INVESTMENT COMPANY INSTITUTE

MEMO# 25455

September 1, 2011

Member Call and ESMA Discussion Paper: Policy Orientations on Guidelines for UCITS ETFs and Structured ETFs

[25455]

September 1, 2011

TO: ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 40-11
ETF ADVISORY COMMITTEE No. 61-11
INTERNATIONAL COMMITTEE No. 23-11 RE: MEMBER CALL AND ESMA DISCUSSION PAPER: POLICY ORIENTATIONS ON GUIDELINES FOR UCITS ETFS AND STRUCTURED ETFS

On July 22, 2011, the European Securities and Markets Authority ("ESMA") published a discussion paper regarding guidelines for UCITS exchange traded funds ("ETFs") and structured UCITS ("Paper"). [1] The portion of the Paper relating to UCITS ETFs is summarized below. Although the Paper concerns ETFs organized as UCITS, members may be interested in the issues raised by ESMA as well as certain proposals or questions posed by ESMA.

ESMA states that it has been looking into ETFs following certain regulatory changes in the European Union ("EU") to identify possible impacts to investor protection and market integrity. ESMA also notes the papers by the Financial Stability Board and the Bank of International Settlements on ETFs and potential implications for the stability of the financial system. ESMA believes that the current regulatory regime applicable to UCITS ETFs is not sufficient to take account of the specific features and risks of these funds. Therefore ESMA is working on guidelines and considering measures that could be introduced to mitigate the risks.

For UCITS ETFs, ESMA identifies the following areas for guidelines:

- Identifier e.g., in their name or prospectus, and content of the identifier (synthetic, physical, actively-managed)
- Index tracking issues
- Securities lending
- Actively –managed ETFs
- Leveraged ETFs
- Secondary market investors e.g., whether to give secondary market purchasers the right to redeem

Comments are due September 22, 2011. Responses will be used to help ESMA narrow its approach. The Institute may submit a comment letter. A member call will be held on Wednesday, September 14, 2011 at 2 PM EST.

Dial –in information for the call:

Inside the United States: 1-888-390-3411

Outside the United States+1-312-470-7183

Passcode: 44988

If you plan to participate, please RSVP to Ruth Tadesse at rtadesse@ici.org

Identifier

To reduce the risk of confusion among investors with other exchange traded products, e.g., exchange traded notes and commodities or listed closed-end funds, ESMA is considering requiring the use of an identifier in the name of an ETF and in the prospectus and marketing material to identify the fund as an exchange traded fund. ESMA also seeks comment on whether the identifier should distinguish between synthetic, physical and actively managed ETFs.

Index Tracking Issues

ESMA states that tracking error is higher for physical replicating ETFs and that synthetic replication may reduce tracking error but does not entirely eliminate it. Although a UCITS prospectus includes a description of a fund's investment policy, ESMA states that in practice index tracking ETFs include a name and a short description of the index and may not specify the replication mechanism, e.g., synthetic or physical, or if physical, full replication or sampling. ESMA believes that the prospectus for index tracking UCITS ETFs should contain a clear description of the index and the mechanism used to gain exposure, including:

- A clear description of the index including details of the underlying components (with a link to a web site with the exact components to avoid frequent updates);
- A description of the replication mechanism and the implications for investors;
- The policy regarding tracking error and any maximum level;
- For index tracking UCITS ETFs, whether a full replication model or sampling will be used.

ESMA seeks comment on these proposals and whether they have analyzed the issues accurately.

Synthetic ETFs

ESMA describes synthetic ETFs as those that generally use total return swaps with a single counterparty to gain exposure to an index. ESMA states that collateral is provided by the counterparty to ensure that the UCITS does not breach the counterparty exposure limits of the UCITS Directive. Notwithstanding these requirements, the collateral may not be in line with the underlying index being tracked. For synthetic UCITS ETFs, ESMA recommends additional disclosure be provided in the prospectus, including the counterparties and type of collateral, and in the annual report, such as details on the underlying exposure obtained, the counterparty identities and the collateral.

Securities Lending

ESMA is concerned with disclosure regarding securities lending. ESMA also is concerned with certain risks that it believes are posed by securities lending. With respect to UCITS ETFs and securities lending, ESMA proposes that:

- The prospectus should inform investors of an ETF's intention to engage in securities lending, including disclosure on risks.
- The prospectus should include a description of the fund's policy in relation to collateral, including types, levels and, in the case of cash, the re-investment policy.
- The extent to which fees from securities lending are earned by the fund should be disclosed and if there is fee sharing, this should be disclosed including the maximum percentage that can be paid to the lending agent or others.
- If the lending agent is the manager or a connected entity, this should be disclosed.
- Any collateral received in the context of securities lending should comply with the criteria for OTC derivatives set out in European guidelines on risk measurement.

ESMA seeks comment on these proposals, including whether additional safeguards regarding collateral are needed. ESMA also asks if there should be a limit on the amount of a fund's portfolio that can be lent in securities lending programs. Lastly, ESMA seeks input on any other general actions that it should consider.

Actively Managed ETFs

While most UCITS ETFs seek to replicate the performance of an index, there are some UCITS ETFs that are actively managed, typically seeking to outperform an index. Depending on stock exchange requirements, index constituents are usually published on a daily basis. ESMA proposes the following:

- Investors should be clearly informed that a UCITS ETF is actively managed including how it will meet its investment policy and any intention to outperform an index.
- Investors should be informed of the main sources of risk due to the investment strategy.
- Given that the majority of UCITS ETFs are passive, an active UCITS ETF should indicate it is not an index tracker and clearly describe its policy on portfolio transparency and where such information can be obtained.
- The UCITS ETF must clearly disclose how the indicative net asset value ("iNAV") is calculated.

ESMA generally asks if there are other issues that it should consider for actively managed UCITS ETFs.

Leveraged UCITS ETFs

UCITS ETFs are permitted to engage in leverage subject to the limits on global exposure set out in the UCITS Directive and implementing measures. Most leveraged UCITS ETFs provide leveraged exposure (long and short) to the performance of an index that they track. They seek to achieve a daily return that is a multiple or inverse multiple of the daily return of an index. ESMA states that in order to comply with European rules, the maximum positive or negative leveraged return cannot exceed twice the return of the index. ESMA makes the following recommendations regarding leveraged UCITS ETFs:

- The prospectus should disclose the leverage policy, including how it is achieved and the risks.
- The impact of any reverse leverage, i.e., short exposure, should be clearly explained.

- The disclosure should include how the daily calculation of leverage impacts returns over the medium and long term and include details of the costs involved.

ESMA generally asks if there are other issues or safeguards that it should consider for leveraged UCITS ETFs.

Secondary Market Investors

ESMA describes market participants as members of exchanges where UCITS ETFs are admitted to trading who also may act as market makers, creating liquid markets in shares. Market participants buy and sell shares directly from the UCITS ETFs in large blocks, or creation units, and are usually the only unitholders of record. For physical UCITS ETFs, these transactions are typically carried out in-kind with securities composing the index and fund portfolio. For synthetic UCITS ETFs, the transactions are usually on a cash basis. After purchasing a creation unit, shares are sold individually on the secondary market. Based on stock exchange rules, the UCITS ETF must publish the securities in the portfolio each day. Throughout the day an iNAV is calculated, usually by a fund agent, but in some cases by the exchange. The iNAV is updated continuously and provides a guide for investors trading in the secondary market. The iNAV is not the price at which investors will buy and sell shares. In many cases, the UCITS ETF will actually trade at a premium or discount to the NAV. The final closing NAV is calculated daily.

ESMA notes that market participants may be the only recognized investors and that rules in the UCITS Directive will not necessarily apply to investors who acquire shares in the secondary market when they are not registered holders. ESMA believes the fund's disclosure and marketing material should inform investors of their status and proposes a general warning stating the following:

> ETF units are not usually redeemable from the fund other than by authorized 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. [2]

ESMA suggests that, as an alternative to this approach, UCITS ETFs be required to give all investors, including those that acquire shares on the secondary market, the right to directly redeem their shares with the fund.

ESMA seeks comment on these proposals and whether there are other issues it should consider with respect to secondary market purchasers. ESMA specifically seeks input on providing secondary market purchasers with the right to redeem and, in addition, whether the right to redeem should be limited to circumstances where market makers are no longer providing liquidity for the units of the UCITS ETF.

If you have any questions or are unable to join the call, you can reach Susan Olson at (202-326-5813 or solson@ici.org) or Eva Mykolenko at (202-326-5837 or emykolenko@ici.org).

Susan Olson
Senior Counsel - International Affairs

endnotes

[1] ESMA/2011/220, Discussion Paper: ESMA's Policy Orientations on Guidelines for UCITS Exchange Traded Funds and Structured UCITS (July 2011), available at http://www.esma.europa.eu/popup2.php?id=7682.

[2] Form N-1A requires similar disclosure for an ETF registered under the Investment Company Act of 1940, e.g., Item 6 (specifies disclosure for ETFs regarding the purchase and sale of fund shares), Item 3 (Risk/Return Summary and Fee Table (modify narrative for expense example for ETFs to explain that investors may pay brokerage commissions).

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.