has identified the following topics for which guidelines should be developed:

- Identifier;
- Index-tracking issues;

[1] FSB: Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs) – 12 April 2011
[2] BIS: BIS Working Paper No 343 Market structures and systemic risks of exchange-traded funds – April 2011

- Securities lending activities;
- Actively-managed ETFs;
- Leveraged ETFs;
- Secondary market investors;
- Quality and types of collateral received.

For structured UCITS, ESMA is of the view that the role of swap counterparties in total return swaps should be subject to specific safeguards as well as the use of strategy indices.

This document does not at this stage include any formal proposals for guidelines on UCITS ETFs and structured UCITS.

Next steps

Responses to this discussion paper will help ESMA in narrowing down its policy approach. In light of the feedback received, ESMA will develop a consultation paper on proposed guidelines for UCITS Exchange-Traded Funds and structured UCITS.

II. General policy discussion

Retailisation of complex products

1. UCITS products, irrespective of the complexity of the structure, are categorised under MiFID as non-complex products (by definition) and they can be sold under the so-called execution only service. Moreover, such products can be freely marketed Union wide pursuant to the UCITS rules which grant a European passport.[3]

2. Notwithstanding the text of the relevant European legislation, and irrespective of possible changes to the current framework stemming from the ongoing MiFID review process, a number of stakeholders as well as national regulators have started questioning the framework for the marketing of such complex UCITS (including complex ETFs) to retail clients. In certain jurisdictions recommendations have been addressed to distributors in order to remind them of their duties vis-à-vis retail investors when selling such products.

3. As part of its input to the Commission on the MiFID review in July 2010, CESR[4] also recognised that there was a case for:

    - considering treating structured UCITS and UCITS which employ complex portfolio management techniques as complex financial instruments for the purposes of the appropriateness test;
    - strengthening the right of clients to request information when they invest in complex or tailor-made products (for example, investors should have the possibility to request (a) a risk/gain profile in different market conditions (prior to the transaction) and (b) independent quarterly valuations of such complex products);
    - defining specific organisational requirements (such as, for example, strengthening compliance controls) related to the launch of new services or products.

4. The guidelines that ESMA is considering issuing would aim at mitigating certain risks identified in the operation of the above-mentioned funds. However, it cannot be excluded that in order to protect investors, preserve the integrity of the market and the reputation of the UCITS brand it may be necessary to issue warnings to retail investors about the risks associated with certain of these products or even to limit the distribution of certain of such products to retail investors. In this context, ESMA may need to ask for appropriate powers for inclusion in the relevant sectoral legislation.

5. Moreover, issuing guidelines in this area would be consistent with the implementation of ESMA's Article 9 tasks relating to consumer protection and financial activities.

Financial stability and systemic risk

6. New types of ETF in the form of UCITS, such as synthetic ETFs, have been growing in popularity in recent years. The emergence of these UCITS has been accompanied by strong growth of collateralised structures and securities lending operations. As noted in the Executive Summary, a number of other international bodies have considered these and other issues arising from ETFs in recent months, with a particular focus on implications for financial stability and systemic risk.

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[3] As of 1 July 2011 the marketing is subject to the new rules provided for in the UCITS IV Directive and its implementing measures.
[4] See CESR's responses to questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID (Ref. CESR/10-860).

7. Practices that could have wider implications from a systemic risk perspective include, for example, the role that certain ETF structures play in allowing credit institutions to raise funding against relatively illiquid portfolios, and potential funding risks that arise for such institutions when acting as swap counterparties for synthetic ETFs. While such issues are not the primary focus of this discussion paper, some policy orientations are aimed at addressing these wider concerns. For example, the requirements on collateral for synthetic ETFs as set out in section III.III may help mitigate concerns around maturity transformation and shadow banking. In addition, the proposals for increased transparency in relation to securities lending activities set out in section III.IV should help both competent authorities and investors have a clearer overview of this activity.

8. Respondents are invited to take into account these wider issues when considering the policy orientations set out in this paper.

Q1: Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.

Q2: Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria could be used to determine which UCITS should be considered as 'complex'?

Q3: Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?

Q4: Do you consider that some of the characteristics of the funds discussed in this paper render them unsuitable for the UCITS label?

Q5: Are there any issues in terms of systemic risk not yet identified by other international bodies that ESMA should address?

9. This paper does not deal specifically with non-UCITS funds although they can be established as ETFs and pursue the types of strategy discussed in this paper. The Alternative Investment Fund Managers Directive (AIFMD) will to some extent consider issues relating to non-UCITS but it will not address retail investor protection concerns. Moreover, there could be concerns in terms of broader market stability which are relevant even for funds exclusively marketed to professional/institutional investors (typically issues related to quality of collateral, liquidity risk, etc).

10. ESMA will give further consideration to the extent to which any of the guidelines agreed for UCITS can be applied to regulated non-UCITS funds established or sold within the European Union.

Q6: Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union? If not, please give reasons.

11. Products similar to those offered as UCITS (i.e. under a harmonised regulatory framework) could also be structured and issued as notes (exchange-traded notes or ETNs) by credit institutions or Special Purpose Vehicles (SPVs). As such they can be sold to retail investors (even if in such a case these products will not fall within the MiFID definition of non-complex products, entailing the application of ad-

ditional rules in the sales process) or admitted to trading on regulated markets or other trading venues.

12. ETNs are structured products that are issued as non-interest paying debt instruments whose prices fluctuate with an underlying index or an underlying basket of assets. Because they are debt obligations, ETNs are backed by the issuer and subject to the solvency of the issuer. When investors hold an ETN until the maturity date, they receive a one-time payment based on the performance of the underlying asset, index or strategy. The note can also be sold on the secondary market as these products are transferable securities which offer real-time pricing and intraday liquidity. ETNs are debt obligations and are therefore not free of credit risk.

13. SPVs and products issued by SPVs are not subject to a UCITS-equivalent framework (nor to the type of requirements to which credit institutions are subject[5]) and they are less likely to have the same level of controls and rules in place in terms of, for example, risk spreading, eligibility, risk management and risk measurement. They are not subject to supervision with respect to the performance of their activity, nor are they subject to ongoing disclosure requirements with respect to the product. In addition, there is no obligation on SPVs to have an external depositary. Credit risk of SPVs is borne entirely by the investor.

14. The Packaged Retail Investment Products (PRIPs) initiative envisaged by the European Commission addresses disclosure issues (in the limited form of Key Investor Information Document) and selling practices (i.e. the distribution activity) for certain of these products without addressing broader issues linked to the manufacturing of the products (in contrast with the UCITS framework).

Q7: Do you agree that ESMA should also discuss the above-mentioned issues with a view to avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.

III. Exchange Traded Funds

III.I. Title

15. Although the majority of European ETFs are authorised as UCITS they have some unique features which are not present in traditional open-ended funds. For example, investors (other than creation unit-holders) usually do not subscribe or redeem directly from the ETF but rather acquire and dispose of their shares on the secondary market. Contrary to other UCITS investors, they may not always receive the fund documentation (such as the KIID) where they acquire UCITS ETF units directly on-exchange, for example, or through dedicated websites.

16. ETFs are also often confused with other types of exchange-traded products such as exchange-traded notes and exchange-traded commodities. They may also be confused with listed closed-ended funds. UCITS ETFs can be established under different forms. UCITS ETFs that intend to replicate the performance of an index may do this either physically or synthetically or a combination of both. Some UCITS ETFs may also aim at outperforming an index and therefore are actively managed. The UCITS

[5] Where the products are issued by credit institutions, the credit institutions are obliged to implement general requirements on risk management and measurement. However, such requirements apply to the whole activity of the credit institution and not, as is the case for UCITS, with respect to the specific product offered.

Directive provides that a UCITS which replicates a stock or debt securities index must include a prominent statement to this effect in the prospectus and any other promotional literature.

Policy orientations identified by ESMA

17. In order to reduce the risk of confusion among investors when they buy UCITS ETFs, ESMA is considering the following policy orientation:

    - ETFs should use an identifier, in their name and in their fund rules, prospectus and marketing material, which identifies them as an exchange-traded fund. This identifier could be either 'ETF' or 'Exchange-Traded Fund'.

Questions to stakeholders

Q8: Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.

Q9: Do you think that the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs?

Q10: Do you think that the identifier should also be used in the Key Investor Information Document of UCITS ETFs?

III.II. Index tracking issues

18. Index-tracking ETFs track a broad range of indices including equity, bond, commodity, currency, sector specific and strategy indices. Almost all European index-tracking ETFs are passively managed and their goal is to replicate the returns of a benchmark index. This can be done physically or synthetically or by a combination of both.

19. Physical replicating or cash based ETFs replicate the performance of an underlying index by investing in all the securities of that index or a representative sample of those securities. Full replication of an index can be difficult to achieve and involves significant rebalancing transaction costs. This is particularly the case for indices with a large number of constituents some of which may need to be purchased or sold in small amounts. There are also issues relating to tracking error which are discussed in more detail below.

20. Synthetic or swap-based index-tracking ETFs hold a basket of securities as collateral and exchange the performance of these securities with a counterparty in return for the performance of the index. This strategy avoids the high rebalancing costs and tracking error associated with physical replication but introduces other risks including counterparty risk.

21. For index-tracking ETFs, the tracking error is the ex post distance (positive or negative) between the return of the ETF's portfolio and the return of the benchmark or index. The tracking error helps measure the quality of the replication and its level depends on the replication method implemented by the UCITS (in the case of physical replication) or through the swap counterparty (synthetic replication).

22. Tracking error is higher for physical replicating ETFs due to transaction costs and difficulties in buying and selling small illiquid components of the index. Where it is not possible to own every stock on an index due to the size of the index or because some components are very illiquid, physical replicators may rely on sampling. The index-tracking ETF implements the sampling strategy by acquiring a subset of the component securities of the underlying index, and possibly some securities that are not included in the corresponding index that are designed to help the ETF track the performance of the index. An index-tracking ETF that uses a robust sampling methodology is still considered to be pursuing a passive investment strategy.

23. Although synthetic replication reduces tracking error, it does not eliminate this problem entirely. Index return swaps are not always based on the same assumptions and calculations as the main version of an index. For example, dividend re-investment assumptions and dividend tax enhancements mean that the version of an index used by a swap may differ from what most investors are familiar with.

24. The prospectus for each UCITS must contain a description of its investment policy. In practice an index-tracking ETF will include the name and a short description of the index. However it may not include sufficient detail in relation to the components of the index or the benchmark to which the index refers. Moreover an index-tracking ETF may not always specify the replication mechanism, physical or synthetic, used to track the index or, in the case of physical ETFs, whether full replication or sampling is used. It is important that investors are provided with sufficient detail to understand the index tracking policy used and the types of underlying assets and strategies they are gaining exposure to. Investors must always be informed of the principle risks in relation to the investment policy of the UCITS.

Policy orientations identified by ESMA

25. ESMA believes that the prospectus for index-tracking UCITS ETFs should contain a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index. This information should include:

    - A clear description of the index including details of the underlying index components. In order to avoid frequent updates of the document, the prospectus can provide investors with a link to a web site where the exact composition of the index can be found;

    - Information on whether the index will be tracked synthetically or physically (or a combination of both) and the implications for investors in terms of their exposure;

    - The policy of the index-tracking UCITS ETF regarding the tracking error including its maximum level;

    - A description of issues which will affect the index-tracking ETF's ability to fully replicate e.g. transaction costs, small illiquid components, dividend reinvestment etc;

    - Details of whether the index-tracking UCITS ETF will follow a full replication model or use, for example, a sampling policy.

Questions to stakeholders

Q11:Do you agree with ESMA's analysis of index-tracking issues? If not, please explain your view.

Q12:Do you agree with the policy orientations identified by ESMA for index-tracking issues? If not, please give reasons.

Q13: Do you think that the information to be disclosed in the prospectus in relation to index-tracking issues should also be in the Key Investor Information Document of UCITS ETFs?

Q14:Are there any other index tracking issues that ESMA should consider?

Q15:If yes, can you suggest possible actions or safeguards ESMA should adopt?

III.III. Synthetic ETFs – counterparty risk

26. Synthetic ETFs generally use total return swaps with a single counterparty to gain exposure to the relevant index. Collateral provided by the counterparty to the UCITS is used to ensure that the UCITS does not breach the counterparty exposure limits set out in the UCITS Directive.

27. Where the ETF receives collateral to reduce exposure to the counterparty, this collateral must comply with the following criteria 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) (hereafter 'CESR's Guidelines on Risk Measurement'):

- Liquidity – any collateral posted must be sufficiently liquid in order that it can be sold quickly at a robust price that is close to pre-sale valuation. Collateral should normally trade in a highly liquid marketplace with transparent pricing. Additionally, collateral with a short settlement cycle is preferable to a long settlement cycle as assets can be converted into cash more quickly.

- Valuation – collateral must be capable of being valued on at least a daily basis and the possibility of 'stale prices' should not be allowed. An inability to value collateral through independent means would clearly place the UCITS at risk, and this would also apply to 'mark to model' valuations and assets that are thinly traded.

- Issuer credit quality – as collateral provides secondary recourse, the credit quality of the collateral issuer is important. This may involve the use of haircuts in the event of a less than 'very high grade' credit rating. It should be reasonable to accept collateral on assets that exhibit higher price volatility once suitably conservative haircuts are in place.

- Correlation – correlation between the OTC counterparty and the collateral received must be avoided.

- Collateral diversification (asset concentration) – there is an obvious risk if collateral is highly concentrated in one issue, sector or country.

- Operational and legal risks – collateral management is a highly complex activity. As such, the existence of appropriate systems, operational capabilities and legal expertise is critical.

- Collateral must be held by a third party custodian which is subject to prudential supervision, and which is either unrelated to the provider or is legally secured from the consequences of a failure of a related party.

- Collateral must be fully enforced by the UCITS at any time without reference to or approval from the counterparty.

- Non-cash collateral cannot be sold, re-invested or pledged.

- Cash collateral can only be invested in risk-free assets.

28. Notwithstanding the criteria applied to collateral under CESR's Guidelines on Risk Measurement, the collateral obtained by synthetic ETFs may not be in line with the underlying index which is being tracked. As noted in the FSB's report of April 2011, this is due in part to the fact that the synthetic ETF creation process may be driven by the possibility for the bank to raise funding against an illiquid portfolio that cannot otherwise be financed in the repo market. In the event of a default by the derivative counterparty the ETF has to liquidate the collateral received by the counterparty for counterparty risk mitigation purposes and needs to conclude a new derivative transaction to ensure the continuity of the product. Investors run the risk that the proceeds of the collateral sale do not cover the loss arising from the default of the counterparty. It is important that investors are informed of the potential risk of default of the counterparty and its effects on the stated investment objective of the ETF.

29. UCITS are required to disclose their portfolios in their annual report, which should include details of any financial derivative transactions. It is also important that the ETFs, which obtain synthetic exposure to an index, provide information in the annual report detailing the underlying exposure together with the counterparty(ies) to the derivative and the collateral held to reduce counterparty exposure.

30. Index-tracking ETFs which follow a synthetic replication strategy through the use of financial derivative instruments must comply with all applicable UCITS Directive requirements, including CESR's Guidelines on Risk Measurement.

Policy orientations identified by ESMA

31. ESMA believes that the information provided to investors in the prospectus of synthetic ETFs should include at least the following:

   - Information on the underlying of the investment portfolio or index, the counterparty(ies) and, where relevant, the type of collateral which may be received from the counterparty(ies); and

   - The risk of counterparty default and the affect on investor returns.

32. The annual report should also contain details of the following:

   - The underlying exposure obtained through financial derivatives instruments;

   - The identity of the counterparty(ies) to these financial derivative transactions; and

- The collateral held by the UCITS to reduce counterparty exposure.

Questions to stakeholders

Q16: Do you support the disclosure proposals in relation to underlying exposure, counterparty(ies) and collateral? If not, please give reasons.

Q17: For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.

Q18: In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

III.IV. Securities lending activities

33. The use of securities lending by UCITS ETFs is growing in popularity as the profits earned can increase returns and offset other costs. Securities lending can be a significant activity for physical UCITS ETFs given the size of their available portfolio of securities and the ability to generate significant returns. Synthetic UCITS ETFs may also engage in this activity, depending on the composition of the portfolio and the nature of the swap instrument. While the activity is likely to boost UCITS ETFs' returns, this can also increase the tracking error for index-tracking UCITS ETFs. However, in certain circumstances the returns from securities lending activity can offset other costs within the index-tracking UCITS ETF and actually reduce tracking error.

34. It is not always evident to investors how the proceeds from securities lending are allocated. The role of securities lending agents is not always clear or disclosed adequately to investors. The type of income generated from securities lending will depend on the type of collateral received by the UCITS. For example, if securities are received as collateral the UCITS will receive a fee from the lender. In the case of cash collateral, income is generated by the reinvestment of this collateral and no fee is paid by the lender who provides the cash. In both cases the income received i.e. fee or interest may be split between the securities lending agent if one is appointed and the UCITS. The securities lending agent may be a related party to the UCITS and in some jurisdictions the investment manager.

35. Securities lending introduces risks arising from borrower default notwithstanding the provision of collateral, and, where cash collateral is received, from the re-investment of cash collateral, all of which must be managed by the UCITS ETF. The criteria for collateral received by UCITS in the case of OTC derivative transactions set out in CESR's Guidelines on Risk Measurement do not apply to collateral received as part of a securities lending transaction. For example, non-cash collateral received as part of a securities lending transaction could be sold, re-used or pledged and there are no restrictions on the re-investment of cash collateral. While Member States may impose their own national rules in this regard, it would seem appropriate to impose the rules which currently apply to collateral received in the context of OTC transactions to collateral received by UCITS as part of a securities lending transaction or repurchase agreement.

36. According to CESR's Guidelines on Risk Measurement the net exposure to a counterparty generated through a securities lending or repurchase agreement has to be included in the 20% limit of Article 52(2) of the UCITS Directive. There is no limit in the guidelines or the UCITS Directive on the amount of a UCITS portfolio which can be on loan.

37. As noted by the aforementioned FSB report, securities lending activities can also potentially give rise to broader systemic concerns. For example, if securities lending is particularly prevalent, there could be a greater risk of a market squeeze in the underlying securities if ETF providers were to recall on-loan securities on a large scale in order to meet redemptions.

Policy orientations identified by ESMA

- A UCITS ETF should clearly inform investors in the prospectus of the intention to engage in securities lending. This should include a detailed description of the risks involved in this activity including counterparty risk and the impact securities lending will have on tracking error for index tracking ETFs.

- The prospectus should also clearly inform investors of policy in relation to collateral. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks attached to the re-investment policy.

- The extent to which fees arising from securities lending are earned by the UCITS ETF should be disclosed. Where an UCITS ETF engages in fee sharing arrangements in relation to securities lending, this should be clearly disclosed together with the maximum percentage of fees payable to the securities lending agent or other third party.

- Where the securities lending agent is the investment manager or a connected party to the manager/ investment manager this should also be disclosed.

- Collateral received in the context of securities lending activities should comply with the criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement.

Questions to stakeholders

Q19:Do you agree with ESMA's analysis of the issues raised by securities lending activities? If not, please give reasons.

Q20:Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q21:Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced? If yes, please specify.

Q22:Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral? If not, please give reasons.

Q23:Do you consider that ESMA should set a limit on the amount of a UCITS portfolio which can be lent as part of securities lending transactions?

Q24:Are there any other issues in relation of securities lending activities that ESMA should consider?

Q25:If yes, can you suggest possible actions or safeguards ESMA should adopt?

III.V. Actively-managed UCITS ETFs

38. Most UCITS ETFs aim to replicate the performance of an index (index-tracking UCITS ETFs) and are passively managed. However, some UCITS ETFs are actively managed usually with an objective to outperform an index or other benchmark. Actively managed UCITS ETFs have the traditional structure of an ETF but the manager has discretion in relation to the composition of the portfolio, subject to the stated investment objectives and policies. Index constituents are published on a daily basis, depending on the requirements of the relevant stock exchange.

Policy orientations identified by ESMA

- The UCITS ETF should clearly inform investors of the fact that it is actively managed and indicate how it will meet with the stated investment policy including any intention to outperform an index.

- The UCITS ETF should inform the investors on the main sources of risks due to the investment strategy.

- Due to the fact that the majority of UCITS ETFs are passive index tracking funds an active UCITS ETF should clearly indicate that it is not an index tracker. It should also clearly describe the policy regarding portfolio transparency and where this information may be obtained.

- The UCITS ETF should clearly disclose how the indicative net asset value ('iNAV') is calculated.

Questions to stakeholders

Q26:Do you agree with ESMA's proposed policy orientations for actively managed UCITS ETFs? If not, please give reasons.

Q27:Are there any other issues in relation to actively managed UCITS ETFs that ESMA should consider?

Q28:If yes, can you suggest possible actions or safeguards ESMA should adopt?

III.VI. Leveraged UCITS ETFs

39. UCITS ETFs are permitted to engage in leverage subject to the limits and rules on global exposure set out in the UCITS Directive and Level 2 and 3 measures.

40. Most leveraged UCITS ETFs provide investors with a leveraged exposure (both long and short) to the performance of the index or benchmark they track. They seek to achieve a daily return that is a multiple or an inverse multiple of the daily return of a securities index. The most common of these are the so-called 2x (double return) or -2x (double-inverse return) which offer investors twice the positive or negative return of the benchmark on a daily basis. In order to comply with ESMA's Guidelines on Risk Measurement, the maximum positive or negative leveraged return cannot exceed twice the return of the index.

41. To accomplish their objectives, leveraged UCITS ETFs pursue a range of investment strategies through the use of swaps, futures contracts, and other derivative instruments. An important characteristic of these UCITS ETFs is that they seek to achieve their stated objectives on a daily basis, and their performance over longer periods of time can differ significantly from the multiple or inverse multiple of the index performance over those longer periods of time. This effect can be magnified in volatile markets.

Policy orientations identified by ESMA

- The prospectus for leveraged UCITS ETFs should disclose the leverage policy, how this is achieved and the risks associated with this policy.

- In particular the impact of reverse leverage i.e. short exposure should be clearly disclosed.

- This should also include a description of how the daily calculation of leverage impacts on investors' returns over the medium to long term and should also include details of the costs involved.

Questions to stakeholders

Q29:Do you agree with ESMA's analysis of the issues raised by leveraged UCITS ETFs? If not, please give reasons.

Q30:Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q31:Are there any other issues in relation leveraged UCITS ETFs that ESMA should consider?

Q32:If yes, can you suggest possible actions or safeguards ESMA should adopt?

III.VII. Secondary market investors

42. Before launching a UCITS ETF the promoter will test the product with market participants to assess investor demand. Market participants are members of the exchange where the UCITS ETF is admitted to trading and may also act as market makers for the fund, creating a liquid market in the shares. Market participants buy and sell shares directly from the UCITS ETF in large blocks known as creation units, and are usually the only unitholders of record. In the case of physical UCITS ETFs these subscriptions and redemptions may be carried out on an in-specie basis using assets which make up the index and the fund portfolio. In the case of synthetic UCITS ETFs creation units are usually issued on a cash basis.

43. After purchasing a creation unit, the market participant splits it up and sells the individual units on a secondary market. This is the usual method by which investors purchase and sell individual units in the fund.

44. According to the rules of the stock exchange where units are traded, the UCITS ETF must publish the securities and other assets in its portfolio every day. Throughout the day an iNAV is calculated, usually by an agent of the ETF but in some cases by the stock exchange. This iNAV is updated continuously, based on the most up to-date information and provides a guide for investors trading on the secondary market. iNAV is not the price at which investors purchase or sell units. In many cases, the UCITS ETF will actually trade at a premium or discount to the NAV due to various factors, including supply and demand, and expectations. Final closing NAV is calculated on a daily basis.

Policy orientations identified by ESMA

45. The market participants who acquire creation units may be the only recognised investors in the UCITS ETF and the rules in the UCITS Directive designed to protect unit holders will not necessarily apply to investors who acquire shares on the secondary market when they are not registered unit holders. While UCITS are retail products and are suitable for all types of investors it is important that, at a minimum, the prospectus and marketing material inform the secondary market investors of their status and rights. The following type of warning could be used in this regard:

‘*ETF units are not usually redeemable from the fund other than by authorised participants of creation units. Investors who acquire units on the secondary market must buy and sell shares with the assistance of a stock broker and investors may incur brokerage fees and pay more than the current net asset value when buying units and receive less than the net asset value when selling units*.’

46. As an alternative UCITS ETFs could be required to give all investors, including those who acquire units on the secondary market, the right to redeem their units directly from the UCITS.

47. One could consider UCITS that redeem creation units on demand satisfying the UCITS Directive requirements in relation to redemption rights so that it might not be necessary to ensure that the stock exchange value of their shares does not differ significantly from the net asset value per share. However, given that most investors acquire units on the secondary market and in line with the requirements of the Directive, consideration could be given to imposing this requirement on all UCITS ETFs.

Questions to stakeholders

Q33:Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q34:Are there any other issues in relation to secondary market investors that ESMA should consider?

Q35:If yes, can you suggest possible actions or safeguards ESMA should adopt?

Q36:In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

Q37:If yes, should this right be limited to circumstances where market makers are no longer providing liquidity in the units of the UCITS ETF?

Q38: How can ETFs which are UCITS ensure that the secondary market value of their units does not differ significantly from the net asset value per unit?

IV. Structured UCITS

48. Structured UCITS use financial derivatives, usually a total return swap (TRS), to provide investors with a predefined payout at the end of a specific period based on the return on underlying assets. The underlying assets can consist of a variety of asset classes, strategies and indices. They are usually passively managed and can incorporate features such as capital protection or payoff guarantee.

IV.I. Total Return Swaps

49. An increasing number of UCITS are gaining exposure to complicated investment strategies using TRS. Generally the UCITS portfolio is comprised of a TRS with a single counterparty. Collateral is provided by the counterparty to the UCITS to ensure that the UCITS does not breach the counterparty exposure limits set out in the UCITS Directive. The UCITS invests in a portfolio of assets, usually debt securities or money market instruments but in some cases other types of assets e.g. an equity portfolio. The UCITS either passes the entire portfolio to the swap counterparty (funded swap) or undertakes to pay the return on the UCITS portfolio (unfunded swap). In return the counterparty provides the UCITS with a return based on the underlying assets.

50. While many structured UCITS provide exposure to a simple basket of assets or traditional index, they can also involve more complex investment strategies which incorporate long/short equity, absolute return, complex macro, arbitrage and commodity strategies through commodity indices only. In most cases the TRS is passively managed by the counterparty. Indeed, the payoff is defined by the management company, which establishes at the outset all of the management guidelines. These guidelines predefine all the investment rules (swap payoff, portfolio composition and risk) which are set out in the swap contract. The role of the counterparty is limited to a replication of the portfolio specified in the swap contract.

51. Questions have arisen on the extent to which the investments of UCITS might not be required to comply with the diversification requirements of the UCITS Directive where the UCITS has invested in a TRS giving exposure to an underlying UCITS compliant index or diversified basket of UCITS compliant instruments.

52. Some UCITS enter into swaps which are not passively managed by the counterparty and the contract incorporates some discretionary elements. For example, the UCITS sets the investment policy but, rather than selecting the individual assets and their weighting in the strategy, the UCITS defines a pool of eligible assets and sets minimum and maximum exposure limits which the counterparty can work within. In some cases the underlying strategy to the swap is managed completely within the discretion of the swap counterparty without a clear objective methodology.

53. Where the UCITS gains exposure to an investment strategy through an OTC derivative, which is not wrapped in an index, the UCITS must ensure that the underlying assets comprising the strategy are eligible assets. The derivative must also comply with the requirements in relation to the eligibility of counterparties, counterparty exposure limits, valuation of the OTC derivative, risk management and calculation of global exposure. The exposure to the underlying assets taken together with the UCITS direct investments (if any) must not exceed the limits set out in Article 53 of the UCITS Directive. The terms of the derivative contract must ensure that the UCITS can obtain sufficient liquidity to meet any redemption requests from investors.

54. However UCITS which enter into an actively managed swap must consider other issues in relation to the management of the UCITS and the role of the counterparty, including conflict of interest or management delegation issues. While there are certain practices which are banned by the UCITS Directive, for example physical short selling and borrowing it is not entirely clear that a counterparty will not engage in these type of transactions are part of the investment strategy.

55. It is worth recalling that structured UCITS which use financial derivative instruments, including TRS, must comply with all applicable UCITS Directive requirements including CESR's Guidelines on Risk Measurement (Ref. CESR/10-788).

56. Arguably, notwithstanding that the underlying of the TRS is UCITS-compliant, it is not possible for a UCITS which has entered into a TRS to acquire a non-compliant portfolio of securities (or one security). Such (an) acquisition(s) would appear to be an advertent breach of the UCITS requirements. While it may be considered that the composition of the physical assets held by a UCITS is not relevant to the asset diversification test, by virtue of the diversification provided through the swap, it is not clear that Article 52 of the Directive would allow for this interpretation.

57. Certain TRS entered into by structured UCITS can include provisions which give the counterparty an element of control of the UCITS portfolio which can affect investment decisions. UCITS can also have difficulty rectifying breaches of the UCITS investment restrictions. While structured UCITS comply in full with the UCITS Directive requirements at the launch date there can be problems rectifying breaches during the life of the UCITS. The following issues can arise in managing the UCITS:

- Changing the composition of the UCITS portfolio and restructuring the swap may affect the pre-defined payoff; alternatively maintaining the pre-determined payoff may result in significant expense for the UCITS;

- In some cases the swap contract specifies the assets which make up the UCITS portfolio to be swapped and the counterparty must approve any change; and

- The agreement with the counterparty may also specify that the UCITS must purchase the securities included in the portfolio from the counterparty.

58. It must also be considered whether these types of provisions in swap agreements are acceptable, and even whether the counterparty ought to be treated (and disclosed) in the same way as an investment manager.

59. Most structured UCITS use a TRS with a single counterparty to obtain the underlying exposure. Collateral is received to reduce counterparty exposure which must comply with CESR's Guidelines on Risk Measurement. It is important that the investor is properly informed of the increased risk of being exposed to a single counterparty and the type of collateral obtained to reduce this risk. Investors should also be made aware of the impact of a counterparty default and the related effects on the return.

Policy orientations identified by ESMA

➢ Both the UCITS' investment portfolio, which is swapped, and the underlying to the swap, which the UCITS obtains exposure to, must comply with the relevant UCITS diversification rules.

- 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.

- 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 or the underlying swap 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.

- Where the approval of the counterparty is required in relation to any portfolio transaction this must be disclosed in the prospectus.

- The prospectus should include information on the underlying strategy, the counterparty(ies) and, where relevant, the type of collateral which may be received from the counterparty(ies);

60. The structured UCITS' annual report should also contain details of the following:

- The underlying exposure obtained through financial derivatives instruments;

- The counterparties to these financial derivative transactions; and

- The collateral held by the UCITS to reduce counterparty exposure.

Questions to stakeholders

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

Q40:Do you support the policy orientations identified by ESMA? If not, please give reasons.

Q41:Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

Q42:If yes, can you suggest possible actions or safeguards ESMA should adopt?

IV.II. Strategy indices

61. A strategy index is an index which aims at replicating a quantitative strategy or a trading strategy. In most cases the strategy is structured and operated by the index provider and not by the UCITS. For instance, if the strategy index aims at replicating a quantitative strategy then the index construction pro-

cess is based on proprietary applications and models developed by the index manager. The model includes an optimisation process which sets up the dynamic portfolio construction process.

62. Where a UCITS gains exposure to a financial index using a financial derivative, it must comply with the UCITS rules in relation to the construction and publication of the index. Regardless of whether the underlying components of the index themselves would be eligible for direct investment by UCITS, the financial index may be eligible provided it complies with the following criteria:

- It is sufficiently diversified and the price movement of one component does not unduly influence the performance of the index. Where the index is composed of eligible assets the components of the index must comply with the limits in Article 53 of the UCITS Directive i.e. 20/35% of assets in a single issuer. If the index does not respect the risk diversification rules in Article 53 the component assets of the index must be combined with the UCITS direct investments to ensure compliance with the UCITS 5/10/40% rule. Where the index is comprised of ineligible assets it must be diversified in an equivalent way to Article 53.

- It represents an adequate benchmark for the market to which it refers and measures the performance of the group of components in a relevant and appropriate way. The index must be rebalanced periodically using publicly available criteria to reflect the market and the underlying components must be sufficiently liquid.

- It must be published in an appropriate manner using sound procedures to collect prices, calculate and publish the index. Information on the index calculation and rebalancing methodologies, index changes and operational difficulties must be publicly available in a timely manner.

63. It is also important to note that, in accordance with CESR's Guidelines on Risk Measurement, leverage which is embedded in an index must be included in the calculation of global exposure.

64. Given the ever expanding universe of indices being created it would appear necessary to provide more guidance on the three criteria to ensure that these strategy indices can properly be defined and treated as financial indices for the purposes of the UCITS Directive. It may also be beneficial to consider how indices comprising interest rates or FX rates can comply with the diversification requirement.

Policy orientations identified by ESMA

Sufficiently diversified

65. The prospectus for an index replicating UCITS must, where relevant, inform investors of the intention to avail of increased diversification limits together with a description of the exceptional market conditions which justify this investment.

66. UCITS which gain exposure to an index which contains a single component which represents between 20% and 35% of the overall index must disclose this fact in its prospectus and describe the exceptional market conditions which justify this investment.

67. A strategy index may contain a component which at the outset represents less than 20% of the overall index. However due to the methodology being followed the impact of a price movement on this component could have an impact on the index return which exceeds 20%. Accordingly it should not be suf-

ficient that the components of the index respect the limits set out in the Directive - their impact on the return provided to investors through the swap should also respect these limits.

- A single component of an index must not have an impact on the overall index return which exceeds the relevant diversification requirements i.e. 20%/35%;

- Commodity indices must comprise of different commodities, e.g. oil, gold, silver which respect the 20%/35% limit in order to be considered an eligible index.

Adequate benchmark

68. A strategy index must be able to demonstrate that it meets with the index criteria including that of being a benchmark for the market to which it refers. Many of these indices are not designed to be benchmarks but are simply an investment strategy wrapped in an index. In some cases the objective of the strategy, the underlying components and their weightings are not fixed and can change depending on market developments.

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

   - ➢ The universe of the index components and the basis from 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 does not affect the objective nature of the index calculation methodology.

Rebalancing

69. The frequency at which an index can be rebalanced must also be considered. Strategy indices tend to be rebalanced far more frequently than traditional indices which typically rebalance quarterly or annually. Strategy indices usually rebalance daily or even on an intra-day basis, however ESMA considers that these type of indices are unlikely to be able to satisfy the UCITS requirements in terms of replication and transparency. This can result in increased costs for the UCITS and can also affect index transparency for investors.

   - ➢ The rebalancing frequency should not prevent investors from being able to replicate the financial index. ESMA considers that indices which rebalance on an intra-day or daily basis cannot satisfy this criterion.

   - ➢ The UCITS prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.

Published in an appropriate manner

70. Strategy indices often include proprietary calculation models and index sponsors do not typically publish the full calculation methodology. It is not considered sufficient for a UCITS to disclose a summary of the objective and calculation methodology.

71. Therefore, the index provider must disclose the full calculation methodology to inter alia enable investors to replicate the strategy.

72. In principle the requirement that an index be published in an appropriate manner means that an investor should be able to access relevant material information on the index with ease, for example, via the internet. Index performance must be freely and continually available. Information on matters such as index constituents, index calculation, re-balancing methodologies, index changes and information relating to any operational difficulties in providing timely or accurate information should also be available.

73. Therefore, strategy indices which involve proprietary information on the composition that the index provider is unwilling to disclose should not be considered as eligible financial indices.

74. 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.

Hedge fund indices

75. In addition to guidelines for financial indices in general, CESR issued the following additional guidelines for the eligibility of hedge fund indices[6]:

    1. The methodology of the index provider 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;

    2. The index provider may not accept payments from potential index components for inclusion in the index.

    3. The index methodology must not permit retrospective changes to previously published index values ('backfilling').

    4. 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 hedge fund 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 an audit, the frequency of index publication and whether this will affect the UCITS ability to calculate its NAV. The due diligence should also cover matters relating to the index components.

76. In order to ensure that all financial indices, including strategy indices:

    - use pre-defined methodologies based on objective criteria and do not include any discretionary element; and

[6] See CESR's Guidelines on the classification of hedge fund indices as financial indices (Ref. CESR/07-434)

- provide adequate disclosure of the index objective and benchmark and appropriate transparency in relation to the index components and calculation methodology

ESMA's preliminary views are that it might be appropriate to require that all financial indices comply with points 1 to 4 in the paragraph 69 above which currently only apply to hedge fund indices.

Conflicts of interest

77. In many cases the manager/investment manager of the UCITS, the counterparty to the swap and the index provider are part of the same group. It is important therefore to ensure that the UCITS has a clearly documented conflicts of interest policy to deal with these issues and a summary of this policy should be disclosed in the prospectus.

- ➢ UCITS must ensure that any valuation of the swap must include an independent assessment of the underlying index.
- ➢ The financial index should be subject to independent valuation.

Questions to stakeholders:

Q43:Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.

Q44:How can an index of interest rates or FX rates comply with the diversification requirements?

Q45:Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

Q46:If yes, can you suggest possible actions or safeguards ESMA should adopt?

Annex I - Summary of questions

Retailisation of complex products

1. **Do you agree that ESMA should explore possible common approaches to the issue of marketing of synthetic ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors? If not, please give reasons.**

2. **Do you think that structured UCITS and other UCITS which employ complex portfolio management techniques should be considered as 'complex'? Which criteria could be used to determine which UCITS should be considered as 'complex'?**

3. **Do you have any specific suggestions on the measures that should be introduced to avoid inappropriate UCITS being bought by retail investors, such as potential limitations on distribution or issuing of warnings?**

4. **Do you consider that some of the characteristics of the funds discussed in this paper render them unsuitable for the UCITS label?**

5. **Do you agree that ESMA should give further consideration to the extent to which any of the guidelines agreed for UCITS could be applied to regulated non-UCITS funds established or sold within the European Union? If not, please give reasons.**

6. **Do you agree that ESMA should also discuss the above mentioned issues with a view of avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.**

7. **Do you agree with the proposed approach for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material? If not, please give reasons.**

8. **Do you think that the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs?**

9. **Do you think that the identifier should also be used in the Key Investor Information Document of UCITS ETFs?**

10. **Do you agree with ESMA's analysis of index-tracking issues? If not, please explain your view.**

11. **Do you agree with the policy orientations identified by ESMA for index-tracking issues? If not, please give reasons.**

12. **Do you think that the information to be disclosed in the prospectus in relation to index-tracking issues should also be in the Key Investor Information Document of UCITS ETFs?**

13. Are there any other index tracking issues that ESMA should consider?

14. If yes, can you suggest possible actions or safeguards ESMA should adopt?

15. Do you support the disclosure proposals in relation to underlying exposure, counterparty(ies) and collateral? If not, please give reasons.

16. For synthetic index-tracking UCITS ETFs, do you agree that provisions on the quality and the type of assets constituting the collateral should be further developed? In particular, should there be a requirement for the quality and type of assets constituting the collateral to match more closely the relevant index? Please provide reasons for your view.

17. In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

Securities lending activities

18. Do you agree with ESMA's analysis of the issues raised by securities lending activities? If not, please give reasons.

19. Do you support the policy orientations identified by ESMA? If not, please give reasons.

20. Concerning collateral received in the context of securities lending activities, do you think that further safeguards than the set of principles described above should be introduced? If yes, please specify.

21. Do you support the proposal to apply the collateral criteria for OTC derivatives set out in CESR's Guidelines on Risk Measurement to securities lending collateral? If not, please give reasons.

22. Do you consider that ESMA should set a limit on the amount of a UCITS portfolio which can be lent as part of securities lending transactions?

23. Are there any other issues in relation of securities lending activities that ESMA should consider?

24. If yes, can you suggest possible actions or safeguards ESMA should adopt?

Actively managed UCITS ETFs

25. Do you agree with ESMA proposed policy orientations for actively managed UCITS ETFs? If not, please give reasons.

26. Are there any other issues in relation to actively managed UCITS ETFs that ESMA should consider?

27. If yes, can you suggest possible actions or safeguards ESMA should adopt?

Leveraged UCITS ETFs

28. Do you agree with ESMA analysis of the issues raised by leveraged UCITS ETFs? If not, please give reasons.

29. Do you support the policy orientations identified by ESMA? If not, please give reasons.

30. Are there any other issues in relation leveraged UCITS ETFs that ESMA should consider?

31. If yes, can you suggest possible actions or safeguards ESMA should adopt?

Secondary market investors

32. Do you support the policy orientations identified by ESMA? If not, please give reasons.

33. Are there any other issues in relation to secondary market investors that ESMA should consider?

34. If yes, can you suggest possible actions or safeguards ESMA should adopt?

35. In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

36. If yes, should this right be limited to circumstances where market makers are no longer providing liquidity in the units of the ETF?

37. How can ETFs which are UCITS ensure that the stock exchange value of their units do not differ significantly from the net asset value per share?

Total return swaps

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

39. Do you support the policy orientations identified by ESMA? If not, please give reasons.

40. Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

41. If yes, can you suggest possible actions or safeguards ESMA should adopt?

Strategy indices

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

43. How can an index of interest rates or FX rates comply with the diversification requirements?

44. Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

45. If yes, can you suggest possible actions or safeguards ESMA should adopt?

Annex II – Cost benefit analysis

1. UCITS Exchange traded funds

Options	Benefits	Costs	Evidence
1. Identifier			
Use of an identifier by UCITS ETFs in their prospectus and marketing material.	Investors would be immediately informed by reading the name of the UCITS that the fund is an ETF.	Management companies, promoters and entities in charge of the commercialisation would have to adapt their documentation to reflect these new guidelines when applicable.	Feedback from the consultation on the costs for modifying prospectus and marketing materials of existing UCITS ETFs.
The identifier should distinguish between synthetic and physical and actively managed ETFs.	Investors would be immediately informed about the type of ETFs by reading the name of the UCITS.	Management companies, promoters and entities in charge of the commercialisation would have to adapt their documentation to reflect these new guidelines when applicable.	Feedback from the consultation on the costs for modifying prospectus and marketing materials of existing materials.
The identifier should also be used in the Key Investor Information Documents of UCITS ETFs.	This would ensure a level-playing field among the different documents provided to investors (prospectus, marketing materials etc.)	Management companies, promoters and entities in charge of the commercialisation would have to adapt the KIID to reflect these new guidelines when applicable.	Feedback from the consultation on the costs for KIID of existing UCITS ETFs.
2. Index-tracking issues			
Prospectus should include a clear description of the index including details of the index components. In order to avoid frequent updates of the documents, the prospectus can provide investors with a link to a web site where the exact composition of the index can be found	Transparency in terms of index composition would be improved. Investors would be better informed about the exposition of UCITS ETFs. UCITS ETFs promoters would not need to keep the prospectus updated with the exact composition of the index tracked by the ETFs as long as investors have	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.

	access to this information via a link to a web site where the exact composition of the index should be disclosed		
Information on whether the index will be tracked synthetically or physically (or a combination of both) and the implications for investors in terms of their exposure.	Investors would have a better understanding of the mechanisms used by UCITS ETFs to replicate the performance of the tracked-index.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying existing prospectus.
The policy of the index-tracking UCITS ETF regarding an acceptable level of tracking-error.	Transparency in terms of performance objective would be improved. This guideline would also allow investors to compare ETFs tracking the same underlying index.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
A description of issues which affect the index-tracking ETF's ability to fully replicate e.g. transaction costs, small illiquid components, dividend reinvestment etc.	Investors would have a better understanding of the mechanisms used by UCITS ETFs to replicate the performance of the tracked-index and their impact on the performance of the funds.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing ETFs.
Details of whether the index-tracking UCITS ETF will follow a full replication model or use, for example, a sampling policy.	Investors would have a better understanding of the mechanisms used by UCITS ETFs to replicate the performance of the tracked-index.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
3. Synthetic ETFs-Counterparty risk			
Prospectus of synthetic ETFs should include information on the underlying investment portfolio or index, the counterparty (ies) and, where relevant, the type of collateral which may be received from the counterparty (ies).	Investors would have a better understanding of the mechanisms used by UCITS ETFs to replicate the performance of the tracked-index and in particular the type of collateral received from the counterparty (ies) in the case of synthetic ETFs.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
The prospectus of synthetic ETFs should include information	Investors would be informed that synthetic	Prospectus of the existing UCITS	Feedback from the consultation on the

on the risk of counterparty default and the effect on investor returns.	ETFs are also subject to counterparty risks and the effect on the return of the fund if this risk materialises.	ETFs may have to be modified to reflect these new guidelines.	costs for modifying prospectus of existing UCITS ETFs.
The annual report should contain details on the underlying exposure obtained through financial derivatives instruments.	This requirement would increase the transparency and the quality of the information provided to investors and competent authorities.	Annual reports may have to be adapted in order to reflect these guidelines.	Feedback from the consultation on the extent to which procedures for elaborating annual reports would have to be modified and the associated costs would be helpful to assess the impact of possible guidelines.
The annual report should also contain details on the identity of the counterparty (ies) to these financial derivative transactions.	This requirement would increase the transparency and the quality of the information provided to investors and competent authorities.	Annual reports may have to be adapted in order to reflect these guidelines.	Feedback from the consultation on the extent to which procedures for elaborating annual reports would have to be modified and the associated costs would be helpful to assess the impact of possible guidelines.
The annual report should also contain details on the collateral held by the UCITS to reduce counterparty exposure.	This requirement would increase the transparency and the quality of the information provided to investors and competent authorities.	Annual reports may have to be adapted in order to reflect these guidelines.	Feedback from the consultation on the extent to which procedures for elaborating annual reports would have to be modified and the associated costs would be helpful to assess the impact of possible guidelines.
4. Securities lending activities			
A UCITS ETF should clearly inform investors in the prospectus of the intention to engage in securities lending. This should include a detailed description of the risks involved in this activity including counterparty risk and the impact securities lending will have on tracking error for index-tracking ETFs.	This requirement would improve the quality of the information provided to investors. This would provide more transparency on securities lending activities which investors are not always aware of and the rationale for management companies to enter into this kind of activity. Also, investors would	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.

	be informed on the potential negative impact these activities may have on their return in the case where counterparty risk materialises.		
The prospectus should also inform clearly investors of policy in relation to collateral. This should include permitted types of collateral, level of collateral required and, in the case of cash collateral, re-investment policy, including the risks attached to the re-investment policy	This requirement would improve the quality of the information provided to investors and the level of transparency in terms of stock lending activities.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
The extent to which fees arising from securities lending are earned by the UCITS ETFs should be disclosed. Where an UCITS ETFs engages in fee sharing arrangements in relation to securities lending, this should be clearly disclosed together with the maximum percentage of fees payable to the securities lending agent or other third party.	This would improve the transparency towards investors and would help them to know to what extent they benefit from securities lending activities.	Prospectus of the existing UCITS ETFs may have to be modified to reflect these new guidelines.	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
Where the securities lending agent is the investment manager or a connected party to the manager/investment manager this should also be disclosed.	More transparency would be provided to investors in terms of repartition of income from stock lending activities.	Prospectus of existing ETFs may have to be modified in order to reflect these new guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
5. Actively-managed ETFs			
The UCITS ETF should clearly inform investors of the fact that it is actively managed and indicate how it will meet with the stated investment policy including any intention to outperform an index.	This would also increase the quality of the information delivered to investors which would better understand the difference between non-actively managed ETFs and actively managed ETFs.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
Due to the fact that the majority of UCITS ETFs are passive index tracking funds and active UCITS ETFs should clearly indicate that it is not an index tracker. It should also clearly describe policy regarding portfolio transparency and where this information may be obtained.	This would permit to avoid investors investing in actively-managed ETFs to think they invest in a 'regular' ETF that tracks an index.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
The UCITS ETF should clearly	This would increase the	Prospectus of exist-	Feedback from the

disclose how the indicative net asset value ('iNAV') is calculated.	quality of the information delivered to investors and help them to better understand the specificities of the mechanisms of actively-managed ETFs.	ing ETFs may have to be modified in order to reflect the guidelines	consultation on the costs for modifying prospectus of existing UCITS ETFs.
6. Leveraged UCITS ETFs			
The prospectus for leveraged UCITS ETFS should disclose the leverage policy, how this achieved and the risks associated with this policy. In particular the impact of reverse leverage i.e. short exposure should be clearly disclosed.	Investors would better understand the impact of the leverage on their return and therefore the risk associated with this type of ETF.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
The prospectus should also include a description of how the daily calculation of leverage impacts on investors returns over the medium to long term and should also include details of costs involved.	Investors would better understand the difference between the daily calculation of the leverage and its impact over the medium to long term.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
7. Secondary market investors			
Option 1: Secondary market investors do not have the right to redeem their unit from the UCITS but the prospectus and marketing material should inform them of their status and rights.	The situation does not differ from current market practices and the impact for asset management companies managing ETFs is limited. Investors are better informed of their rights via the proposed disclaimer to be included in the prospectus and marketing material.	The rights of secondary markets do not change as they cannot ask for redemption of their units directly from the UCITS. Prospectus and marketing material of existing ETFs have to be modified to reflect the guidelines.	Feedback from the consultation on the costs for modifying prospectus and marketing material of existing UCITS ETFs.
Option 2: All investors, including, secondary market investors, should have the right to redeem their units directly from the UCITS.	If market participants can no longer provide liquidity in the secondary market, secondary market investors can directly redeem their shares from the UCITS.	ETFs management companies would have to be able to meet redemption requests at any time what may have an impact on their business model as currently secondary market transactions do not have an impact on the assets of the ETFs since there is no reduction	Feedback from stakeholders on the impact of the guidelines

		of the capital of the ETFs.	

2. **Structured UCITS**

Options	**Benefits**	**Costs**	**Evidence**
1. Total return swaps			
Both the UCITS's investment portfolio, which is swapped, and the underlying to the swap, which the UCITS obtains exposure to, must comply with the relevant UCITS diversification rules.	This requirement would ensure that both legs of the total return swaps comply with the UCITS diversification rules.	Some structured UCITS based on UCITS' investment portfolios that do not comply with the relevant UCITS diversification rules would not be possible under these guidelines. Some UCITS management companies may be obliged to change their investment policy and restructure their offer.	Information on the number of structured UCITS based on total return swaps and whose investment portfolios do not comply with UCITS diversification rules may be useful in order to assess the impact of the guidelines.
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.	This would improve the quality of the information provided to investors that are often not aware of the role played by counterparties in the case of UCITS using total return swaps.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
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 or the underlying swap 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 re-	This would improve the quality of the information provided to investors that are often not aware of the role played by counterparties in the case of UCITS using total return swaps.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.

quirements on delegation. Thus, this entity should be treated and disclosed as an investment manager.			
Where the approval of the counterparty is required in relation to any portfolio transaction this must be disclosed in the prospectus.	This would improve the quality of the information provided to investors that are often not aware of the role played by counterparties in the case of UCITS using total return swaps.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
The prospectus should include information on the underlying strategy, the counterparty (ies) and, where relevant, the type of collateral which may be received from the counterparty (ies).	This would improve the quality of the information provided to investors that would better understand the strategy of the fund.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines	Feedback from the consultation on the costs for modifying prospectus of existing UCITS ETFs.
2. Strategy indices			
Sufficiently diversified • A single component of an index must not have an impact on the overall index return which exceeds the relevant diversification requirements i.e. 20%/35%. • Commodity indices must comprise of different commodities, i.e. oil, gold, silver which respect the 20%/35% limit in order to be considered an eligible assets	This requirement would ensure that the performance delivered to investors in case of strategy indices is not driven by a too limited number of components and comply with UCITS diversification rules. Also this requirement would ensure consistency with the treatment of structured UCITS as defined in ESMA guidelines on Risk Measurement and Calculation of Global Exposure for structured UCITS.	Structured UCITS based on strategy indices that do not comply with the UCITS diversification rules would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to comply with ESMA guidelines.	Information on the number of strategy indices that do not comply with the diversification requirements may be helpful assess the impact of the guidelines.

Adequate benchmark • An index must have a clear single objective in order to represent an adequate benchmark for the market. • The universe of the index components should be clear to investors and competent authorities as should the basis from which these components are selected for the strategy. • If cash management is included as part of the index strategy, the UCITS must demonstrate that this does not affect the objective nature of the index calculation methodology.	This requirement would ensure that investors and competent authorities can understand the exact strategy of the underlying index and how this index in constituted.	Structured UCITS based on strategy indices that do not comply with this requirement of adequate benchmark would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to comply with ESMA guidelines.	Information on the number of strategy indices that do not comply with the requirement of adequate benchmark may be helpful assess the impact of possible guidelines.
Rebalancing • The rebalancing frequency should not prevent investors from being able to replicate the financial index. Indices which rebalance on intra-day or daily basis could not satisfy this criterion. • The UCITS prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.	Investors would be able to better replicate the performance of the underlying index what would enhance the understanding of the fund by investors.	Structured UCITS based on strategy indices that do not comply with this requirement would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to comply with ESMA guidelines.	Information on the number of strategy indices that do not comply with the rebalancing requirement may be helpful assess the impact of possible guidelines.
Published in an appropriate manner • Index provider must disclose the full calculation	Investors would be able to better replicate the performance of	Structured UCITS based on strategy indices that do not	Feedback from stakeholders on the costs to disclose the full calcu-

methodology to inter alia enable investors to replicate the strategy. • The constituents of the index should be disclosed together with their respective weightings.	the underlying index what would enhance the understanding of the fund by investors.	comply with this requirement would not comply with ESMA guidelines. Therefore, UCITS management companies may cease to use some strategy indices if they want to comply with ESMA guidelines.	lation methodology of the underlying strategy index may be useful to assess the impact of possible guidelines. It would also be interesting to get feedback from stakeholders on the potential problems that this disclosure requirement could cause in terms of proprietary issues.
Hedge funds indices • The methodology of the index provider 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; • The index provider may not accept payments from potential index components for inclusion in the index. • The index methodology must not permit retrospective changes to the constituents of the index. • 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	This requirement would ensure a minimum level of due diligence by UCITS management companies when selecting hedge funds indices as underlying of the strategies. This requirement would also prevent from potential conflicts of interest between the index provider and index components which otherwise could undermine the adequate benchmark requirement of the index.	Structured UCITS based on strategy indices that do not comply with this requirement would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to comply with ESMA guidelines.	Information on the number of strategy indices that do not comply with these requirements may be helpful assess the impact of possible guidelines.

the weightings and classification of the components on the basis of the hedge fund 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 an audit, the frequency of index publication and whether this will affect the UCITS ability to calculate its NAV. The due diligence should also cover matters relating to the index components.			
Conflicts of interest • UCITS must ensure that any valuation of the swap must include an independent assessment of the underlying index. • The financial index should be subject to independent valuation.	This requirement would mitigate the risk on conflict of interests between the manager/investment managers of the structured UCITS and the counterparty of the swaps and the index provider.	Some UCITS management company managing structured UCITS may have to change their valuation policy if they cannot comply with the requirement of independent assessment and valuation of the underlying index.	Information on the number of strategy indices that do not comply with the requirement on conflicts of interest would be useful to assess the impact of possible guidelines. Also, information on the costs for UCITS management companies that decide to adapt their valuation policy may be helpful.