Deutsche Börse Group

Comments

ESMA
Discussion Paper

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

22 September 2011

Deutsche Börse Group appreciates the opportunity to comment on ESMA's discussion paper on policy orientations on guidelines for UCITS Exchange-Traded Funds (ETFs) and Structured UCITS. We have an interest in ESMA's work in this area given our strong presence as a trading platform for ETFs. Over the electronic trading platform Xetra®, Deutsche Börse Group offers access to more than 860 ETFs generating a total average monthly trading volume of about €14 billion. This represents among the most diverse product portfolios and highest turnovers in the segment of all stock exchanges in Europe.

Generally, we note that unlike actively managed funds, where the investment objective of the fund manager is to outperform a reference index, ETFs pursue a passive investment strategy, the aim of which is to replicate the performance of an underlying index as accurately as possible. Underlying indices may be national or international equity indices, bond and real estate indices, or commodity or strategy indices. The investor acquires an entire basket of securities in a single stock exchange transaction, enabling investment strategies to be implemented easily and efficiently.

Benefits to investors of ETFs traded on exchanges such as Xetra® include:

- Transparent price information
- Narrow bid/offer spreads due to high liquidity during continuous trading
- Low purchase and management cost without front load fee
- High degree of risk diversification with a single investment and facilitation of a variety of investment and trading strategies
- Protection from issuer risk due to separate pool of fund assets

We focus our comments on a subset of questions posed in the paper where we believe our expertise in ETFs from the perspective as a trading platform can provide most value.

Answers to selected questions

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.

The UCITS Directive aims at ensuring a high level of transparency by requiring prospectuses to include all information necessary for investors to be able to make an informed judgment of the investment, and, in particular, of the risks attached thereto. This is also apparent by the requirement that prospectuses shall include, independent of the instruments invested in, a clear and easily understandable explanation of the fund's risk profile.

In addition, investment companies are required to publish key investor information documents that include appropriate information about the essential characteristics of the UCITS concerned with the objective to enable investors to understand the nature and the risks of the investment product and, consequently, to take investment decisions on an informed basis.

We therefore do believe that the existing UCITS regulation already provides a sound framework for both institutional and retail investors to take self-directed, educated investment decisions in UCITS instruments. However, if current transparency requirements are considered insufficient for certain UCITS, we would welcome a strengthening of these requirements via a corresponding amendment of the UCITS Directive rather than limiting or even prohibiting the distribution of such UCITS to retail investors. Such action would also prevent retail investors actively seeking exposure to certain markets and strategies to switch to less-regulated and less-transparent products that may encompass significantly higher risks for the individual investor than any UCITS structure.

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'?

In general, we think that UCITS should not be considered complex investment products. However, if a certain portfolio management technique would be considered as complex, we believe that adequate transparency requirements could be established to provide investors with the information deemed necessary to enable self-directed, educated investment decisions.

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?

We believe that self-directed, educated retail investors should not be restricted from investing in UCITS as long as adequate information on the product and its risks is made available to the investor. Particularly, we do not support potential limitations on the distribution of synthetic UCITS ETFs to retail investors. We note that such limitations are not in place for many alternative investment products marketed to retail investors such as CFDs, certificates and warrants.

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?
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.
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.

No comment.

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.

We support the use of an identifier for ETFs.

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

We support the use of an identifier that distinguishes between passive and actively managed ETFs. With regard to index replication techniques, we believe it to be of greater importance that investors can easily access a clear and complete description of the technique employed by an ETF and of less importance that the technique itself is used as an identifier in the fund's name.

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

We believe that an identifier should also be used in the KIID.

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

No comment.

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

We agree with the policy orientations identified by ESMA.

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?

No comment.

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

We welcome the intention to further improve the transparency standard of UCITS ETFs and therefore support the disclosure proposals in the policy orientations identified by ESMA.

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.

No comment.

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

No comment.

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

We welcome the intention to further improve the transparency standard of UCITS ETFs and therefore support the disclosure proposals in the policy orientations identified by ESMA.

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?

No comment.

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

We welcome the intention to further improve the transparency standard of UCITS ETFs and therefore support the policy orientations identified by ESMA.

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?

No comment.

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

No comment.

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

We welcome the intention to further improve the transparency standard of UCITS ETFs and therefore support the policy orientations identified by ESMA.

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?

No comment.

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

We support the assessment that UCITS are retail products and suitable for all types of investors. However, as the name ETF already implies that these products are exchange-traded, we do not find it necessary to explicitly issue a warning regarding the latter. This is particularly true with regard to brokerage fees incurred for the purchase and sale of UCITS ETF shares, which are typical for all exchange transactions, and which may represent only a small fraction of the front load fees typically incurred for the purchase and sale of UCITS via traditional sales channels. An explicit statement regarding brokerage fees may also create the misleading impression that investors may have to incur fees in excess of the fees typically charged for an exchange transaction. We furthermore believe that other measures identified in this paper such as the introduction of a separate identifier for ETFs will provide sufficient transparency to investors regarding the exchange-traded status of ETFs.

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?

No comment.

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?

Deutsche Börse requires the commissioning of at least one market maker (Designated Sponsor) for continuous trading in ETFs. The core task of Designated Sponsors is to provide the market with liquidity by entering binding bid and ask limits (quotes) in compliance with certain minimum requirements such as a maximum spread and a minimum quoting volume. Designated Sponsors determine their quotes based on the portfolio composition files published by ETF issuers on a daily basis and thus are able to ensure that their quotes are close to the fund's current net asset value.

In addition, Designated Sponsors are able to create and redeem fund shares with the issuer and may therefore execute even large order sizes without resulting in a significant market impact for the investor. The same creation/redemption mechanism also enables Designated Sponsors and other Authorized Participants to exploit arbitrage opportunities if an ETF trades at a premium or discount to its net asset value, thus further minimizing potential deviations between the fund's market price and its net asset value.

Overall, we believe that the existing market mechanisms, in combination with the high level of transparency offered by ETFs through the availability of bid and ask prices and indicative net asset values (iNAVs) on a pre-trade basis, have resulted in a sound trading framework for investors. Therefore, we currently do not see the need for introducing a rule to prevent price deviations from the fund's net asset value.

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?

No comment.

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?

No comment.

Closing
We hope that you have found these comments useful and remain at your disposal for further information. If you have any questions please do not hesitate to contact:

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