

MEMO# 25540

October 5, 2011

ICI Letter on ESMA's Policy Orientations on Guidelines for UCITS ETFs and Structured UCITS

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TO: INTERNATIONAL MEMBERS No. 46-11
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 42-11
ETF ADVISORY COMMITTEE No. 64-11 RE: ICI LETTER ON ESMA'S POLICY ORIENTATIONS ON GUIDELINES FOR UCITS ETFS AND STRUCTURED UCITS

On September 30, 2011, the Institute submitted a comment letter on the European Securities and Markets Authority's ("ESMA's") Discussion Paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS (the "Paper"). [\[1\]](#) The Institute's comments focus on ESMA's policy orientations on guidelines for UCITS ETFs and do not address structured UCITS.

In the Paper, ESMA states that it has been looking into ETFs following certain regulatory changes in the European Union to identify possible impacts to investor protection and market integrity. It 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, and is therefore 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

Enhanced Disclosure to Investors

To address concerns about the specific features and risks associated with UCITS ETFs, many of the policy orientations identified by ESMA contemplate enhanced disclosure in a UCITS ETF's prospectus, annual report, and/or other fund documents. The Institute's letter provides that, as a general matter, we believe it is critical for investors and potential investors in UCITS to have an accurate understanding of the fund in which they invest or are considering investing and that the Institute would not, therefore, object to ESMA's consideration of guidelines that include enhanced (or different) disclosure requirements for UCITS ETFs. However, the letter cautions ESMA to carefully develop such proposed guidelines so as not to disproportionately impact a particular type or types of UCITS ETF by requiring disclosure that inappropriately suggests or insinuates that a particular type of UCITS ETF is less desirable as an investment option, or leads an investor to draw a conclusion that is otherwise inaccurate.

Identifier

The Paper states that, although the majority of European ETFs are authorized as UCITS, ETFs have some unique features that are not present in traditional open-ended funds. In addition, the Paper asserts that ETFs are often confused with other types of exchange-traded products, such as exchange-traded notes and exchange-traded commodities, as well as closed-end funds. In order to address this perceived issue, ESMA is considering requiring the use of an identifier in the name of a UCITS ETF and in the prospectus and marketing material to identify the fund as an exchange-traded fund. ESMA is also considering whether the identifier should distinguish between synthetic, physical and actively managed UCITS ETFs.

The Institute's letter questions whether an identifier alerting investors that an ETF is "exchange-traded" would adequately distinguish that product from other exchange-traded products, such as exchange-traded notes, which we understand to be ESMA's goal. It further states that requiring an identifier for UCITS ETFs, but not for other products, would single out ETFs as disproportionately more or less risky in investors' minds when they are compared to other products without such an identifier. In addition, the letter provides that, if ESMA determines to proceed with requiring a UCITS ETF to use an identifier such as "ETF" or "Exchange-Traded Fund," ESMA should not require further distinction between different types of ETFs, such as synthetic, physical or actively-managed ETFs.

Securities Lending

The Paper states that the use of securities lending by UCITS ETFs is growing in popularity and raises concerns about securities lending including (i) that securities lending activities could potentially give rise to broader systemic risk concerns, (ii) the need for increased disclosure to investors regarding securities lending, and (iii) risks arising from borrower default notwithstanding the provision of collateral. To address certain of these issues, ESMA proposes a number of policy orientations focused on disclosure to investors and, with respect to the collateral received, compliance with the criteria for over the counter derivatives set out in CESR's Guidelines on Risk Management.

The Institute's letter explains that ESMA, as well as other regulators, must be cautious in attributing potential systemic or market risks, or risks to shareholders, to the securities lending activities of UCITS ETFs because other types of collective investment vehicles also

engage in securities lending. The letter states that, to the extent there is concern about the impact of securities lending activities on the broader markets, it should not be approached as an ETF-specific issue. The letter also provides that the issues identified by ESMA regarding disclosure to investors about securities lending arrangements and collateral qualifications should likewise be addressed in the context of all types of collective investment vehicles, and not just UCITS ETFs. Imposing enhanced requirements on UCITS ETFs only would unfairly single out one type of fund, while leaving unaddressed the same issues with respect to other collective investment vehicles.

Secondary Market Investors

In the Paper, ESMA states that it believes that a UCITS ETF's disclosure and marketing material should inform investors of their status (e.g., that market participants may be the only recognized owners) and proposes a 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.”

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

The Institute's letter explains that, to the extent information about how an ETF is bought or sold is not already required to be included in a UCITS ETF's prospectus and/or marketing material, we would not object to ESMA's proposal to require UCITS ETFs to include such a warning. The letter, however, expresses serious concern about ESMA's statement that, as an alternative to the proposed disclosure, UCITS ETFs could be required to give all investors the right to redeem units directly from the UCITS. The letter explains that we fail to understand how an ETF that provides investors with the ability to buy and sell shares intra-day on the market, as well as the ability to redeem single shares at the end of each business day directly from the UCITS ETF, could operate.

Eva M. Mykolenko
Associate Counsel - International Affairs

[Attachment](#)

endnotes

[1] See 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>.

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