INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

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ICI Comment Letter on ESMA's Proposed Guidelines for UCITS ETFs and Other UCITS Issues

September 13, 2011 A-1 March 30, 2012 Mr. Steven Maijoor, Chair European Securities and Markets Authority 103 Rue de Grenelle 75007 Paris France Re: ESMA's Proposed Guidelines for UCITS ETFs and Other UCITS Issues Dear Mr. Maijoor, The Investment Company Institute ("ICI")1 appreciates the opportunity to comment on the European Securities and Markets Authority's ("ESMA") Consultation Paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and other UCITS issues (the "Paper").2 Exchange- traded funds ("ETFs") registered under the U.S. Investment Company Act of 1940 are an important part of both the U.S. fund market and the global ETF market. Many of our members sponsor ETFs both in the U.S. and in the European Union.3 Our comments focus on ESMA's guidelines for UCITS ETFs, and specifically on the proposed guidelines with respect to secondary market investors. As we noted in our comment letter on ESMA's Policy Orientations on Guidelines for UCITS Exchange-Traded Funds and Structured UCITS,4 we support ESMA's review of UCITS ETFs following the implementation of UCITS III. As ESMA notes, other regulatory bodies, including the International Organization of Securities Commissions ("IOSCO"), the Financial Stability Board ("FSB") and the Bank for International Settlements, are also evaluating ETFs, particularly their potential implications for the stability of the financial system. We firmly believe that authorities and 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.98 trillion and serve over 90 million shareholders. 2 See ESMA/2012/44, Consultation Paper: ESMA's Guidelines on ETFs and Other UCITS Issues (January 2012). 3 As of December 2011, ETFs registered under the Investment Company Act of 1940 held $939 billion in assets under management, or 70% of the global ETF market. 4 See Letter From Karrie McMillan, General Counsel, Investment Company Institute, to Steven Maijoor, Chair, European Securities and Markets Authority, dated Sept. 30, 2011. Mr. Steven Maijoor March 30, 2012 Page 2 of 5 market participants must improve their understanding of the potential risks inherent in financial products and the ways in which such risks can be mitigated.5 We support ESMA's goals of improving secondary market investors' understanding of their status and rights with respect to purchasing and selling shares of ETFs, as well as seeking ways to strengthen the ability of such investors to sell their shares even during market disruptions. We have concerns, however, with ESMA's two proposed options for addressing the latter goal: 1) requiring

UCITS ETFs or their management companies to ensure that the market maker(s) of their shares continue to make markets whenever the market is open for trading; or 2) requiring the ETF to accept redemptions directly from shareholders.6 As to the first option, we are concerned that, practically speaking, an ETF may not be able to ensure that market makers will continually make markets to enable investors to sell their shares whenever the market is open for trading, i.e., even in the event of a major market disruption. Additionally, we strongly oppose ESMA's proposed alternative option to require ETFs to offer redemptions directly to secondary market investors; indeed, we believe this approach could harm investors, and potentially exacerbate market disruptions. We believe the more appropriate regulatory approach for seeking to protect secondary market investors is to pursue initiatives designed to improve the overall market structure and prevent such disruptions altogether, and to enhance investor understanding of the nature and potential risks of secondary market trading. Each of these approaches is discussed in more detail below. Improving Disclosure to Secondary Market Investors The proposed guidelines would require the prospectus and marketing communications of a UCITS ETF to include additional information for secondary market investors about their status and rights. Specifically, these communications would inform investors that that they must buy and sell shares on the secondary market with the assistance of an intermediary, that they may incur a fee for doing so, and that they may pay more than the current net asset value when buying shares and may receive less than the current net asset value when selling them. We support this requirement. We believe that it is of paramount importance that investors understand the product in which they have invested or are considering investing. Understanding how shares of a fund may be purchased or sold is fundamental to understanding an investment in the fund. ETFs regulated under the Investment Company Act are required to include similar disclosures in their 5 See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Secretariat of the Financial Stability Board, dated May 16, 2011, responding to the Financial Stability Board's note on Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds, available at http://www.ici.org/pdf/25189.pdf. 6 See Box 5 of the Paper at pp. 15-16. Mr. Steven Maijoor March 30, 2012 Page 3 of 5 prospectuses, which must be provided to secondary market investors.7 Such ETFs are also required to describe the principal risks of investing in the fund; these disclosures typically include additional information about the nature and potential risks of secondary market trading.8 Ensuring the Continued Ability of Investors to Sell in the Secondary Market The first option proposed by the guidelines would require, as one method of ensuring that secondary market investors can sell their shares whenever the market is open, that a UCITS ETF or its management company ensure that the market makers of the ETF shares continue to offer "redemption"9 to secondary market investors whenever the market is open, and that the ETF or its management company take appropriate action to replace the market makers if they fail to do so. This approach would further require that the ETF ensure the ability of shareholders to sell shares in the event of such a replacement or a market disruption, including by allowing investors to sell them directly back to the ETF or its management company. As discussed further below, we strongly oppose requiring an ETF to accept direct redemptions10 from secondary market investors in any circumstances. Further, we believe there are practical limitations with respect to requiring that the ETF or its management company make contractual arrangements with each market maker so that a market maker may not withdraw from secondary market activities unless it has been replaced. It is important to stress that high levels of secondary market trading activity are beneficial for ETFs, and U.S. ETFs seek to encourage such activity. A liquid secondary market for an ETF typically lowers the bid/ask spread that an investor pays, reducing the ETF's overall cost to investors and therefore improving its performance. However, we do not believe that an ETF or its management company could ever ensure that a market maker continues to make two-sided markets under any circumstances when the market is open. In the U.S., ETFs have no direct contractual relationship with their market markers; rather, the designation of lead market maker status is conveyed and remunerated by the ETF's listing exchange. We understand that in Europe some ETFs may have relationships with their market makers, either via 7 Form N-1A, the disclosure form applicable to open-end ETFs registered under the U.S. Investment Company Act of 1940, requires ETFs to state, among other things, that individual shares may only be purchased and sold on a national securities exchange through a broker dealer, that investors may pay brokerage commissions on their purchases and sales, that the price of shares is based on market price, and that shares may trade at a price greater than or less than net asset value. 8 For example, ETFs typically explain that it is possible that an active trading market in the ETF shares may not be maintained, and that trading may be halted due to market conditions. 9 We understand this to mean that market makers should make it possible for shareholders to sell their shares in the secondary markets. 10 Allowing investors to purchase directly from an ETF would also be problematic, for different reasons. Mr. Steven Maijoor March 30, 2012 Page 4 of 5 contract or as affiliates controlled by a common parent. Nonetheless, in a truly disrupted market, such as in the event of a major technological failure, the risk to the market maker from continuing to make markets could be far greater than the risk of being in breach of a contract. We do not believe contractual provisions could force market makers to maintain two-sided markets in such circumstances. The market events of May 6, 2010 in the U.S. are informative on this point. Faced with the risk of trading on inaccurate pricing information, coupled with the risk of potential trade cancellations and lack of transparency of market and order information, market makers – even lead market makers – pulled back from bidding for ETF shares.11 We believe the more appropriate regulatory approach to ensuring adequate market liquidity would be to pursue initiatives designed to improve overall market structure and limit such disruptions. ICI has strongly supported initiatives in Europe to address inefficiencies in the current structure of the financial markets and to ensure that regulatory changes encourage, among other things, robust liquidity in the markets.12 Many of our recommendations focused on the implementation of effective systems and controls to reduce the risks to the markets or trading that could negatively impact market liquidity. Requiring ETFs to Accept Redemptions Directly from Secondary Market Investors The second option proposed by the guidelines would require ETFs to accept redemptions directly from secondary market investors at any time. We strongly oppose this approach. As a threshold issue, 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, would face significant management and operational issues. The proposed guidelines do not specify whether such redemptions would be in cash or in specie, but both approaches are problematic. As the Paper notes, physical ETFs typically create and redeem large blocks of shares in specie. This process allows the ETF to be fully invested, i.e., not need to 11 See, e.g., Statement of Kevin Cronin, Global Head of Equity Trading, Invesco Ltd., to the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues August 11, 2010, available at http://www.sec.gov/comments/265-26/265-26- 31.pdf; Statement of Noel Archard, Managing Director, BlackRock, to the Joint CFTC-SEC Advisory Committee on Emerging Regulatory Issues, August 11, 2010, available at http://www.sec.gov/comments/265-26/265-26-33.pdf. 12 See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Directorate General, European Commission, dated February 2, 2011 (European Commission Review of MiFID), available at http://www.ici.org/pdf/24946.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Steven Maijoor, Chair, ESMA, dated October 3, 2011 (Consultation on Guidelines on Systems and Controls in a Highly Automated Trading

Environment for Trading Platforms, Investment Firms and Competent Authorities), available at http://www.ici.org/pdf/25546.pdf; and Letter from Karrie McMillan, General Counsel, Investment Company Institute, and Dan Waters, Managing Director, ICI Global, to Markus Ferber, Member, European Parliament, dated February 13, 2012 (Questionnaire on MiFID/MiFIR 2), available at http://www.ici.org/pdf/25827.pdf. See also Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Werner Bijkerk, Senior Policy Advisor, IOSCO, dated August 12, 2011 (IOSCO Consultation on Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency), available at http://www.ici.org/pdf/25408.pdf. Mr. Steven Maijoor March 30, 2012 Page 5 of 5 maintain cash on hand to meet daily redemptions, which is one key benefit of the ETF structure. If individual investors were able to redeem shares in small amounts in cash, the UCITS ETF would likely need to maintain more cash in its portfolio, which would impact The ETF's portfolio management, expenses, and returns, and would diminish this benefit of the ETF structure. Providing redemptions to individual investors in specie, however, would likely be unfeasible, in large part because more often than not an investor's ETF shares would translate into fractional shares of the underlying securities, which may not be transferred.13 More importantly, we believe that requiring ETFs to accept redemptions directly from shareholders in a disrupted market could harm investors, and could potentially exacerbate the market disruption. To meet redemptions in cash, an ETF would be forced to sell its securities into the disrupted market, potentially at a loss. This could harm all shareholders of the ETF, including those that do not redeem, by diluting the value of the fund. If the ETF offered redemptions in specie, investors in the fund would not see such dilution because redeeming shareholders themselves would sell the underlying securities. In either case, however, the sale of securities into a disrupted market could magnify any disruption. Rather than requiring ETFs to accept direct redemptions, we recommend pursuing initiatives designed to improve overall market structure and limit such disruptions, and to improve investor understanding of the nature and potential risks of secondary market trading. * * * * * We appreciate the opportunity to provide comments on the Paper. If you have any questions about our comments or would like additional information, please contact me (kmcmillan@ici.org or 202-326-5815) or Susan Olson, Senior Counsel – International Affairs (solson@ici.org or 202-326- 5813). Sincerely, /s/ Karrie McMillan Karrie McMillan General Counsel 13 As the Paper notes, there are also practical operational challenges associated with individual investors redeeming directly with an ETF. See Paper at p. 15, n.4.
