30 March 2012

JAC Response to ESMA Consultation Paper on its guidelines for ETFs and other UCITS issues

This letter is a response to ESMA's consultation paper published on 30 January 2012 on ESMA's policy orientations on guidelines for UCITS ETFs and other UCITS issues (the ***Consultation Paper***).

The Joint Associations Committee on Retail Structured Products (the ***JAC***)[1] welcomes the opportunity for a public discussion of the matters raised in the Consultation Paper. The members of the JAC comprise most of the major firms (both financial institutions and law firms) involved in the creation within the EU of structured products that are distributed to retail investors. Many also deal with UCITS– both exchange-traded and traditional.

The JAC is aware that two broad objectives underpin the current regulatory interest in the UCITS market and, in particular, the ETF market: (a) systemic stability and the impact that products of this sort could have on that; and (b) investor protection. The Consultation Paper tends to focus on the second of these, as does this response.

Yours sincerely,

Timothy R Hailes

Chairman, Joint Associations Committee

---

1 The JAC is sponsored by multiple associations with an interest in structured products. In the first instance, queries may be addressed to ajacobs@isda.org.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you agree with the proposed guidelines?

We agree, in general, with the proposed guidelines but believe that certain points require further clarification:

(a) Participants have expressed concerns over the level of description of the index required in the prospectus and the requirement to publish the exact composition of the index, if it is proprietary in nature. Certain aspects of the index may contain proprietary aspects of a manager's strategy which are the basis on which funds compete. Provided the investor is supplied with sufficient detail on how the index operates and the assets in which it invests, further disclosure should not be required.

(b) The guidelines would benefit from a clear definition of the term "index-tracking UCITS". We recommend using the guidance already provided by Article 53 of the UCITS Directive 2009/65/EC (the "UCITS Directive"). Therefore, the following definition should be included in Box 1 of the ESMA guidelines:

"A UCITS qualifies as an index-tracking UCITS when, according to the fund rules or instrument of incorporation, the aim of the UCITS` investment policy is to replicate and track the performance of an eligible index."

A distinction should also be drawn between UCITS which are actually tracking UCITS and those which are linked to an index but which may have a separate component to its investment objective and policy.

(c) As well as the proposals in the guidelines, an absolute level for tracking errors should be included, above which a UCITS cannot claim to be an index tracking UCITS. Any maximum tracking error should have sufficient margin so that newly created funds or indices will not fall foul of the level.

(d) Participants note that neither the target tracking error nor maximum tracking error should be disclosed in the prospectus or annual report as this may prove misleading for investors.

Participants noted that it would be more appropriate to disclose the tracking difference and/or tracking error in the KIID which is updated annually, so that investors can see what the actual tracking difference and/or tracking error has been. The past performance chart in the KIID would clearly show the tracking difference by comparing the actual fund performance against the benchmark index.

Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs?

We believe that there is merit in producing further guidelines for calculating tracking errors. Additional guidelines would go some distance in distinguishing between "tracking errors" and "tracking differences". Tracking errors and tracking differences will occur in all index tracking products and we believe that precise guidelines will allow better harmonization and comparability between different funds. In terms of definitions, we suggest the following wording:

"Tracking Error" - ESMA already provides a summary definition in point 5, page 7 for "tracking error" and a proposed definition would be as follows:

"For index-tracking UCITS, the tracking error is usually defined as the volatility of the difference between the return of the index-tracking UCITS' portfolio and the return of the benchmark or index. The tracking error helps measure the quality of the replication."

"Tracking Difference" – We propose the following definition:

> *"Tracking difference is defined as the annualised difference in total returns between a fund and its underlying benchmark index over a specific period of time. Tracking difference can be calculated as an absolute measure and a relative measure."*

We recommend that the following criteria be used to calculate tracking errors:

> *"Tracking Error is calculated as the daily (weekly, monthly) annualized standard deviation of the daily (weekly, monthly) index/ETF log return difference.*
>
> *A minimum of 30 data points is recommended to achieve a statistically significant measure."*

We recommend that the following criteria be used to calculate absolute tracking differences

> *"The absolute tracking difference over a certain time period is calculated as the cumulative total returns in the index tracking UCITS minus the total returns of the underlying benchmark index."*

Example:

Description	**UCITS NAV**	**Index Value**	**Absolute Difference (ETF-Index)**
31.01.2011	54.7762	548.0100	-
31.01.2012	62.1257	623.0100	-
Total Return	13.417%	13.686%	-0.269%

We recommend that the following criteria be used to calculate relative tracking differences

> *"The relative tracking difference over a certain time period is calculated as the cumulative total returns in the index tracking UCITS divided by the total returns of the underlying benchmark index. The relative measure removes the price movement over the specific period from the calculation and provides a more accurate picture of the actual total return difference between the index tracking UCITS and the underlying benchmark index over the specific period."*

Example:

Description	**UCITS NAV**	**Index Value**	**Relative Difference (UCITS / Index)**
31.01.2011	54.7762	548,0100	-
31.01.2012	62.1257	623,0100	-
Total Return	13.417%	13.686%	-0.236%

Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?

We believe this is not necessary and is dealt with sufficiently in the past performance section of the KIID.

Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?

In principal we agree with the proposed guidelines for index-tracking leveraged UCITS.

However, the guidelines would benefit from a clear definition of what an "index-tracking leverage UCITS" is and suggest that one be developed by ESMA. There are various UCITS index strategies which incorporate a leveraged element but which should not be considered an index-tracking leveraged UCITS. As noted in Question 1, we believe that the definition should be based on the guidance provided by Article 53 of the UCITS Directive and suggest a definition as follows:

> *"A UCITS qualifies as an index-tracking leveraged UCITS when, according to the fund rules or instruments of incorporation, the aim of the UCITS` investment policy is to provide investors with a constant leveraged exposure (both long and short) to the performance of an eligible index."*

We think it is important to distinguish between non-leveraged UCITS which track a leveraged index and leveraged UCITS which track an index which may or may not itself be leveraged. In the former case (in particular for interest rates and FX indices and long-short equities indices), the leverage applied is at index level and is a consequence of the index being based on swap components (and the implied leverage given the difference between swap premium and swap notional). There is still a one-for-one relationship between the investment in the fund and the total return swap that the fund may enter into to gain exposure to such a leveraged index.

We also think it is important to distinguish between leveraged UCITS which actually track an index and leveraged UCITS which are linked to a UCITS but which may have a separate component to its investment objective and policy.

Q5: Do you believe that additional guidelines should be introduced requiring index-tracking leveraged UCITS to disclose the way the fund achieves leverage?

Broadly speaking we believe that the current guidelines are sufficient. However, there could be merit in disclosing the level of leverage to investors (such as "twice leveraged", "double leveraged" or "x2").

Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?

We broadly agree with the definition.

There is a general consensus that there should be a focus on the role of the market maker and that the requirements relating to the market maker should be more closely defined. The following definition would, therefore, be more appropriate:

> *"A UCITS exchange-traded fund ("UCITS ETF") is a UCITS at least one unit or share class of which is continuously tradable at the initiative or with the prior consent from the UCITS management company or UCITS investment company on at least one regulated market or MTF with at least one market maker which takes action to ensure that the value of its units or shares does not significantly vary from their net asset value."*

We would like clarity on whether the ETF classification will be an optional classification for UCITS ETFs or whether it will be a compulsory classification in the event UCITS ETFs meet the conditions set out in the definition.

Q7: Do you agree with the proposed guidelines in relation to the identifier?

We broadly agree with the proposed guidelines in relation to the identifier.

Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?

We believe strongly that the identifier should not distinguish further between synthetic and physical ETFs and that the more appropriate place to disclose whether a UCITS ETF follows a synthetic or physical investment policy or whether an ETF follows an actively managed strategy are in the prospectus and the KIID.

Such classification would highlight an aspect of the UCITS which is secondary to the overall purpose (i.e. the way the fund replicates the index). There is, therefore, a risk that focusing on the synthetic/physical distinction of the UCITS would mislead investors. In addition, there may be confusion around dual-physical and synthetic providers.

Q9: Do you think that the use of the words 'Exchange-Traded Fund' should be allowed as an alternative identifier for UCITS ETFs?

We believe there is little merit in requiring the use of the words "Exchange-Traded Funds" as an alternative identifier for UCITS ETFs.

Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?

While we believe that there is some merit in assessing the suitability of market makers, we do not believe that there should be a strict minimum number of market markets imposed on a UCITS. In practice it can be difficult to attract market makers for certain products. Generally they will be willing to market make the simple or blue chip ETFs but not certain other more complex ETFs. The result could create barriers to entering the market.

UCITS are free to select a higher number of market makers if this is a decision which would benefit the investors.

Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in the prospectus, the KIID or any marketing communications of the UCITS ETF?

The JAC in general agrees with the proposed guidelines.

However, we do not believe it is necessary to disclose how the indicative net asset value (iNAV) is calculated. The calculation is not relevant for investors as they will buy at the offer price on an exchange. There is no guarantee that this will be close to the iNAV, especially where markets for the underlying securities are closed. The exchange price has economic value to market participants, whereas the iNAV has only theoretical value which cannot be corrected by market forces if incorrect. In addition, the calculation of the iNAV is not part of a fund manager's duties and is typically performed by an external service provider based on proprietary systems and methodologies.

Q12. Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?

Our preferred option is Option 1. We have no alternative proposals.

Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.

The JAC believes that Paragraph 2 of option 1 in Box 5 provides sufficient protection.

Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.

We have no comments on this matter.

Q15: Can you provide further details on the relationship between the ETF's register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?

We have no comments on this matter.

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

In general, we support proposals to increase the transparency and strengthen the risk mitigation of EPM techniques. However, we do have a certain number of concerns with the proposed guidelines. The main focus is to ensure that collateral comprises high quality and, more importantly, highly liquid assets given that investors only have exposure to collateral in the event of a default and receive additional protection via a haircut policy.

We believe that the guidelines would benefit from the following clarifications:

(a) <u>Point 4</u>: The fee split requires further clarification. It is not clear enough in which cases the securities lending agent may be a related party to the UCITS or the investment manager (see 44. on page 17).

(b) <u>Point 5</u>: The guidelines in paragraph 5 could prevent a UCITS from entering into securities lending transactions for a fixed term. This would not be in the interests of investors.

(c) <u>Point 6</u>: The application of the CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk (CESR/10-788) would restrict the re-investment of cash collateral in "risk free" assets only. This undermines the use of cash as collateral and we therefore suggest allowing UCITS to apply their general investment policies for cash.

(d) <u>Point 7</u>: Counterparties and UCITS would face significant operational hurdles to comply with the proposed rules to an extent that many transactions would not be viable because of the difficulty to manage collateral in the way the rules would require it.

Typically, both counterparties would define the eligibility rules for collateral for specific transactions which are set out in a written document (Credit Support Annex or CSA). This will set out requirements concerning eligible asset classes and other risk parameters such as the general credit quality of the assets (including closed links, for examples). When the counterparty is required to secure a position, the collateral will be "tested" whether it meets these eligibility criteria either by the UCITS itself or typically through another agent (e.g. the custodian bank).

Under the proposed rules, participants would have to introduce an additional eligibility test that would restrict certain assets depending on the portfolio composition of the UCITS at that moment. As a result, counterparties would not only i) have to apply daily changing eligibility criteria creating additional risk of operational error and dispute, they would also have to ii) establish an additional pre-trade check between the trading decision and the collateral process because the acquisition of certain assets could change whether any additional collateral would still meet the diversification rules. In a worst case scenario, an additional investment in a certain asset could not be executed unless collateral already received would be substituted for other assets.

Such a process creates an unwarranted dependency between trading and collateral decision whose benefits are outweighed by the additional risks it introduces. Ultimately, it may preclude many funds from entering into any EPM techniques at all. So whilst it is obvious that collateral should be diversified, we believe that a cross-check to the investment portfolio would be counterproductive. We propose to delete this requirement from the future guidelines. A more pragmatic approach would be to reconcile overall concentration risks at regular intervals allowing for some tolerance levels.

(e) Point 9: It should be highlighted that in practice haircuts for collateral are subject to negotiations between the involved parties. The negotiations involve economic and risk aspects. An investment manager should have the possibility to agree on margin on a bilateral basis with the counterparty taking into account its own credit risk evaluation and should therefore not be forced to take into account margin requirements of exchange-traded derivatives which follow a different approach, as proposed in the draft guidelines.

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If not, please explain.

Subject to our concerns set out in question 16 above being considered and implemented, we believe the guidelines will set standards that will ensure that the collateral received in the context of EPM techniques is of good quality.

Q18: Do you see merit in the development of further guidelines in respect of the reinvestment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?

We believe that the treatment of cash collateral received in the context of EPM should be treated identically to cash collateral received under an OTC derivatives except that cash reinvestment from securities lending should be excluded from the CESR guidelines for OTC derivatives.

Q19: Would you be in favour of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio? Please explain your view.

We are not in favour of requiring a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio.

The key issue is that an equivalent level of cash can be obtained in case of counterparty default. In this context we note for example, that the European Markets Infrastructure Regulation (EMIR) does not require collateral to mirror the underlying index or instrument. Rather, the EMIR requirements reflect the purpose of collateral.

The objective of collateral is to cover counterparty risk. We do not believe that a high correlation between the collateral provided and the composition of the UCITS' underlying portfolio is helpful. In our opinion the emphasis should be on having collateral which is highly liquid. A high correlation between the collateral and the composition of the UCITS' portfolio may in fact be problematic. In case of a counterparty default the collateral will be liquidated and the proceeds will be used to buy the loaned securities in the market. Therefore, the most important feature of the collateral is its liquidity, allowing the sale of collateral and the purchase of the securities to take place simultaneously.

Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

No. We believe that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should not be required to comply with the UCITS diversification rules. Different rules apply to the collateral and the assets of the UCITS as they serve a different purpose – the two should not be confused and a distinction should remain between them. The liquidity and quality of the collateral are of a higher importance than diversification rules. It would not be in the interest of the investors to be forced to accept less liquid collateral in order to adhere to diversification rules.

Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Our preference is for a list of qualitative criteria as set out in CESR's guidelines on risk measurement. An indicative list may bring a level of volatility into eligibility criteria that are undesirable. By way of example, CESR/10-788 requires collateral to meet certain issuer credit quality standards. The indicative list (page 19f) however generally includes bonds admitted by the ECB. The ECB recently temporarily suspended the application of minimum credit ratings for certain government debt. An alternative option is to leave funds to set their own rules based on high level principles which should be complemented by practical guidelines how the compliance could measured e.g. using average daily trading volume to measure liquidity of stocks etc.

Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.

No, we do see merit in prescribing an exhaustive list of assets eligible for use as collateral.

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transactions when calculating the maximum exposure under Article 52(1) of the UCITS Directive?

No, we believe that such an approach would create a contradiction between these guidelines and existing CESR guidelines. CESR/10-788 already provides that any net exposure to a counterparty generated through a stock-lending or repurchase agreement must (also) be included when calculating the issuer concentration limits of 20% specified in Article 52 (2) of the UCITS Directive. Such fact has already been highlighted in paragraph 46, on page 18 of this consultation paper.

The counterparty risk created by EPM techniques should not fall under the counterparty risk as defined in Article 52 (1) of the UCITS Directive but should rather fall under Article 52 (2) (c) (2nd sub-paragraph) of the UCITS Directive.

Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?

We agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?

As long as securities lending is sufficiently collateralised, we would question what the rationale for such a limitation would be.

Q26: What is the current market practice regarding the proportion of assets that are typically lent?

The market practice for the amount that is lent differs per asset class and per exposure (there are various factors which affect the proportion of assets lent, e.g. current market circumstances, dividend season, quality of assets and client demand). While it is generally low, it is clear that in some cases the amount lent can be very high and can represent a significant proportion (more than half) of the portfolio.

Some physical providers seem to set a limit of 95% of the UCITS that can be lent out. During dividend season the figure for equity funds is typically quite high. Outside of dividend season the amount that is lent is gerenally much lower.

Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

We believe that securities lending should encompass the rehypothecation risk of assets, so that investors are able to understand the counterparty risk inherent in the structure. Investors may also wish to have transparency on the assets that have been lent out, and not just on the percentage of assets that are lent.

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?

Assuming that "fund rules" refer to the establishment documents of the UCITS (e.g. articles of incorporation), we do not believe that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules.

Furthermore, the JAC have concerns about the practical implication of including the required information in the prospectus. It is unclear what information is required in respect of each counterparty. The information required may be subject to frequent change. In particular, a UCITS may invest with different market counterparties on a regular basis and it is impractical to continually update the counterparty risk disclosure within a prospectus. In addition to the practical difficulties, regular prospectus updates would lead to significant administration and legal costs for the UCITS and would also increase passporting costs.

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

We believe such a requirement would provide limited additional value. At best, we believe that identification could occur in the yearly and half yearly reports.

Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interest?

We believe that within an affiliated group any potential conflicts of interest can be managed by ensuring that there are clearly defined boundaries between the depositary functions and the collateral management functions and by ensuring that this is captured in a robust conflicts of interest policy.

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

The concept 'automation of portfolio management' requires further clarification. We believe any such flexibility should be subjected to strong and effective risk controls from the Investment Manager. Regulations should not allow the counterparty to freely post any collateral and parameters relating to the collateral posted should be built into an automated system. The lending agent should not be allowed to freely choose the securities that are lent. There should be some regulations governing the approval of the securities being lent and any collateral received before such the transaction is actually put in place.

Q32: Do you agree with the proposed guidelines?

We generally agree; however there are a number of points which require clarification:

(a) Point 1: In the case of a total return swap we suggest referring to a delta adjustment of the swap underlying. We believe that a reference to "UCITS diversification rules" does not correctly reflect the use of a Total Return Swap which is in line with the UCITS rules regarding risk and investment in derivatives. ESMA has such a delta weighting/calculation already in CESR/10-788 (see Box 27, paragraph 4 and 5 and Box 2).

(b) Point 5 a): During the lifetime of a UCITS the requested information changes often and counterparties may change due to economic reason. The information should not be contained in sales prospectuses and a more flexible approach is needed.

(c) Point 5 c) and d): We believe that there should be a balance between situations where a counterparty has discretion over the composition/management of a portfolio and where it may require a certain level of discretion over the portfolio for purely operational reasons. The JAC does not advocate situations where Investment Managers, in practice, absolve themselves of responsibility for investment management decisions by entering into a swap transaction which effectively transfers management responsibility of a portfolio to a counterparty. Where the counterparty has discretion over the composition/management of the portfolio, this should be disclosed and highlighted in the sales prospectuses. However, we believe that the words "any other discretionary decision" as outlined in d) of paragraph 5 may result in difficulties where, for example, a counterparty may have to decide on corporate actions of equities that are part of the swapped portfolio or where they are required, for technical reasons, to rebalance a swap. These decisions do not influence the management of a portfolio but would be captured under the words "any other discretional decision". Therefore, "any other discretionary decision" should be either be deleted or amended to "any other material discretionary decisions" to ensure that in minor cases the counterparty can act in accordance with derivative terms as agreed by the counterparty and the fund manager without being defined as the "investment manager".

    Importantly, there are no requirements for a counterparty to be classified as an investment manager when securities are lent out and collateral is posted by the counterparty freely. ESMA does not propose to treat the counterparty of securities lending operations or the lending agent as an Investment Manager. In the name of fairness, consistency and to avoid regulatory arbitrage, we believe that ESMA should treat similar economic transactions equally. ESMA should also consider how a UCITS could manage a constant change on counterparties, which is a regular feature of total return swaps.

Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return swaps is of good quality? If not, please explain your view.

Subject to the points set out under our response in question 32, we believe that the proposed guidelines set standards that ensure that the collateral received in the context of total return swaps is of good quality.

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?

Assuming that "fund rules" refer to the establishment documents of the UCITS (e.g. articles of incorporation), we do not believe that the information to be disclosed in the prospectus in line with paragraphs 5 of Box 7 should be included in the fund rules.

Furthermore, the JAC has concerns about the practical implication of including the required information in the prospectus. It is unclear what information is required in respect of each counterparty. The information required may be subject to frequent change. In particular, a UCITS may invest with different market counterparties on a regular basis and it is impractical to continually update the counterparty risk disclosure within a prospectus. In addition to the practical difficulties, regular prospectus updates would lead to significant administration and legal costs for the UCITS and would also increase passporting costs.

Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

Please see our response under question 21 above.

Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.

Please see our response under question 22 above.

Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

Please see our response under question 20 above

Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?

The JAC generally agree.

Q39: Do you consider the proposed guidelines on strategy indices appropriate? Please explain your view.

The JAC considers that the proposed guidelines would create many legal uncertainties. In particular:

(a) The guidelines would benefit from a clear definition of "Strategy Index" and "UCITS which replicates strategy indices";

(b) Point 1: While the focus should remain on ensuring the weighting of the components of an index comply with the UCITS diversification rules, there should be some degree of flexibility to deviate from those limits temporarily where such deviation results from market movements, provided that regular rebalancing is applied to bring the index back within the UCITS weightings. ESMA should limit this requirement to UCITS using the 35% limit on a single component as set out under Article 53(2) of the UCITS Directive. ESMA should mention clearly in its guidelines that this requirement only applies to UCITS that intend to make use of the increase diversification limits. Otherwise, standard diversification limits should apply.

(c) Point 2: We believe that this guideline may be breached regularly in practice if the price of a single equity moves significantly on a day where the remaining equity components move very little. It can be argued that up to 100% of the movement in the index on that day was driven by the performance of one stock. The stock may still represent less than 20% of the value of the index/portfolio (or the UCITS as a whole based on our proposed test above), ensuring that the diversified investment exposure interest is still met, irrespective of the higher return impact which the stock has had on that day. We therefore view the 20%/35% limits as needing to refer solely to the weighting of a component (including any leverage factor in the index) in the UCITS.

(d) Point 3: The reference to 'commodity indices' is redundant since the diversification requirements for non-UCITS eligible assets are already mentioned in Article 9 (1)(a), (iii) of the Eligible Assets Directive 2007/16/EC (the "Eligible Assets Directive") and should be deleted accordingly. Furthermore, the JAC disagrees that commodity indices must consist of different commodities which respect the 20/35% limit in order to be considered an eligible index as this would exclude single commodity indices where the components are sub indices with different futures, roll yields and maturities and, given the components of these indices, there is already a sufficient level of diversification within the index. We would also add that it is often not appropriate to aggregate single commodities.

An index which tracks a specific commodity future (example WTI Dec contracts) provides a risk/return exposure which is different from a commodity index which does not track a specific future. A commodity index which does not track a specific future has a pre-defined rolling program which systematically tracks a defined future contract (first, second or third contracts) at a predefined period. By having these predefined terms, the index can generate a systematic cost for the UCITS. Investing in diversified indices does not allow the UCITS to hedge properly a risk on a specific commodity. Furthermore, in the commodity market, the front end future contract price can be lower than the back end future contract price. In this case, on the contract rolling date, the index has to sell the front end contract at a lower price and buy the back end contract at a higher price in order to continue to trade the commodity, causing a structural lost for the fund and therefore for the shareholders. Investing in commodities is not more risky than the resulting exposure on certain asset classes as volatility trades on an eligible asset class. Funds investing in single commodity indices should disclose it in their prospectus and highlight the risk to investors. CTA uses the investment in commodity for diversification purposes. The investment is sized in line with the expected return, volatility and correlation of other assets in the portfolio. Given that any commodity index would be aggregated with the rest of the portfolio under the 5/10/40 rule, we do not believe that imposing further restrictions are necessary for investor protection and investing in single commodity indices under the 5/10/40 rules provides better diversification that investing in a diversified commodity index within the 35/20 rule.

Please note that we believe the same point can be made in the case of interest rate and FX indices (as mentioned under paragraph 81). We believe that the same challenges will be faced if a UCITS is limited to invest in interest rate and FE indices which respect the 20/35% limit. Interest rates or FX indices should by their nature be eligible assets as there is no issuer risk which may exists with, for example, equity indices. A more suitable test for eligibility could be that there is an open market, operating with a number of participants in any given currency and for a certain term.

(e) Point 4 a): Many major indices have multiple objectives (to maximise return, reduce risks via diversification and reduce volatility via a large cap equity stock exposure strategy, whilst remaining a tradable index) and to focus on a single objective may be detrimental to investors and reduce investor choice.

(f) Point 4 c): We believe further clarity is necessary in this area.

(g) Point 5: Where the rebalancing frequency is known at the outset, this can be included in the prospectus. Where it will vary depending on factors such as market movements or market disruption, it should be sufficient for the index to state that these factors may trigger future rebalances in the index without giving specific details.

With respect to costs within the index strategy associated with rebalancing, it is generally not possible to detail upfront in a prospectus what the transaction costs associated with each rebalancing are as these will depend on the trigger for the rebalance and market costs at the time of the rebalance. Accordingly, in relation to disclosure in the UCITS' prospectus of the effects on the cost within the strategy due to any rebalancing, it should be sufficient to disclose that rebalancing may have an affect on transaction costs, along with the expected materiality, if this is known at the outset.

(h) Point 6: The current draft on replication is not consistent with Article 9 (1)(b)(ii) of the Eligible Assets Directive and represents its extension rather than interpretation. The directive does not link the ability to replicate financial index to the protection of investors.

The rebalancing frequency of an index should be reflective of the market which it is seeking to track. As markets have different frequencies, indices which rebalance intra-day or daily should be eligible. Were such a rule imposed then it would be impossible for certain markets to be tracked accurately by a UCITS since the indices for such markets would not be eligible – this is not in the interest of investors. In any event, frequency of rebalancing does not, of itself, render replication impossible.

(i) Point 7: The level of detail required to be provided by the index-provider should be calibrated in terms of commercial sensitivity and intellectual property rights.

(j) Point 11: The calculation of indices is reliant on data feeds which do on occasion contain errors which in turn result in errors in the index value calculated using that data and often those errors are not notified to the index provider until after the index values have been published. Any restriction on the restatement of index values will impact on tracking errors and the potential for funds to provide subscriptions and redemptions at net asset value for certain index-tracking funds. We believe a limited right to restate previously published index values in light of data, systems or other errors, as being essential to the proper operation of an index and the associated product.

(k) Point 12: We consider that obligations on a manager should be to ensure that the index is eligible to be a UCITS index. Guideline 12 could be interpreted as imposing additional obligations on UCITS' manager in respect of due diligence on the index which could unfairly burden the UCITS manager and result in having to apply additional threshold checks on an index which already meets UCITS eligibility criteria.

(l) Point 13: How does the independent assessment of the index differ for the due diligence required in point 12?

(m) Point 14: It is not clear what is meant by independent valuation - indices have levels but not values. Whilst it would be possible to ask independent third parties to verify index levels, it may be a cause for concern for investment managers who do not wish to disclose their proprietary methodologies. In many cases, underlying component valuation may depend on proprietary models, as opposed to published prices, especially for strategy indices that are reliant on, for example, interest rate curves. These values can be objectively verified by auditors and in the course of a due diligence but for commercial reasons are not freely available.

(n) Paragraph 81: Please note that we believe the points made under (d) point 3 above can also be made in the case of interest rate and FX indices. We believe that the same challenges will be faced if a UCITS is limited to invest in interest rate and FE indices which respect the 20/35% limit. Interest rates or FX indices should by their nature be eligible assets as there is no issuer risk which may exists with, for example, equity indices. A more suitable test for eligibility could be that there is an open market, operating with a number of participants in any given currency and for a certain term.

(o) Paragraph 83: Proprietary methodologies are the basis on which investment managers compete and are therefore commercially sensitive. Therefore, they should not be required to be fully disclosed. As long as an investor understands how the index operates and into which assets it invests – via appropriate disclosures – the interests of the investor are sufficiently protected. In this context we also disagree with the statement that strategy indices involving undisclosed proprietary information should not be considered eligible financial indices.

There are a number of benchmark indices which would be impossible to replicate, unless a licence agreement is entered into with an index provider. The major index sponsors withhold this information in order to monetise their proprietary methodologies. Proprietary methodologies developed by investment managers should not be treated differently from such benchmark indices. Therefore, should this measure be implemented then it must, in the interests of fairness, be equally applied to all financial indices (rendering many existing benchmark indices ineligible). It is not in the interests of investors to reduce the diversity of UCITS available to them.

The JAC would question the benefit for investors from being able to fully replicate any financial index tracked by a UCITS. Were this the case then UCITS tracking the benchmarks discussed above would not be as popular as they are. What is important for investors, is to understand that there are elements of the methodology that are withheld for commercial reasons, but that there are firm rules and methodologies in place to ensure the integrity of the index. In the experience of members, for indices where proprietary information is not provided, members very rarely receive requests for such information and have not received feedback from investors that this is of concern to them.

Furthermore, innovation amongst index providers will be stifled if it is not possible to protect intellectual property. This is not in the interests of investors.

Q40: Do you think that further consideration should be given to potential risks of conflict of interest when the index provider is an affiliate of the management company?

The JAC believes that once the management company has a clearly documented conflicts of interest policy no further requirements are necessary. There is merit in ensuring that indices should be, at the very least, calculated by an independent function within the UCITS' promoter that is subject to effective information barriers (see also our response to Question 41 below).

Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.

In general we consider the proposed transitional provisions appropriate.

However, we believe that it is inconsistent to grandfather fund rules but not rules governing collateral and would propose that there is no differentiation between the two.

<u>Paragraph 89:</u> We believe that existing investors should be permitted to continue to make further subscriptions into a sub-fund that does not comply with the new guidelines. It would be prejudicial to their interests if they were not permitted to manage their holdings by making further subscriptions over the life of the UCITS. In particular, large proportions of the fund investor base are actively allocating on behalf of several portfolios across multiple funds and therefore need to be able to make regular subscriptions and redemptions. It is not sufficient merely to allow existing investments to retain their existing holdings without this flexibility.

There are many reasons why investors need the ability to rebalance allocation including (1) market movements e.g. if equities drop by 20% in any week the relative proportion between the different asset classes will need to be readjusted, (2) the portfolios themselves having continuous client flows from end clients of the intermediary fund of funds, (3) even within a sub-allocation e.g. alternatives, weekly rebalancing is required due to relative performance differentials between managers in the strategy.

Furthermore, given that a very large proportion of investors hold their assets via depositories/custodians/nominees, it is difficult, if not impossible to identify the actual investors. As a result, the only viable and equitable result is to allow existing funds to continue to accept subscriptions without restriction.

The prospectuses of grandfathered funds should indicate that they were established prior to the implementation of any new guidelines.

Irrespective of the transitional provisions that are implemented, it should be clear that there will be an adequate time period between the introduction of any new rules and the cut-off date for new investments. We believe that it is important for the orderly conduct of the market, and in investors' best interests, to enable a period of time for investors to make decisions in relation to their holdings, and for promoters to assess the future viability of funds. This period would need to be significant as only allowing a short amount of time would lead to an exceptionally disorderly market. As such the transitional period should last beyond 2012.

Finally, with regards to point 3 of Box 9, we understand that this provision is a grandfathering provision especially for indices which comply with either Article 53 of the UCITS Directive or with Article 9 of the Eligible Assets Directive. We understand that these indices – and to be more precise, the investments made in such index derivatives - still remain eligible for UCITS. We further understand that adaptations (increases or decreases) of the notional value of a Total Return Swap (which swaps an index performance) does not qualify as a new "investment" which would then not benefit from the grandfathering rule in point 3 of Box 9. However, text should be further clarified to ensure interpretation in the respect.

We would like to take this opportunity to raise a point relating to the transitional provisions for collateral posted to Structured UCITS which were launched prior to the publication of

We would like to take this opportunity to raise a technical point with respect to the transitional provisions for collateral posted to Structured UCITS which were launched prior to publication of CESR/10-788. The exemption provided by ESMA for compliance by Structured UCITS to these guidelines (ESMA/2011/112) cover the requirements set out in Boxes 1 to 25. ESMA acknowledged that if Structured UCITS were obliged to comply with the guideline it may be detrimental to the fund payout. We believe that the same principle is equally applicable to Box 26 of CESR/10-788 and we believe that the same exemption should apply to Box 26 for Structured UCITS launched before CESR/10-788 was published. Structured UCITS payout terms are designed based on collateral costs for specific collateral assets, with such costs fixed for the life of the fund. Any post-launch change to the collateral rules would impact the pre-defined payout terms set out in the fund documentation, which would not be a positive outcome for investors.

ABOUT THE ASSOCIATIONS

British Bankers' Association

British Bankers' Association ("BBA") is the leading association for UK banking and financial services for the UK banking and financial services sector, speaking for over 220 banking members from 60 countries on the full range of the UK and international banking issues. All the major banking players in the UK are members of our association as are the large international EU banks, the US banks operating in the UK and financial entities from around the world. The integrated nature of banking means that our members are engaged in activities ranging widely across the financial spectrum encompassing services and products as diverse as primary and secondary securities trading, insurance, investment banking and wealth management, as well as deposit taking and other conventional forms of banking.

International Swaps and Derivatives Association

Since its founding in 1985, the International Swaps and Derivatives Association has worked to make over-the-counter (OTC) derivatives markets safe and efficient.

ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. The Association has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool.

Today, the Association has more than 815 members from 58 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.

ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of the Association toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

UK Structured Products Association

The UK Structured Products Association (UK SPA) is an organisation established by companies that create and distribute structured products to the UK financial services market in order to provide a useful and responsive source of information, education and comment on structured products by promoting their contribution to effective financial planning.

The Association's formation is a direct response to the members' belief that structured products are sometimes misunderstood and misrepresented and that this lack of understanding can prevent structured products forming an integral part of financial planning for investors.

The UK SPA is committed to publishing research, information and educational material about structured products and so create greater acceptance about their potential.

The UK SPA is not a commercial organisation and education and research are its core activities.