AGA - n° 2931_09/Div.

ESMA
103 Rue de Grenelle
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Paris, 20 September 2011

AFG comments to ESMA's discussion paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS

Ref.: ESMA/2011/220

The Association Française de la Gestion financière (AFG)[1] welcomes ESMA's discussion paper on ETFs and Structured UCITS. We thank ESMA for the opportunity to express the French asset management's opinion on these issues, especially as our industry manages a complete spectrum of asset classes and techniques, including ETFs and structured UCITS.

General Comments

ETFs and structured funds are UCITS

ETFs are listed funds that effectively trade on exchange

ETFs may be passive tracking funds (and this is a subcategory of index tracking UCITS) or actively managed

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements.

Our members include 411 management companies. They are entrepreneurial or belong to French or foreign banking or insurance groups.

AFG members are managing 2600 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1600 billion euros managed from France, i.e. 23% of all EU investment funds assets under management), wherever the funds are domiciled in the EU, and second at worldwide level after the US. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes and products such as regulated hedge funds/funds of hedge funds as well as a significant part of private equity funds and real estate funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

AFG has a broad view on asset management, as all asset classes, structures and techniques are employed by our members.

Our ETF industry counts as of end of June 2011 363 funds domiciled in France that represent € 45.6 Bn. This is about 4% of overall French asset management with funds domiciled in France.

In our view, there is clear understanding that ETF are UCITS, except that they are listed and actively traded on a European stock exchange. UCITS should be treated the same, whether they are listed or not. Synthetic ETFs and structured UCITS are regulated under the UCITS rules that provide a strong European regulatory framework and in our view, an effort of regulatory level playing field (ex: PRIPS initiative) is absolutely fundamental and should be given priority.

For better clarity, we suggest appropriate definitions and categories be used for this consultation. Indeed,

- some guidelines should apply to all UCITS (like those concerning derivatives or share lending)
- some guidelines, like those concerning *tracking error*, should apply to some UCITS categories, like index tracking UCITS.

<u>Please see our detailed responses below:</u>

<u>RETAILISATION OF COMPLEX PRODUCTS</u>

<u>FINANCIAL STABILITY AND SYSTEMIC RISK</u>

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.

i) First of all, AFG is fully supportive of the efforts made by ESMA to better understand evolutions in the products offered by the asset management industry and in particular those offered to retail investors.

As in any industry, new structures and techniques are first of all innovative and their offer is restricted to a limited number of rather qualified customers and afterwards, these techniques are becoming more common to the benefit of a larger base of clients. Regulatory guidelines must also take into account how they address the usefulness of products to their clients. Indeed, further precision in the UCITS regulatory environment should take also into account the point of view of the ones it is supposed to protect, ie investors' point of view. Indeed, we would like to remind that non regulated products are also available to the same customers and an effort of regulatory level playing field (ex: PRIPs initiative) is absolutely fundamental and should be given priority. If not, the gap keeps broadening.

In this respect, we believe that such debate has its proper forum in the framework of the MIFID review and also, maybe, the PRIPs Directive. That framework would allow consideration of all retail products, not olny UCITS. It would not be fair, nor efficient, to single out UCITS in this respect, knowing that they are the most regulated financial products. For example, it would not make sense to qualify leveraged UCITS as complex products, if equivalent certificates are not qualified as complex. That would create some potential for regulatory arbitrage in favor of products that are already less regulated.

ii) Second, let's remind that synthetic ETFs and structured UCITS are regulated under the UCITS rules that provide a strong European regulatory framework. As such they are subject to the same requirements and constraints than other UCITS. As a result synthetic ETFs and structured UCITS should not bear any distribution limitation to retail investors.

We can also add that synthetic ETFs (unlike the other UCITS funds) must comply with a second set of rules (the 'listing rules') including the obligation to calculate and publish an indicative NAV, the spread limits and minimal bid / ask spreads, the obligation to have a market maker etc. Therefore both set of rules (regulatory rules' and 'listing rules') impose a very detailed set of requirements regulating the investment product itself and provide a high level of investor protection.

We therefore continue to think that before considering limitations on the distribution of certain UCITS, regulators should first regulate other less regulated products like ETN, structured notes.

iii) Third, in any case, complexity is a difficult concept and its definition should be first carefully fine-tuned.

What is a complex product from the point of view of retail investors?

A complex product is a product that is difficult to evaluate by the investor (payoff) and in the same time is not protective (how much can I lose?). Indeed:

- a fund that makes use of sophisticated techniques but results in a product that has a high degree of protection of capital is not a complex product.

- also, a fund that makes use of sophisticated techniques but results in a product that has a relatively easy to evaluate payoff is not a complex product.

Thus, pragmatically, complexity is to be seen in relation to the payoff (is the payoff relatively easy to evaluate?), in relation to the risks borne by the investors, if is capped by the degree of protection offered. Reducing the complexity to the sum of sophisticated techniques used into the fund is restricting investors to benefit from better services in the asset management industry and in this respect such a regulatory approach would not be protective for them, on the contrary.

iv) Finally, to the extent that ESMA would wish to restrict the retailisation subject to UCITS and therefore, if a distinction is to be made between UCITS, we strongly believe that complex and non-complex should not apply to broad categories but to specific funds. There are complex Structured UCITS but there are also simple Structured UCITS. Same for ETFs: there are some simple ETFs, for example those that are purely indexed on simple indices, but there are also complex ETFs, those that are indexed on Hedge Fund indices for example. There are also other UCITS that are complex and that are neither ETFs nor Structured Funds. We reiterate that the distinction between simple and complex should not be based on the assets of the fund or on the way a UCITS is managed, but rather on the precise objectives and risk profile of the fund.

A UCITS can be very simple for investors and use sophisticated techniques in order to improve the performance of the fund. For example, some very traditional equity funds also use derivatives in order to manage their exposure to the market in a most efficient way. This does not make them complex products. Another example, a simple structured index fund that replicates a market index such as Eurostoxx 50 and that is capital guaranteed. Undoubtedly this product is simple, perfectly appropriate for retail and bears little risk. However, such a payoff cannot be offered without making use of derivatives.

As a consequence, we do not consider necessary to introduce additional constrains in respect of the distribution of synthetic ETFs and structured UCITS.

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'?

No. The distinction between simple and complex must not be based on the fact that a UCITS employs "complex portfolio management techniques". More generally, it cannot be based on the instruments used by the fund. The only suitable way to define complexity is to base such assessment on the precise objectives and risk profile of the fund. Why? Just apply for instance this concept on another industry: if we apply such reasoning to the car industry, should we conclude that a car with a complex engine is not safe for drivers?

Therefore, it is to be understood that there is a clear distinction between the financial product's structure (i.e. portfolio management technique) and its payoff. From a retail point of view, complexity is linked to the risks borne by investors and the degree of protection offered. Therefore it is much more linked to the fund's payoff rather than its financial structure, especially because the fund's structure is well-regulated under UCITS rules.

Explained differently, the investors have to understand both the return objectives of the UCITS and the risk factors, but it is not asked from them to understand and be able to replicate the techniques employed. It is the duty of the investment manager to select appropriate techniques to reach the risk-return objectives of the UCITS.

Finally, if some of the UCITS were categorised as 'complex' under MiFID requirements, these UCITS funds would belong to the same category of other financial products such as ETVs (Exchanged Traded Vehicles), ETCs (Exchanged Traded Commodities) or ETNs (Exchanged Traded Notes) that are already 'complex' products under MiFID. From a distribution perspective they would be considered at the same level with the same set of constraints.

Although they look similar to UCITS from a financial point of view, their legal form is completely different. It appears that these financial instruments – such as Notes or Certificates - are far less regulated than UCITS funds (no diversification rules, issuer risk, no counterparty risk limit, lack of independent valuation, lack of best execution requirements, no auditor nor custodian).

Having 'complex' UCITS would remove visibility from a retail point of view. Additionally, having Notes, Certificates and UCITS in the same category would be very harmful for investors since it would encourage financial actors and markets to create and develop those less-regulated financial products. This encourages a strict distinction among PRIPs, i.e. between UCITS funds (that are already very well regulated) and other listed products (such as the other ETPs) that are not UCITS.

We strongly believe there is no hard justification to split UCITS today. However, in case we go further to the MiFID definitions and framework (and if we consider that some UCITS may be 'complex') it could be considered that 'complex' UCITS are more sophisticated products. Products 'complexity' should not be linked to the portfolio management technique (nor the financial instruments used in the portfolio) but to the products' payoff itself (for example hedge funds UCITS that are indexed on a Hedge Fund index or some long/short UCITS would be 'complex' while other UCITS, for example those tracking 'vanilla' market indices would not).

In those cases the 'complex' definition should not apply to a broad category of UCITS products as a whole, but on a case by case basis, i.e. to specific funds. The fact that an ETF is listed on an exchange should not be a determining factor to consider it as 'complex'. We may have 'simple' ETFs (such as the ETFs based on well-known indices) and 'complex' ETFs (such as the ETFs based on hedge funds indices for example). In this case, only calibrated specific guidelines concerning some categories of funds that would be considered as complex might constitute an answer. Funds that do not fall in such guidelines would be considered as simple. For example, as regards Structured Funds, specific regulation already exists in France with the AMF: http://www.amf-france.org/documents/general/9662_1.pdf. Another guideline of this kind could be adopted for so-called "Newcits", based on the complexity of the strategy's payoff and the difficulty of investors to understand it.

It is important to underline that: (i) strict definitions and guidelines should be given by ESMA considering the UCITS funds that would classified as 'complex' and (ii) that any limitation to retail distribution should strictly apply through MiFID rules, i.e. using the 4 criteria defined by MiFID, and more specifically through the suitability and appropriateness tests.

To sum up our view on the matter, we reiterate that there is no evidence of the need to split UCITS and the actual benefits of splitting UCITS are highly hypothetical. Notwithstanding the aforementioned, if we get to this stage, complexity should be defined in relation to the payoff, not to the techniques used to construct the fund. Also, there is no broad “complex category”; the approach should be a calibrated specific set of guidelines.

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?

We consider that UCITS funds are appropriate for retail investors.

Nevertheless, should we distinguish ‘complex’ UCITS, this is clearly a subject that should be addressed through MIFID. ETFs should be treated like other UCITS and UCITS should be treated as all the other products in this respect. Under MIFID, it would be useful to issue specific disclosures. Investors themselves require more transparency and disclosures so as to help them make good choices.

4. Do you consider that some of the characteristics of the funds discussed in this paper render them unsuitable for the UCITS label?

No, we do not consider that some of the characteristics of the funds discussed in this paper render them unsuitable for the UCITS label. This ESMA paper does not really discuss specific funds characteristics, but rather the use of some financial instruments, like derivatives or securities borrowing or lending, by all UCITS. These techniques are useful and necessary for the whole asset management industry. They are not characteristics of a fund that would make them unsuitable for some investors. Indeed, as all the other UCITS, structured UCITS are submitted to a strong regulatory framework: the same European standards apply (same set of requirements, constraints and disclosure rules) and are at the heart of the high level of retail investor protection.

ETFs provide valuable features for retail investors because they are simple (index tracking and passive), transparent (index tracking and real time pricing), liquid (intra-day liquidity and several market makers) and low cost products, whether based on physical or synthetic replication. ETFs are probably today among the most transparent products in the savings industry in terms of the disclosure of funds assets.

Please note that restricting the UCITS framework would have the unintended consequences of pushing the market towards less regulated structures. The evolution of an industry in not only driven by the offer (innovation), but also by the demand. Investors require more transparency and disclosures so as to help them make good choices. Restricting UCITS framework would be highly harmful for investors and would encourage financial actors and markets to favor less-regulated financial products.

5. Are there any issues in terms of systemic risk not yet identified by other international bodies that ESMA should address?

From our point of view there is no issue in terms of systemic risk. What is potentially systemic is rather everyone doing the same thing, in the same way, at the same time. We would like to insist on the role of the diversification to prevent such a risk (for example, in what may concern fund structures).

Sampling replication creates a risk for investors that a UCITS, which is supposed to be indexed, is in fact only benchmarked to the index. In marked stressed events, it is likely that such replication technique will not work and produce significant tracking errors.

At minimum, investors should be warned of the risks incurred by sampling replication.

There should be some minimum tracking error requirements to have the right to be qualified as an index fund. ETFs that use sampling replication with significant tracking error should be qualified as "actively managed ETFs".

Sampling replication may also create some systemic risks because models of sampling replication tend to be the same. Therefore indexed funds tend to be exposed to the same shares, different from the index. There could a sort of chain reaction in the industry, where the sales of indexed funds would depress the prices of the shares that are used in the sample. The performance of indexed funds would therefore be affected even more, compared to the index. That would trigger even more sales of funds etc.

In general, the massive and uncontrolled use of statistical methods, implemented automatically or nearly automatically, deserves some consideration as regards systemic risks

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.

It is extremely important that ESMA should emphasize the following points:

- making appropriate distinction between ETFs that are UCITS and those that are not subject to such detailed regulation;

- making appropriate distinctions between UCITS ETFs and other exchange traded products which provide much less investor protection and transparency;

- improving the understanding of these distinctions among investors and the public.

To this extent, the UCITS guidelines and label should be preserved. We encourage ESMA to keep the ‘ETF’ name for UCITS ETFs only. This would allow a clear distinction between European ETFs and other non-UCITS ETFs. Indeed, how useful the UCITS framework would be in order to effectively protect European investors in ETFs, if different products are proposed indistinctively (for instance, US-based ETFs are widely marketed in Europe, whereas these products are using the private placement or passive marketing regimes of European Member States that allow for retail marketing; these funds are often listed in Amsterdam. Thus, these funds not regulated like UCITS are more risky and much less protective: active management, higher leverage etc.)

7. Do you agree that ESMA should also discuss the above mentioned issues with a view of avoiding regulatory gaps that could harm European investors and markets? If not, please give reasons.

Yes. Yes the paradox of this consultation is that it targets only the most regulated products, UCITS.

Regulatory gaps harm European investors and markets. Those gaps are increasing over time and it appears that UCITS (that are already far well-regulated) are getting more and more regulated while other financial products (such as notes) are not. This is in contradiction with the PRIPs initiative.

We believe that ESMA should also target structures that are ETFs non-regulated in Europe or that are close to funds:

a) Products issued by SPVs. They look very much like funds but they are not regulated as funds and are marketed all over Europe using the Prospectus Directive. Indeed, ETFs are often confused with other ETPs (such as ETNs, ETCs or ETVs) while the features of these products and the underlying risks for investors are different. We strongly encourage ESMA to clarify the situation and make appropriate and clear distinctions between these products, both in terms of regulatory frameworks and distribution among retail investors. Investors should naturally understand than the highest level of protection is achieved with UCITS rather than with other financial products.

b) Non-European funds that are currently marketed in Europe using private placement regimes and that will fall soon in the scope of the AIFM Directive, especially those that are marketed retail in some European countries and listed on a European regulated market (Amsterdam in general).

<u>**EXCHANGE TRADED FUNDS**</u>

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.

We fully agree with the proposal to use an identifier such as ‘ETF’ in the UCITS ETF name. The ETF “brand” should be protected in Europe, just like now the name “Money Market Fund” is protected.

This ‘ETF label’ has to be well defined and protected. This label should be exclusively used for listed and actively traded UCITS funds. There should be a legally-binding restrictive definition of “traded on a regulated market”. This should be a real continuous trading, with small bid-offer spreads and significant offered size. A simple listing on a regulated market should not be good enough. Otherwise, any fund could be named ETF since listing on a regulatory market is quite easy. It may also create problems with Danish funds. Danish UCITS are all listed, but they are not really traded continuously. We propose that, in order to be able to be named “ETF”, a UCITS should be listed on at least one European regulated market, with at least one market-maker. Market making is currently regulated only at the level of each stock exchange. Each of them provides some regulation concerning minimum size of market making, maximum spreads and minimum activity. We believe that these regulations should be harmonized by ESMA.

Also, it is extremely important to make a distinction between ETFs and other ETPs (Exchanged Traded Products that are not funds) since the risk of confusion between both categories is currently very high. Although they look similar from a financial point of view (all are listed on an exchange) they are different in terms of legal structure (UCITS funds versus investment banks Notes or Certificates) and underlying risks. Those Notes and Certificates are far more risky than UCITS ETFs: issuer risk, lack of independent valuation, no diversification requirements nor counterparty risk limit, no depositary nor auditor).

As regards non-European ETFs, the use of the word "ETF" should be restricted to funds that follow strictly UCITS rules. 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 are not allowed in Europe. If not, all this would be completely useless.

ESMA should also prohibit the inappropriate use of very similar names (e.g. “ETFS”) that could be misleading. Therefore ESMA should oblige the issuers to amend the misleading existing commercial names that use, in an inappropriate manner, the brand ETF and very similar brands. 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.

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

We do not agree with the proposed approach to use an identifier in the UCITS ETFs name that would distinguish between synthetic and physical ETFs for the following reasons:

A) SUCH IDENTIFIER COULD BE MISLEADING TO INVESTORS

- With "physical ETF", investors could believe that such ETF simply holds the securities that constitute the index. But that ignores the fact that the securities can be and are normally lent. ETF investors could therefore believe that a physical ETF does not embed any counterparty risk whereas this is in fact not the case. Therefore, the identifier should not be "physical replication" but "physical replication with securities lending".

- The identifier “synthetic ETF” would implicitly communicate to investors a generic “swap counterparty risk” without specifying its magnitude (and this is a key point); thus mixing together non-risky and risky ETFs. In fact there is a huge difference between a synthetic ETF with an almost 0% counterparty risk (because “almost fully collateralized”) and a synthetic ETF with a 40% counterparty risk due to the use of multiple counterparties.

- Investors could believe (and it is false) that synthetic ETFs are riskier than physical ETFs and they could believe that the identifier wants to confirm this perception. On the contrary, this is absolutely not true: e.g. a synthetic ETF with a 2% swap counterparty risk is less risky than a physical ETF with a 9% securities lending risk not collateralized.

- Investors could believe (and it is false) that the ETFs with the identifier “physical” can invest only in the securities of the Index while, in reality, they can invest in more securities than the Index with a high risk of tracking.

- Investors could believe (and it is false) that the ETFs with the identifier “physical” invests in all the securities of the Index while, in reality, they can invest in less securities than the Index, because they use a sample replication technique, with a high risk of tracking.

- Investors could believe (and it is false) that the ETFs with the identifier “physical” can invest in stocks and bonds only while, on the contrary, physical ETFs sometime invest in Certificates on single stocks (e.g. a Certificate of HSBC on ENI), instead of investing in the stocks (e.g. ENI). As these Certificates are not collateralized, they have a 100% counterparty risk towards the bank issuer.

B) SUCH IDENTIFIERS WOULD BRING TO PROMINENCE A DISTINCTION THAT IS NOT MATERIAL TO INVESTORS

- "Swap-based" ETFs or "physical with securities lending" ETFs are very similar in terms of risks for investors. In both cases, the portfolio owned by the fund, directly or as collateral, is different from the portfolio to which the fund is exposed.

- If we had to provide such information as identifier, we would have to distinguish between unfunded swap-based ETFs, funded swap-based ETFs, and physical replication ETFs with securities lending. In many ways, funded swap structures are very close to “physical replication with share lending”: the fund has only a right to receive some collateral if the counterparty fails. In unfunded swap structures, the fund has full ownership of the “collateral portfolio” and is therefore safer than a “physical replication ETF with securities lending”.

- There are distinctions that are more relevant to investors because they may have an impact on the quality of the replication, which is what should matter the most to investors: the distinction between “full replication ETFs” and “sampling replication ETFs”. Full replication ETFs, whether they are “synthetic” or “physical with securities lending”, produce nearly the same result in terms of tracking error. But sampling replication can produce other results. It seems to us more important to mention this prominently. On the contrary, “swap-based” or “physical replication with securities lending” matter to investors only if a counterparty fails, which is in practice very unlikely. Since there are also some actively managed ETFs, if there is an identifier, we believe that it should be: “total replication ETF”, sample-replication ETF” and “actively-managed ETF”.

C) THIS DISTINCTION WOULD NOT ACCOMMODATE MIXED SITUATIONS

- For example, one could believe that "physical" ETFs do not use derivatives at all. But this is not true. Physical ETFs sometime invest in futures or in Certificates on single stocks (e.g. a Certificate of HSBC on ENI), instead of investing in the stocks (eg. ENI). As these Certificates are not collateralized, they have a 100% counterparty risk towards the bank issuer.

- ETFs can use several techniques. So there should be some threshold to switch them in one category or another. If an ETF own physically 90% of the shares of the index, proportionally to the weighting of the index, but uses synthetic replication only for the remaining 10% of the index, by purchasing some other shares and swapping them with the rest of the index, it should be considered as a physical replication ETF. Asset Managers can switch from one replication to another, or use a combination of them, in order to optimize the return of the fund. Indeed, let’s not forget that the objective of the fund manager is to track the benchmark index, and that he/she must make every effort within the regulatory framework to achieve this objective. For example, if the fund is managed in pure replication, and the composition of the index changes in such a way that the fund manager may no longer track the benchmark properly, or if the underlying market becomes no longer accessible to the manager, than the manager should resort to synthetic replication in order to ensure the performance continuity. Similarly, if the fund is managed synthetically, and it happens that the fund manager finds no counterparty willing to swap the performance of the underlying index at a reasonable price, than the fund manager should be able to implement its management expertise to track the index directly.

- If such identifier were to be proposed, there should be some thresholds in order to distinguish between the two categories. "Physical" ETFs often use some derivatives, like futures or certificates, and "synthetic" ETFs also own securities that belong to the index. There should be some rule about the proportion that is required of each type of instruments in order to qualify for the right category, for example, physical replication if the fund owns 80% of the index, swap-based ETF if the fund owns less than 80% of the index etc.

D) The right place is the KIID, not the name

- There is not enough space: the name of the ETF must already include “ETF”, the name of the provider and the name of the index, which are the 3 main topics that should be there. It is simply confusing to add something close to the title. The appropriate place is rather the KIID.

- “Swap-based” or “physical replication with securities lending”, are difficult concepts that cannot be understood just like that, without more detailed explanations.

- Synthetic ETFs and “physical replication” ETFs are very similar for investors, to the extent that physical replication ETFs lend their shares. They both do not own the shares of the index but other shares and some right to exchange these shares with the shares of the index.

E) If such distinction is made, it should be made consistently over all UCITS, without restricting it to ETFs

- If such distinction between "synthetic" and "physical with securities lending" were relevant, it should be used for any indexed UCITS, not only ETFs.

Physical replication, with securities lending, is similar to replication through derivatives

What happens with synthetic ETF is exactly the same as what happens with share lending. The only economic advantage of synthetic replication is to benefit from the favorable economics of share lending. This can be shown mathematically.

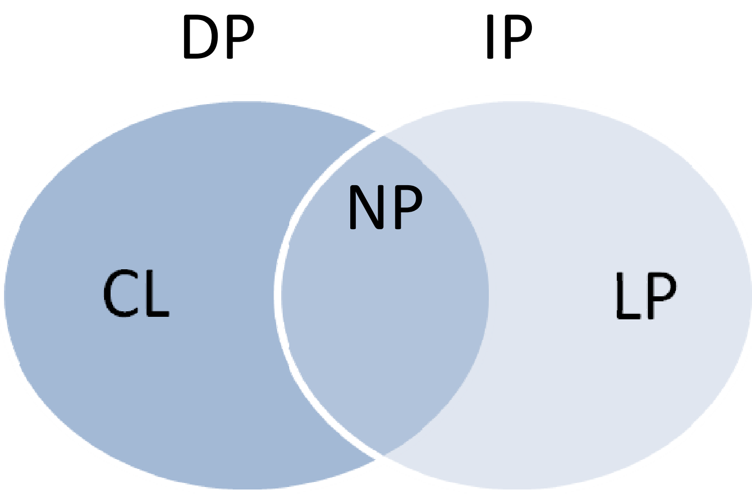
Let’s name the shares owned by the ETF the “direct portfolio”, “DP” and the shares of the index the “index portfolio”, “IP”. The performance of portfolio DP is swapped against the performance of portfolio IP.

Now we can consider 3 portfolios:

- The portfolio which is made of the mathematical intersection between the 2 portfolios DP and IP. Let's name it the "non lent portfolio", "NP".

- The portfolio which is made of the index portfolio IP minus the non lent portfolio NP, which we will name "lent portfolio", "LP".

- The portfolio which is made of the direct portfolio DP minus the non lent portfolio NP, that we will name the "collateral for lent portfolio", "CL".



The synthetic fund has exactly the same profile as a physical replication ETF, which is invested in the index portfolio IP, but which lends the portfolio LP and receives as collateral for the lending operation the portfolio CL.

Synthetic replication is only a way to obtain for investors the economic benefits of differences in the borrowing and lending prices of different securities. It is nothing more that a way to do it with different instruments.

In fact, "synthetic replication" is less risky than "physical replication with securities lending" in the case of "unfunded swaps". The reason is that, in the case of a default of a counterparty, in the case of physical replication, the fund has only a right to a collateral for the securities that have been lent, CL. In the case of an unfunded swap, on the contrary, the fund already owns the securities CL. The risk of accessing the collateral is zero.

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

The KIID should include some explanations about how the index is replicated, but not in the form of an identifier that would overly simplify the explanation.

We believe that the basics of the replication method can be explained in a few words in the KIID. For example:

- The manager replicates the index by purchasing a sample of the shares that constitute the index. Some of these shares are lent to bank. The manager received some collateral for this lending. See the prospectus for more explanations.

- The manager replicates the index by purchasing a portfolio of shares and exchanging its return with banks against the return of the index. See the prospectus for more explanation.

- The manager replicates the index by purchasing the whole portfolio that constitutes the index. Shares may be lent to bank counterparties, against some collateral. See the prospectus for more explanation.

Etc.

INDEX TRACKING ISSUES

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

We agree with ESMA's analysis of index-tracking issues except on the item #23 since the issue raised is not specific to synthetic replication.

Dividend re-investment and dividend tax issues apply both to synthetic and physical ETFs, and might lead to tracking error.

In French ETFs prospectuses, the maximum limit of tracking error allowed by European regulation has to be disclosed. In addition to this maximum limit we could also disclose a 'tracking error objective': this would allow UCITS ETFs to give more accurate tracking error data to investors since the expected tracking error figures for these funds are generally below the current limit disclosed in the funds prospectuses.

Incidentally, please note that first sentence of §21 contains an error: the tracking error is the standard deviation of the distance, not the distance itself.

More generally we encourage ESMA to define and publish a clear tracking error formula and a standardized calculation method so as:

- to avoid any confusion between the performance gap (that is a 'distance' between the index and the ETF) and the tracking error (that is the standard deviation of the distance) ; ESMA should indeed encourage ETF providers to not use the tracking error word when they communicate on performance differences. Performance differences and tracking errors data do not refer to the same thing but they are complementary; they help investors in comparing indexed funds with their benchmarks. Both are key elements in ETFs quality appraisal.

- harmonize tracking error calculations among Europe (some asset managers calculate the tracking error using the data on one specific weekday while other use the weekly average data, etc.). ESMA should give precise guidelines on the calculation of the tracking error, in order to avoid the confusion that currently exists in the market, including the confusion that exists at the level of the marketing documents. Indeed, one objective of the KIID is to allow comparability of funds and without any common definition of tracking error, there is no possible comparability. Our Association has already issued recommendations to our members:

(http://www.afg.asso.fr/index.php?option=com_docman&task=doc_download&gid=2152&Itemid=241&lang=fr).

- make tracking error comparison possible among European index tracking funds;

Please note, however, that ETFs should not be treated differently than other indexed UCITS. The guidelines should be applicable to all indexed UCITS, not only ETFs, and should not be applicable to the extent that ETFs are actively managed, not indexed funds. The guidelines should be written as guidelines concerning indexed funds, including listed indexed funds.

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

We agree with ESMA's policy orientations identified by ESMA for index-tracking issues and the information to be produced in the UCITS ETF legal documentation.

French UCITS funds already comply with the mentioned requirements.

We believe that disclosing whether the fund manager is allowed to use a sampling policy is key, as it implies a model-based proprietary investment strategy, the quality of which can significantly impact the tracking error of the ETF.

13. 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?

Yes we agree: these are key elements that should be, in a simplified form, in the KIID, for all indexed funds.

This does not mean that there should be a specific KIID structure for ETFs or for index funds. But the part of the KIID that describes the objectives and investment policy of the fund should include the basics of such information, with reference to the prospectus for more details.

14. Are there any other index tracking issues that ESMA should consider?

Regarding tracking issues we could suggest the following points for all index UCITS:

- Define a tracking error formula and standardized calculation methodology and require the use of this same formula for all funds in order to make comparisons possible between ETFs.

- Obligation to disclose the effective ex-post tracking error data in annual reports (for example the tracking error over the last past 3 years) in order to make comparisons possible between funds.

- Define what an 'indexed' fund is: among a tracking error limitation range a fund would be 'indexed fund' while above the limit it would become an 'actively-managed fund'.

- The sampling methodology, if any, should be described in the prospectus. Indeed, for funds using a sampling methodology, the quality of tracking is dependent on the fund manager's proprietary model.

15. If yes, can you suggest possible actions or safeguards ESMA should adopt?

There should be some maximum tracking error that would define what an indexed fund is, for example 1% or 2%. Above such level, the indexed fund becomes an actively managed fund benchmarked on the index.

Tracking error should be a regulated concept included in ESMA guidelines and it should be published in the annual report of the fund.

<u>SYNTHETIC ETFS – COUNTERPARTY RISK</u>

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

Regarding the prospectus of the fund, we agree in general with the principles underlying the disclosure proposal in relation to underlying exposure, counterparties and collateral. However, from an operational point of view, these provisions may concern parameters that change over time and would concern all UCITS using derivatives or doing securities lending, therefore it should be taken into account the cost effectiveness of any measure as it will undoubtedly come as a cost to the whole industry.

For operational and commercial reasons, we are not in favor of disclosures in the prospectus that change often. For example, we believe that the policy concerning the choice of the counterparty of derivatives should be disclosed. However, we do not believe that it is appropriate to publish the names of the counterparties, at least when they change often according to a predetermined process, like an auction process.

Our Association would like to comment on the following point in the Consultation:

> *"As noted in the FSB's report of April 2011, this is due in part to the fact that the synthetic ETF creation process may be driven by the possibility for the bank to raise funding against an illiquid portfolio that cannot otherwise be financed in the repo market."*

This point relates to the economic reason for using synthetic replication and concerns over potential "shadow banking". Our members strongly deny that this is the economic reason for synthetic replication. Synthetic replication is only a way to obtain for investors the benefits of share lending, but obtained through different instruments. Indeed, the only economic advantage of synthetic replication is to benefit from the favorable economics of share lending, the same as the one within physical replication.

(see our response to Q9 relative to "*Physical replication, with securities lending, is similar to replication through derivatives")*

17. 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.

UCITS regulation requires strict collateral rules and there has been no argument to explain why these guidelines have not been sufficient.

We think that as soon as the fund assets comply with the liquidity, valuation, issuer credit quality, diversification constraints, then it is not necessary to have a special requirement for the quality and type of assets constituting the collateral to match closely the relevant index.

a) If new guidelines were to be decided, they should be applicable to all UCITS

We believe that there should be no difference in terms of disclosures between index-tracking UCITS that are not listed and index-tracking UCITS that are listed, i.e. ETFs.

As regards the regulations applicable to the collateral, we also do not see why there should be a distinction between index-tracking UCITS and non-index-tracking UCITS. All UCITS should be treated equally.

b) We believe that existing guidelines are appropriate

There are criteria for the collateral that are in Box 26 of CESR' guidelines on Risk Measurement. These provisions are adequate and they already provide detailed guidelines on the requested liquidity, valuation and issuer quality of the collateral. There has been no argument to explain why these guidelines - which are only one year old - are not sufficient. We do not see any argument to request more detailed guidelines. There has been no case and no example to show that these guidelines have not been sufficient.

c) As regards the requirement for the quality and type of assets constituting the collateral to match more closely the relevant index, we do not believe that a regulation is necessary.

<u>- Counterparty risk limits create an incentive to go in that direction</u>

What are the risks of having collateral that differs very much from the index portfolio? There is only one risk: the risk of not respecting the counterparty risk limit: if the market moves in different directions very strongly, the counterparty risk limits (5% or 10% by counterparty) could be breached.

So this regulation that limits counterparty risk creates an incentive for the ETF manager to request some collateral that is well correlated to the index that is replicated. And we see that in practice: equity ETFs have collateral equity, bond ETF have bond collateral. There is a natural tendency to use collateral that is correlated to the index that is replicated.

<u>- Flexibility serves better the interest of investors</u>

Regulations in this matter would have a negative effect, because it is in the best interest of investors to give the manager some flexibility in order to optimize the return of his fund. For example, the manager may prefer, in some instances, in order to respect the counterparty limits at all times, to have some over-collateralization, but some badly correlated assets. For another fund, the manager may prefer to have well correlated asset, but to be closer to the counterparty limit.

<u>- It is not always possible to have a collateral that is close to the index</u>

It is also not always possible to have a collateral that is close to the index. For example, this is not possible for commodities indices. There is no possible commodity collateral. There are also cases where it may be easier and preferred by investors, to have a collateral that is not linked to the index; for example in ETFs indexed on emerging markets indices. There are also often tax reasons that make it advantageous to use a specific collateral.

- Investors would lose part of the economics of the structure

As explained in Annex 1, "synthetic" ETFs or "physical replication with securities lending" ETFs are very similar in terms of risks and returns.

The very reason why synthetic replication or securities borrowing and lending exist is to allow the fund to benefit from the differences between repo rates on different securities. Requiring a collateral that is similar to the index would be like asking fund managers, when the lend securities, to receive a collateral that is similar to the securities they lend. But then, there would be no economic advantage to lend the securities and the securities would simply not be lent.

- What would be the requirements for non-indexed UCITS?

Obviously there is no reason to treat differently funds that are indexed and funds that are not indexed. But ESMA proposed regulations would be possible only if the fund replicates an index. So funds would have an incentive not to be indexed in order not to bear those constraints. That would twist the market and the competition between managed funds and indexed funds.

d) If some specific guidelines were to be decided by ESMA as regards collateral, such guidelines should be extended to the collateral of securities lending operations

Again the two are economically very similar so it would not make sense to treat them differently.

18. In particular, do you think that the collateral received by synthetic ETFs should comply with UCITS diversification rules? Please give reasons for your view.

As explained above, Box 26 of CESR' Guidelines on Risk Measurement bring already qualitative requirements on collateral diversification.

Moreover, collateral diversification rules and UCITS funds assets diversification rules reach two distinct objectives: the purpose of the collateral diversification is to reduce counterparty risks while the purpose of the fund assets diversification is to require a minimum of lines in the fund's assets (minimum number of securities preventing from a 'concentration' of the investment).

SECURITIES LENDING ACTIVITIES

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

We agree particularly as regards the application of CESR Guidelines on Risk Measurement to securities lending.

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

We particularly encourage ESMA to require the same level of disclosures for all over-the-counter operations (including both derivatives and securities lending). This orientation will bring transparency in the funds' costs structure.

In French prospectuses, it is already required to mention the fee sharing arrangements in relation to securities lending. Where an UCITS engages in fee sharing arrangements in relation to securities lending, this should be clearly disclosed together with the maximum percentage of fees payable to the securities lending agent or other third party.

21. 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.

We do not see further safeguards to be introduced above the ones listed by ESMA.

22. 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.

We agree with the proposal. In order to mitigate risks and harmonize risk policies, collateral received in the context of securities lending activities should comply with the criteria for OTC derivatives set out in CESR's Guidelines on risk measurement.

23. 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?

No, this is not necessary nor appropriate as long as the collateral is well managed. Putting restrictions would potentially reduce the return of the fund. Investors would be penalized.

24. Are there any other issues in relation of securities lending activities that ESMA should consider?

From our point of view it is important to require in the fund's prospectus the mention the fee sharing arrangements in relation to securities lending.

25. If yes, can you suggest possible actions or safeguards ESMA should adopt?

ACTIVELY MANAGED UCITS ETFS

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

Yes we agree.

27. Are there any other issues in relation to actively managed UCITS ETFs that ESMA should consider?

There is a risk that the ETF brand will be used by UCITS that have nothing in common with ETFs as they are understood today.

It is legitimate to have actively managed ETFs, but the guidelines should make sure that they are real ETFs, i.e. that they are really actively traded on a regulated market. Otherwise, any UCITS could just list itself on a regulated exchange, without any real trading, and make itself appear as an ETF.

It could also create problem for some jurisdictions, like Denmark, where it is usual to have listed UCITS, but they don't qualify as ETFs as we mean it, i.e. really permanently listed funds, with real liquidity.

In order to be able to communicate as an ETF, a UCITS should have real liquidity on a stock exchange.

Nonetheless, today European ETFs are mostly passive products that comply with the UCITS rules. In other jurisdictions such as the US, 'active ETFs' are allowed: the 'ETF' wrapper obey to US tax requirements rather than regulatory guidelines. Therefore it is extremely important that ESMA make sure that these 'active ETF' comply with the ETF label requirements and therefore can keep their terminology while marketed and distributed in Europe and apply the same regulatory and distribution playing field between European UCITS ETFs and other ETFs.

28. If yes, can you suggest possible actions or safeguards ESMA should adopt?

The ‘active managing’ strategy has to be specified. From our point of view it should be possible to have listed ‘active ETFs’ as soon as those products are well identified from the investor’s point of view: they must have a different terminology from other UCITS ETFs and publish both underlying risks and funds rules in a clear way so as to avoid any confusion with other UCITS ETFs. Moreover they should be listed on a different stock exchange segment than other ‘passive index-tracking’ UCITS ETFs.

UCITS ETFs using the ETF ‘label’ must stay passive listed products, with a transparent index with systematic and non discretionary managing rules.

As explained above the ‘ETF label’ has to be protected. This label should be exclusively used for index-tracking, listed and actively traded UCITS funds. In order to bear the ‘ETF’ name a fund should be listed on at least one European regulated market, with at least one market maker and complying with the 3 obligations of a market maker: offering a minimum size on the ETF trading, with a maximum spread and a minimum of time presence. This would allow the fund to have a real liquidity on the exchange.

Market making is currently regulated only at the level of each stock exchange. Each of them provides some regulation concerning minimum size of market making, maximum spreads and minimum activity. We believe that these regulations should be harmonized by ESMA.

LEVERAGED UCITS ETFS

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

Yes we agree.

Please note that European UCITS regulations, contrary to US mutual fund regulations, allow only a leverage of 2, whereas it is usual in the US to have a leverage of 3. We believe that European regulations are appropriate.

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

Yes we agree.

31. Are there any other issues in relation leveraged UCITS ETFs that ESMA should consider?

We don't see any specific policy issue here.

32. If yes, can you suggest possible actions or safeguards ESMA should adopt?

n.a.

SECONDARY MARKET INVESTORS

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

We support the objectives of ESMA in this regard.

We agree that all investors should have the right to subscribe or redeem directly on the primary market and this is already the case for instance for French ETFs. However, for operational costs reasons, ETFs should have the right to put subscription and redemption fees on the primary market, some independent from the size of the order, in order to limit the number of such subscriptions. The result of such fees is that only market makers have an incentive to access the primary market, most other investors have an advantage in purchasing or selling their ETFs through the secondary market. Thus, it allows investors to benefit from optimal fund management and intraday liquidity.

Indeed, if retail investors were allowed to create and redeem for small sizes, the fund manager will lose operational efficiency and it will greatly impact the tracking error of the funds, as small fractions of the index are not possible to trade. Authorized Participants are investment professionals who ensure the liquidity of the ETF on the secondary market, if retail investors could create and redeem on the primary market, the profitability of the Liquidity Providers would be impacted, which in return will impact the intraday market spreads. Also, creation and redemption costs may change as it corresponds to the actual execution costs, and are billed to the funds, so that existing shareholders are not impacted by new entrants or redeeming shareholders. This mechanism requires a good understanding of the underlying market to anticipate execution costs, and may sometimes lead to the payment of a separate invoice after the settlement of the ETF transaction when execution is delayed by a market disruption event. Such mechanism may not be implemented with retail investors, and the role of Authorized Participants as intermediaries simplifies the process for these investors.

But, the simple fact that any sizeable investor can access the primary market at reasonable costs is an important guarantee for all investors. They are sure that arbitrages will happen, if necessary, that will limit any discrepancy between the primary and the secondary market.

Also, if the secondary market becomes disrupted for operational reasons or because the fund has been delisted, then the fact that final investors may exercise their right to create or redeem on the primary market constitutes also an important guarantee for all investors.

We are also in favor of protecting investors by having a hard trading limit of 1.5% between the price at which an ETF is traded on the secondary market and an "instantaneous NAV" that is calculated at any time. The "instantaneous NAV" is the NAV of the fund at any time, calculated under the supervision of the manager. This type of arrangement actually exists on Euronext Paris: an ETF cannot be traded at a price which differs by more than 1.5% from this instantaneously-calculated indicative NAV. This provides another guarantee for investors. There are different rules to protect investors, by different stock exchange. We favor more harmonization in this respect.

34. Are there any other issues in relation to secondary market investors that ESMA should consider?

Secondary markets are already highly regulated under MIFID and the market abuse directive.

We believe that MIFID post-transparency rules should be extended to the trading of ETFs.

35. If yes, can you suggest possible actions or safeguards ESMA should adopt?

n.a.

36. In particular, do you think that secondary market investors should have a right to request direct redemption of their units from the UCITS ETF?

Yes we do. ETFs are UCITS and investors should have the right to redeem their fund directly. ETFs are like other UCITS except that their distribution channel runs through the stock exchanges. "Classical" UCITS are purchased often through distributors.

It must be reminded that primary access on the primary market is a UCITS requirement. The terms that define how to place subscription/redemption orders directly with the fund are subject to legal provisions in the fund's jurisdiction and to rules in the fund's prospectus. In particular the French jurisdiction currently allows direct orders from non market makers. As stated in the prospectus entry/exit fees (expressed in EUR or in % of the amount traded) can be charged by the management company to the investor. Therefore, all investors are allowed to place subscription/redemption orders to a French UCITS ETF.

From an operational point of view it is important to point out the role of market makers for UCITS ETFs as 'order centralizing agent'. In the case of non exchange traded UCITS, distributors act as 'order centralizing agent'. Both retail and institutional investors are able to place their trades on the primary market provided that they bear subscription / redemption fees that will cover the operational costs of the fund's hedging. The subscription / redemption order would be executed at NAV.

37. If yes, should this right be limited to circumstances where market makers are no longer providing liquidity in the units of the ETF?

Exceptional circumstances should include those cases where secondary market would not function properly while there would be no dysfunction on other markets (i.e. primary market and underlying index markets). In order to accept direct redemptions from investors the UCITS ETF must be able to trade the underlying hedging on the index dedicated markets. In case the fund could not hedge its position (by adjusting the OTC derivatives, the substitute basket or the collateral assets), then no direct orders could be allowed.

Events impacting the secondary market could include for example the absence of any market maker on a specific ETF. Indeed, ETF are regulated by the stock exchange, and the stock exchange requires that a least one market marker ensures the liquidity of the fund. The market maker has a contractual obligation with the exchange to provide liquidity in the units of the ETF, with minimum time presence and size and maximum bid-ask spread requirements. If the ETF is delisted or the secondary market is disrupted, the secondary market investors should be able to request direct redemptions of their units from the fund.

38. How can ETFs which are UCITS ensure that the stock exchange value of their units do not differ significantly from the net asset value per share?

Investors can ensure that the secondary market value of a UCITS ETF does not differ significantly from its net asset value per unit using the (Indicative Net Asset Value' (iNAV).

The iNAV is the fund's instantaneous real-time theoretical market value at a given moment, used as a reference price by market-makers and day traders. The iNAV is published by the stock exchange operator throughout trading hours on every day on which the fund's NAV can be calculated and published.

The price of a unit traded in the secondary market depends on supply and demand and roughly matches the indicative NAV.

The secondary market is provided by "market-makers" acting as market counterparties. They contract with concerned market companies so as to maintain the difference between the highest bid and lowest offer prices within a set range. Their activities ensure that trading in fund units remains liquid. They also ensure, through arbitrage between the primary and secondary markets, that the fund's listed market price does not diverge significantly from its iNAV.

On Euronext for example, the iNAV is published every 15 seconds throughout the Paris trading session (09:05 – 17:40). Reservation thresholds are set giving a range of 1.5% on either side for indices covering European underlying (3.0% for all other geographical zones) of the fund units' iNAV, as published by Euronext Paris SA.

The iNAV data and the thresholds described above are good indicators and safeguards. Nonetheless some of European Stock Exchanges (such as the London Stock Exchange for example) do not publish iNAV since it is not one of their listing rules.

To this respect, we believe that these ETF listing requirement should be harmonized at European level. It would be highly beneficial and improve investors' information and protection.

<u>STRUCTURED UCITS - TOTAL RETURN SWAPS</u>

39. Do you agree with ESMA analysis of the issues raised by the use of total return swaps by UCITS? If not, please give reasons.

Yes we agree, except on the following sentence in point 56: "While it may be considered that the composition of the physical assets held by a UCITS is not relevant to the asset diversification test, by virtue of the diversification provided through the swap, it is not clear that Article 52 of the Directive would allow for this interpretation."

1. We believe that a constant interpretation of most regulators, all over Europe, has been that diversification has to be implemented after derivatives, and **only after derivatives**.

2. We believe that this is reinforced by a simple economic analysis: the purpose of diversification is to diversify the exposure of investors. **Exposure is real only after derivatives.**

Also, we do not agree with the following sentences in point 54: "While there are certain practices which are banned by the UCITS Directive, for example physical short selling and borrowing it is not entirely clear that a counterparty will not engage in these type of transactions are part of the investment strategy." The UCITS Directive regulates what the fund does, not what the counterparty does. The counterparty can hedge itself (or not), without any restriction.

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

We do not believe that diversification is required. The purpose of diversification regulations is to diversify the risks taken by investors. <u>Risks taken by investors are the real exposure of the fund, after the effect of derivatives.</u>

About the question whether to treat counterparty as an investment manager:

We agree if the counterparty has discretion and flexibility on investments that have an impact on the performance/NAV of the UCITS. But if the counterparty has discretion only on the collateral of the TRS (i.e. the investment portfolio that is swapped), it would be illogical to treat it as an investment manager. As for any swap, the investment manager of the UCITS sets guidelines for acceptable collateral and the counterparty has discretion within these guidelines to choose the securities it gives as collateral.

Regarding the investment management delegation agreement, we believe that this is not appropriate:

- The manager can give to the swap counterparty some flexibility as regards the choice of the underlying of the leg of the swap where the fund pays the performance of the direct portfolio. The reason is that the composition of this underlying (which is also the composition of the portfolio directly owned by the fund) has not effect on the exposure of the fund. The position of the fund through this leg of the swap is exactly compensated, by definition, by the portfolio directly owned by the fund. The only relevant consideration for the manager is the net advantage of such structure and whether the portfolio give a proper guarantee to the fund in case the counterparty would default. This is exactly what the manager is looking at. But the manager of the fund can very well give a lot of flexibility to the swap counterparty: this is in the best interest of the investors, because that allows a better net remuneration for the fund. This operation is very similar to lending securities and earning the appropriate proceeds from securities lending. The manager does not have to choose the precise securities that will be lent, provided that this is on line with its guidelines.

- Obviously, such flexibility for the swap counterparty does not make the bank an investment manager. An investment manager is an actor which decisions have an effect on the return of the fund. This is not the case here.

41. Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

No, we believe that derivatives are highly regulated by Europe, especially since the CESR Guidelines on Risk Measurement.

42. If yes, can you suggest possible actions or safeguards ESMA should adopt?

n.a.

<u>STRATEGY INDICES</u>

43. Do you agree with ESMA's policy orientations on strategy indices? If not, please give reasons.

For the sake of clarification, we believe that the proposed ESMA orientations as regards indices should be applicable to all indices, not only to strategy indices.

- Diversification : we do not understand the 'impact' concept and the definition (quantitative or qualitative) would need to be clarified. We agree with requirements proposed for commodity indices. We understand ESMA proposal as being, for example, that a WTI contract and a Brent contract should be seen as only one asset for the sake of diversification. ESMA should also be explicit about whether crude oil and gasoline, for example, should be seen as only one commodity.

- Adequate benchmark: By suggesting that an index must be a benchmark for the market to which it refers, ESMA seems to restrict the scope of eligible financial indices to long only and beta financial indices not embedding any kind of strategy. In other words, the ESMA Discussion Paper might be construed as making a distinction between plain vanilla, long only and beta financial indices, on the one hand, and strategy indices relying on an optimisation process with a view to producing an alpha return, on the other hand.

In its advice of January 2006 (Ref: CESR/06-005), CESR advised that in order to be recognised as being an adequate benchmark for the market to which it refers, the index "must measure the performance of a representative group of underlyings in a way that is meaningful and useful". Strategy indices can be designed with a view to satisfying this condition. There are numerous strategy indices meeting that requirement that have been approved by the supervisory authorities across the EU over the last decade and in connection with UCITS products. It is also worth noting that some of those strategy indices have become benchmark indices themselves.

UCITS funds providing an exposure to strategy indices have been raising and are still raising subscription proceeds amounting to billions of Euros, which is per se already a strong indication that there is demand for those UCITS funds and that they have been delivering a performance deemed as being a competitive one in comparison with other types of UCITS funds and other investment products.

We are wondering which grounds are sustaining the perceived ESMA belief that strategy indices are not appropriate for UCITS funds where there are no clear evidences that strategy indices are failing in terms of risk & return by comparison with plain vanilla, long only and beta financial indices.

- Rebalancing : the rebalancing frequency (that has to be disclosed in the prospectus) is not a guarantee for transparency nor linked to the costs issue. Traditional indices have a rebalancing policy which is, in general, quarterly. However, the world of indices knows a lot of innovation these days and we do not see why having a more frequent rebalancing, even intra-day, would be in itself a problem in terms of public policy. ESMA mentions two problems: the costs and the transparency. Investors should clearly be informed that rebalancing can happen intra-day, but the costs are not necessarily significant, since the underlying concerned can be very liquid (futures etc.). Also, the rebalancing can affect only a small part of the portfolio so that would not be significant in terms of costs. Transparency may be an issue, but the frequency of rebalancing is not the issue. An index can be rebalanced quarterly and be completely non transparent. An index can be rebalanced intra-day and be very transparent. We believe there is no absolute relation between the two. We agree with the disclosure of the rebalancing frequency in the prospectus.

- Published in an appropriate manner: Some index providers do not provide for free the components and weights of their indices. This is in fact very usual. Besides, the notion of the investors being able to “replicate” the performances of the underlying index is according to us not as relevant as it seems. Some well-known and recognized financial indices (e.g. the S&P GSCI) allow some discretion, though constrained through their index committee and some other indices do not disclose commercially sensible information (which would allow an investor aiming at replicating the index to arbitrage it). It seems to us that the right criteria as regards transparency should be that investors must be able to assess which market is exactly represented, what the objectives of the index are and how the rebalancing methodology works.

44. How can an index of interest rates or FX rates comply with the diversification requirements?

We believe that interest rate derivatives and FX derivatives should be disregarded for the sake of diversification of indices, i.e. their notional should not be taken into account for the sake of diversification.

There is no proper way to take them into account and they are already disregarded for the computation of diversification of assets held directly by UCITS according to article 52 of the UCITS Directive.

The reason is that such derivatives do not have an "underlying" according to article 51(3) paragraph 3 of the UCITS Directive.

Let's take an example with an FX derivatives. Let's assume that an index provider want to create an index "quanto", for example a quanto S&P 500 in EUR. This index would be made of the S&P 500 in EUR, but protected from the variation of the USD/EUR rate. The index would be made of the 500 shares of the S&P 500, plus a swap USD/EUR for a notional amount equal to the index. Such index would however be properly diversified, in spite of the fact that its EUR/FX swap has a notional equal to 100% of the value of the index. There is no underlying securities of such swap that has to be taken into account.

However, we believe that an FX position has a diversification feature in itself, e.g. a portfolio having an index exposure and FX positions might be better diversified than a portfolio only exposed to the index. As a consequence, when evaluating the exposure of an index to a given asset, managers should be given the option to include the FX exposure gained through FX future contracts used for investment purposes (as opposed to hedging purposes) in the calculation.

45. Are there any other issues in relation to the use of total return swaps by UCITS that ESMA should consider?

The situation of "indices of indices", indices that contain some other indices among their constituents, should be clarified.

If the sub-index is itself an index according to the UCITS Directive and ESMA guidelines, the sub-index is itself properly diversified. The weight of the sub-index should therefore be allowed to be higher than 35%.

For example, we propose that it should be possible to have an index that would be made of 4 constituents, each of them for 15% of the index, plus a compliant sub-index for 40% of the index. As a constituent of the index, the sub-index can represent more than 35% of the index.

We do not see other specific issue.

46. If yes, can you suggest possible actions or safeguards ESMA should adopt?

ESMA guidelines should include a paragraph allowing indices that include other indices as constituents. It should simply mention that when an index includes as constituent another index (the "sub-index") and when the sub-index respect European regulations as an index, the exposure to such index can be higher than 35% of the index.

If you need any further information, please don't hesitate to contact Eric Pagniez, at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr) or Adina Gurau Audibert, at +33.1.44.94.94.31 (a.gurau.audibert@afg.asso.fr) or myself at +33.1.44.94.94.29 (p.bollon@afg.asso.fr).

Sincerely Yours,

(signed)

Pierre Bollon