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Discussion Paper on ESMA's policy orientation on guidelines for UCITS Exchange-Traded Funds and Structured UCITS (the "Discussion Paper")

The Italian Association for Certificates and Investment Products (*Associazione italiana certificati e prodotti di investimento*, in acronym "**ACEPI**"), which counts among its members a number of leading investment banks, pursues the objective of promoting investment products, improving their knowledge among market participants and investors and supporting the sustainable development of the relevant market. For further information, please refer to www.acepi.it.

ACEPI is very supportive of measures that are aimed at creating an efficient and transparent market for investment products and safeguarding investors.

The association therefore welcomes the opportunity to respond to ESMA's Discussion Paper and hopes that its comments will assist ESMA in developing proportionate guidelines on this subject matter.

We set out below our replies to selected questions raised in the Discussion Paper.

PART II. GENERAL POLICY DISCUSSION

1. QUESTION 1

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.

- 1.1 These proposals appear closely linked with the ongoing debate in the context of the MiFID review relating to the proposed changes to Article 19(6) of MiFID and the concept of complex/non-complex products for the purposes of the appropriateness test. We note that the issue of



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increasing retail investors' protection by revising MiFID's automatic categorisation of all UCITS as non-complex products was already examined by CESR in 2010¹. In that occasion CESR:

- (a) noted that market participants' views were sharply divided on whether introducing a differentiation within the UCITS category between complex and non-complex products was appropriate;
- (b) refrained from making a proposal to change the current MiFID regime; but at the same time
- (c) conceded that there was a case to consider treating "*structured UCITS and UCITS which employ complex portfolio management techniques*" as complex financial instruments for the purposes of the appropriateness test².

1.2 This last point was followed up in Question 89 of the Public Consultation on the Review of MiFID launched by the European Commission on 8 December 2010³, to which again many market participants (including Efama, Assogestioni, J.P. Morgan Asset Management, Deutsche Börse Group) responded opposing the proposal to differentiate within the UCITS category and highlighting the potential fallacies of any differentiating criteria.

1.3 It seems therefore that the common guidelines which ESMA is specifically considering for the retail marketing of synthetic ETFs and structured UCITS may not be developed irrespectively of the ongoing MiFID review process and that any such guidelines should be coordinated with, and may not override nor anticipate, the final decisions taken on the review of Article 19(6) of MiFID, given that the latter specifically relates to the protection of retail investors from access to complex products. Further, we do not believe that additional conduct of business rules (such as restrictions on distribution or issue of warnings) should be specifically imposed for structured UCITS and synthetic ETFs beyond the general rules of suitability and appropriateness, as this would unjustifiably single out two types of products within the vast universe of investment products available to retail investors, many of which (as recognised by ESMA itself, see for example the case of notes issued by SPVs) present a higher structural risk profile than structured UCITS and synthetic ETFs.

1.4 As to the merits of intervening on the marketing of synthetic ETFs and structured UCITS to retail investors, we do not see any specific reason to limit the debate as to whether restrictions to the distribution of complex products should be introduced for structured UCITS and synthetic ETFs only, especially in light of the fact that UCITS as such are already subject to a rather stringent set of rules and regulations. We note that in the majority of cases access by retail investors to UCITS occurs outside the context of execution only transactions, and is therefore assisted by the conduct of business rules relating to suitability (where investment advice is provided) and appropriateness (in all other cases). Therefore in our view the protection provided by MiFID in respect of the marketing of investment funds, which is based on the correct profiling of clients by the financial intermediaries or asset management companies marketing the funds, coupled with

¹ *Technical Advice to the European Commission in the context of the MiFID Review – Investor Protection and Intermediaries* of 29 July 2010 (CESR/10-859).

² *CESR's Responses to Questions 15-18 and 20-25 of the European Commission Request for Additional Information in Relation to the Review of MiFID* of 29 July 2010 (CESR/10-860).

³ "(89) Do you consider that all or some UCITS could be excluded from the list of non-complex financial instruments? In the case of a partial exclusion of certain UCITS, what criteria could be adopted to identify more complex UCITS within the overall population of UCITS?"



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the enhanced disclosure regime which UCITS are subject to under UCITS IV (particularly through the KIID) and the stringent investment limits and risk management rules which all UCITS already must comply with, represent a satisfactory legal and regulatory framework to deal with the concerns raised by ESMA in the Discussion Paper. We also note that a more appropriate framework in which to address such concerns, as well as the ones raised by the Financial Stability Board and by the Bank for International Settlement, would be an intervention on the UCITS IV Directive, particularly as regards the contents of the offering documents and the concept of eligible assets and eligible investment techniques, in line with what has been done in the past in respect of extensively debated issues such as the eligibility of hedge fund indices.⁴ This appears supported also by the fact that all the policy orientations identified by ESMA in the Discussion Paper in relation to structured UCITS involve interventions (only) on the UCITS IV Directive.

1.5 However, should the decision be made to revisit the rules on marketing of UCITS funds in terms of their complexity/non-complexity, in our view a horizontal, risk-based approach in respect of marketing of investment products to EU investors, regardless of their legal form, would prove more effective than focusing on a single category. This approach appears to be consistent with the PRIPs initiative, which aims at introducing a common set of rules for packaged retail investment products at European level, irrespective of how these products are packaged or sold, with regard to (i) the form and contents of the key information to be disclosed to investors; and (ii) the conduct of business of product distributors. A multi-product approach would also present the advantage of promoting consistent outcomes in terms of investors' protection and level playing field for distributors and product providers.

1.6 In this perspective, we believe that the assessment of whether a financial product is complex or not should not be based on broad pre-determined categories but on the review of the features of the specific product, for example relying on the indicators of non-complexity listed in Article 34 of Commission Directive 2006/73/EC. More importantly, the distinction between simple and complex products should not be based on the assets of the fund or on the way a UCITS is managed, but rather on the specific investment objectives of the fund. A UCITS can be very simple to understand for investors while using sophisticated techniques in order to improve its performance: for example, some very traditional equity funds also use a variety of derivatives in order to manage their exposure to the market in the most efficient way, but this in itself does not make them complex. We believe that an investor needs to understand the risk and return profile of a given financial product; to the extent that the investment objective of a fund can be readily understood and that the other requirements under Article 34 of Commission Directive 2006/73/EC are satisfied, then the product should be considered as non-complex, and any remaining concerns about the specific financial techniques by which the relevant investment objective is pursued in practice should be addressed (as they already are) through the risk disclosures.

2. QUESTION 2

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'?

⁴ In that case specific guidelines were developed to limit the risks associated to the use of such indices, but no intervention was proposed nor made on the rules for marketing of UCITS referencing such hedge fund indices.



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- 2.1 Firstly, as mentioned in respect of Question 1 above, we do not believe that there is a case for revisiting the treatment of UCITS as non-complex financial products pursuant to Article 19(6) of MiFID. As noted by many market participants in their responses to the European Commission Consultation on the review of MiFID earlier this year, all UCITS substantially meet the criteria set out in Article 34 of Commission Directive 2006/73/EC and, contrary to other financial products, are assisted by the specific safeguards provided under the UCITS IV Directive, with particular regard to:
- (a) the provisions on limits on investments, eligibility of assets and risk diversification, to which all UCITS are subject;
 - (b) the extensive disclosures from which investors benefit, particularly through the KIID; and
 - (c) the regulatory supervision to which investment managers and custodians of UCITS are subject.
- 2.2 Secondly, if a sub-division of UCITS into complex and non-complex were to be carried out, we do not believe that it should be based on the portfolio management techniques which the UCITS employ. Indeed, any such categorisation (inevitably based on broad categories, such as "synthetic ETFs" or "UCITS using derivatives") risks to inadequately represent the real risk/return profile of a given product. As mentioned above, a UCITS can pursue a very straightforward investment policy while at the same time using sophisticated techniques in order to improve its performance. Many funds, including very simple funds, use derivatives or sophisticated techniques like securities borrowing or lending. For example, some very traditional equity funds use derivatives in order to manage their global exposure to the market in the most efficient way. A structured fund can also be very simple: for example a structured UCITS purely indexed on a classic and well-established market index and capital guaranteed cannot be seen as a complex product, although it makes use of derivatives in order to achieve the return prospected to investors. The same is true for ETFs: an ETF which tracks a classic and well-established market index through synthetic replication techniques is nonetheless a product whose features can be easily and readily understood by a retail investor. Conversely, there are other UCITS which are complex due to the specific investment policies which they pursue and which are neither ETFs nor structured UCITS (for example the so-called "Newcits").
- 2.3 In light of the above, we believe that the only appropriate way to assess complexity is on the basis of the specific investment objectives of the fund. As it seems very difficult to establish a single and simple set of criteria to define what is complex and what is not, the driver should be the ability of investors to understand what they invest in and the type of risks involved. While the potential risk scenarios highlighted by ESMA (and previously by the Financial Stability Board and by the Bank of International Settlements), which are linked to the specific portfolio management techniques used, are certainly significant, they would appear to apply in extreme circumstances and should be considered as of secondary importance (in determining the complexity of the product) to the risks normally associated with the investment policy of the fund (i.e. will the investors achieve the return / will he lose his investment in whole or in part), which are the drivers of the investor's decision to enter into a given investment.
- 2.4 In this context, we believe that ESMA should rather attempt to give some specific guidelines concerning some categories of funds and other financial products which would be considered as complex based on the investment strategy which they pursue. Funds which do not fall within such guidelines would be considered as simple. These guidelines should capture also so-called "Newcits", based on the complexity of the investment strategy and the difficulty for investors to



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understand it. In this way we would have a European framework of specific guidelines concerning specific types of products that would define some categories of complex products. We would welcome such development and are prepared to help ESMA draft such guidelines.

3. **QUESTION 3**

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?

- 3.1 As mentioned above, we do not believe that there is a case for introducing additional conduct of business rules specifically targeting structured UCITS and ETFs. In our view the generally applicable rules on suitability and appropriateness already provide sufficient protection to retail investors, particularly considering that most purchases of UCITS by retail investors occur in ways which require financial intermediaries or asset management companies to specifically carry out suitability or appropriateness assessments.
- 3.2 Should additional intervention on retail marketing be considered, in our view the relevant measures should not be limited to UCITS but should be as inclusive as possible and refer to all financial products that are considered complex (on the basis set out in our reply to Question 2 above). We note that a typical solution has been to use the marketing process in order to make sure that investors understand the risks associated with a specific product, in line with MiFID requirements. Another possible route is to make the product providers responsible for controlling the marketing of their products and for limiting it to appropriate categories of retail investors. This may however give rise to uncertainty in the implementation phase, as there may be differing views as to which products are suitable for a given type of investors. In this respect, a priority which in our view should be pursued by ESMA is to focus on practical regulations which are clear for market players and easy to implement.

4. **QUESTION 6**

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.

- 4.1 This is a very important question. In our view, the answer depends on whether ESMA believes that there is a systemic problem or not.
- 4.2 If the only concern is that of investor protection, we note that the Alternative Investment Fund Managers Directive ("**AIFMD**") sets up an adequate supervisory and regulatory framework in respect of managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the European Union, and establishes a sufficient level of protection for professional investors dealing in these products.
Based on the draft technical advice to the European Commission, published by ESMA for public consultation on 13 July 2011, we also expect, as a result of the adoption of the implementing measures of the AIFMD⁵, a further alignment of the requirements set out for AIFs with the

⁵ See ESMA's Consultation Paper of 13 July 2011, ESMA/2011/209, "ESMA's draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive".



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existing provisions of the UCITS IV Directive and MiFID as regards, particularly, general operating conditions, organizational requirements and risk and liquidity management.

The scope of the AIFMD, however, only covers certain kinds of non-UCITS funds (i.e. AIFs) and, generally, does not address issues relating to the marketing of non-UCITS funds to retail investors, so a regulatory gap could arise here.

- 4.3 Further, to the extent that (as seems to be the case), ESMA's concerns also relate to broader market stability, and for the purposes of ensuring a level playing field for market participants, we are of the view that any guidelines issued in respect of UCITS should also be applied to non-UCITS funds which are established or sold in the European Union.
- This extension, particularly, should be operated in respect of US-based ETFs, as they are widely marketed in Europe. Based on the information at our disposal, indeed, around 25% of ETFs AUM held by European-based investors consists of US-based ETFs. As a result, approximately a quarter of the European ETF market appears to consist of US-based ETFs.
- US-based ETFs are, in fact, massively marketed in Europe to professional investors and asset managers, taking advantage, to the extent possible pursuant to the regulations in force in the specific EU Member States, of private placement or passive marketing regimes. US-based ETFs are also allowed for retail marketing in the Netherlands and are listed on Euronext Amsterdam.

PART III. EXCHANGE TRADED FUNDS

5. QUESTION 8

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.

- 5.1 We agree with ESMA's proposal of introducing the requirement for UCITS ETFs to use an identifier in their names, fund rules, prospectus and marketing material as this would increase market transparency and, hence, improve investors protection and help achieving a level playing field for market participants.
- 5.2 We note that this requirement is already in place in respect of other collective investment schemes, such as monetary funds, and has the advantage of enabling investors to immediately understand the kind of investment product they are dealing with.
- 5.3 Particularly, the use of the "ETF" identifier should be prescribed (and only reserved) to all UCITS listed on European regulated markets which meet certain specific criteria, to be elaborated at EU level on the basis of the essential features of UCITS ETFs currently traded on European stock exchanges, such as;
- are traded on a stock exchange as shares;
 - are traded on a continuous basis;
 - meet specific diversification and risk management requirements;
 - ensure information flexibility and transparency typical of shares traded in real time; and
 - ensure adequate liquidity through the mandatory appointment of a market maker or specialist who commits to display, on a continuous basis, bid and ask orders for a minimum quantity and a maximum spread as established by the relevant exchange.

There should be a narrow definition of "traded on a regulated market" including the requirement for real continuous trading, with small bid offer spreads and significant offered size. Indeed, the mere circumstance that a UCITS is listed on a regulated market should not *per se* requires/allows the use of the ETF identifier. This is to avoid than any listed UCITS, although not meeting the



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requirements above, may use the ETF identifier and, consequently, create confusion among investors. This would be the case, for instance, in respect of Danish UCITS which, to our understanding, are all automatically listed, but do not meet the requirements set out above, particularly as regards continuous trading.

- 5.4 In our view, the objective ultimately pursued is to ensure that when an investor approaches an investment in a product featuring the ETF identifier, the main features of such an instrument are easily identified (i.e. it is listed on a regulated market; it meets specific liquidity, diversification and risk management requirements; etc.).
- 5.5 As regards liquidity requirements, we note that market making for ETFs is currently regulated only at a domestic level, under the relevant stock exchange regulations. Particularly, each exchange sets out specific provisions in respect of minimum size of market making, maximum spreads, etc. Also with a view to the definition of the criteria for the use of the ETF identifier, we believe that these regulations should be harmonized at EU level.
- 5.6 In respect of non-EU (and, generally, non UCITS) ETFs, the use of the word "ETF" should be restricted only to these funds, offered to EU investors, which present equivalent features to UCITS ETFs, i.e. meet the general criteria identified for the use of the "ETF" identifier. Therefore, for example, a US-based or Swiss-based ETF on gold should not be allowed to name itself as an ETF since single-commodity ETFs do not comply with the diversification requirements set out in respect of UCITS ETFs.
- 5.7 Together with the introduction of the ETF identifier, adequate measures should be implemented in order to prohibit the inappropriate use of the ETF brand or of similar names (e.g. "ETFS") by funds and other financial products which do not amount to "ETFs" pursuant to above criteria, as this would obviously be misleading for investors. Issuers should therefore be required to amend accordingly the existing commercial names when these make an inappropriate use of the brand ETF and/or of very similar expressions/acronyms. For example, a company should not be allowed to put the acronym "ETF" in its commercial name whereas it promotes mostly financial products that are not ETFs.
- 5.8 We are aware that the introduction of an ETF identifier would result in additional costs for market participants in terms of adapting their current offering documents and marketing materials to such new requirements; these costs, however, could be limited to the extent that issuers are allowed to introduce the ETF identifier (or to eliminate inappropriate references to the ETF brand or similar names) in connection with the first suitable update of the relevant documentation and material (i.e. changes to the prospectus due to the introduction of a new sub-fund in case of umbrella structured UCITS).

6. **QUESTION 9**

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

- 6.1 Whilst we are generally very supportive of initiatives aimed at increasing market transparency and improving investors protection, our view is that the inclusion in the ETF identifier of further distinctions between synthetic and physical ETFs, and actively-managed ETFs, may result in confusing, if not misleading, information for investors.



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Particularly, we note that:

- what is meant by synthetic ETF as opposed to physical ETF; or actively managed ETF as opposed to passively managed ETF, is not common knowledge among non-sophisticated investors;
- the use of an identifier distinguishing between synthetic and physical ETFs may lead investors to the erroneous conviction that synthetic ETFs, as such, are riskier than physical ETFs; by contrast, investors should be made aware that different risks relate to different products, depending on their specific features, and that these risks should be assessed on a case by case basis;
- as pointed out by the Commission in respect of the PRIPs initiative, information on investment products should be comprehensible to target investors, who often may have little or no investment experience; accordingly, the disclosure of information which, in the absence of adequate guidelines, investors are likely not to fully understand or even to misinterpret, may result not only ineffective but also counterproductive.

6.2 In light of the above, we are of the view that, in order to ensure effective investor protection and understanding of the relevant product, adequate information as regards the synthetic or physical nature of the ETF and as to whether it is actively or passively managed should be included in the offering documents as part of the investment policy description, together with a concise, clear and simple illustration of the relevant implications, particularly from a risk perspective. By contrast, the identifier should only specify that the relevant product is an ETF which, in our view, is an information that investors are generally able to correctly understand.

We remain at your disposal for any further information or clarification.

Yours faithfully,

Adele Bricchi
Secretary General