ASSOGESTIONI
associazione del risparmio gestito

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ESMA
European Securities and
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103 Rue de Grenelle
75007 Paris

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Reply to ESMA's guidelines on ETFs and other UCITS issues

Assogestioni([1]) is grateful for the opportunity to comment on ESMA's guidelines on ETFs and other UCITS issues.

We welcome ESMA's approach to look further than ETFs and we favour measures enhancing investor protection. We wish however to express concern regarding some specific issues.

With reference to index-tracking UCITS, we are in favour of giving investors more extensive disclosure on the index replicating components, but we do not support the general request of disclosing all index constituents with their respective underlying. We do not believe the disclosure of the exact component of the index to be proportionate to the objectives of transparency since it does not bring real-added value to investors.

We agree with ESMA proposal extending the rules on collateral to mitigate counterparty risk for OTC derivatives to EPM techniques. However we strongly disagree with the proposed diversification rules on collateral requiring that the "*combination of the collateral received by UCITS and the assets of the UCITS not subject to EPM techniques*" should comply with UCITS diversification rules. We have important concern on a proposal that gives the same emphasis and the same risk to the portfolio assets and to collateral assets. The assets constituting collateral have a guarantee function as they are a secondary guarantee after the first one formed by the counterparty. Additionally this rule would require a complex management of the assets received as collateral. Further the implementation of the envisaged calculation method would increase administrative and compliance burdens also

[1] Assogestioni is the Italian association of the investment fund and asset management industry and represents the interest of members who currently manage assets whose value is close to 900 billion euro in open ended UCITS and non UCITS funds, real estate fund and discretionary mandate.

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where the EPM techniques are concluded only in relation to a fraction of the UCITS portfolio or with more than one counterparty.

We have also some remarks regarding the limitation of investing cash collateral only in risk-free assets for EPM techniques. CESR guidelines 10/788, published in July 2010, set already clear rules on the "further" use of collateral received by UCITS and where investors are informed about the potential risk arising from EPM techniques, UCITS should be allowed to reinvest collateral also in not free-risk assets.

As regards strategy indices, the scope of ESMA's proposed guidelines needs some clarification. In our opinion these guidelines should be interpreted in line with the principles set in art. 9(1) in the Eligible Asset Directive and with the indication set in the point 22 of the CESR/07-044 guidelines. In this context, UCITS may invest in a strategy index that does not respect these guidelines only for diversification purposes where the exposure to the individual indices comply with the 5/10/40% rules.

Lastly and on a more general level, we strongly encourage ESMA to take an horizontal approach also to all other products, different from UCITS, sold to retail investor in the revision of the MiFID and in the PRIPs proposal to enhance investor protection and limit risk on certain practices.

Here below the Assogestioni responds in detail to the consultation documents.

I. Index-tracking UCITS

Q1: Do you agree with the proposed guidelines?

We welcome ESMA's approach extending the scope of the proposal also to include index tracking UCITS that are not ETFs.

In order to unequivocally determine the scope of these guidelines we propose providing a definition of "index-tracking UCITS". In line with art. 53 of UCITS directive, we suggest that the aim of an index-tracking UCITS should be replicating the performance of a benchmark.

More in general, we support the proposed guidelines, subject to the following remarks.

Paragraph 1a. (disclosure of index's composition)

We support ESMA in proposing that in the prospectus of index-tracking UCITS sufficient detail should be provided to allow to understand the index tracking policy used and the types of underlying assets and strategies they are gaining exposure to.

We are in favour of giving investor more extensive disclosure on the index replicating components, but we do not support the general request of disclosing all index constituents with their respective underlying. We do not believe the disclosure of the exact component of the index to be proportionate to the objective of the transparency since it does not bring real-added value to investors or help them assess the UCITS risk/return profile. In particular, we believe that also a broad

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description of its entire relevant element, together with the techniques used to replicate the performance of the index and with other information foreseen in the guidelines could provide sufficient detail to investors to better understand the index-tracking UCITS.

In any case, as regards disclosure of details of the index underlying components, we ask to clarify whether "*the exact composition of the index published*" is intended as real-time information of such composition or allowing for a time lag. Such lag should however not be incompatible with the overall objective of the offering documents.

On a more general level, the disclosure of the detail of the index is not controlled by the investment management, but rather depends on the index provider policies. And over time fewer and fewer index providers give this information for free. We believe that the proposed provision would also generate a dominant position of index providers and costs for UCITS management company reflecting eventually on the cost of the UCITS themselves.

To improve disclosure of index constituents, used not only by index tracking UCITS, we suggest ESMA should adopt measures that help preventing the gaining of dominant position by index providers for instance by envisaging that index provider should disclose for free both the index constituent, especially those whose weight is above a threshold, and the information on the performance of the index.

Paragraph 1c. (disclose of tracking error)
We appreciate the ESMA rewording of point 1.c) regarding the disclosure in the prospectus of the ex-ante tracking error and its target volatility. The new indication explains better that the disclosed target level is not intended to be a limit and it could be allow for temporary fluctuations over time. Only where a index-tracking UCITS deems that the information disclosed in the prospects are no longer representative it should update the offering documents. In any cases, the divergences between the ex-ante information given in the prospectus and the ex post data will be then explained in the periodic report.

Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs.
To allow for comparability, ESMA should define and publish a clear tracking error definition and a standardized calculation method; for instance the type of data and the time period to use should be indicated.

It is important that only one methodology is set, regardless of the replication method being used.

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Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?
We ask to clarify this proposal with respect to the disclosure set in the KIID.

It appears that disclosure is already requested in the KIID. Art. 18(1) of Regulation 583/2010 set: "*Where the 'Objectives and investment policy' section of the key investor information document makes reference to a benchmark, a bar showing the performance of that benchmark shall be included in the chart alongside each bar showing the UCITS' past performance.*"

Is the aim of the current proposal to include this information also in the annual and half-year report?

II. Index-tracking leveraged UCITS
Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?
We agree with the proposal.

Q5: Do you believe that additional guidelines should be introduced requiring index tracking leveraged UCITS to disclose the way the fund achieves leverage?
No, we do not believe that further guidelines are necessary.

III. UCITS Exchange Traded Funds

Definition of UCITS ETFs and Title
Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?
We have no comments.

Q7: Do you agree with the proposed guidelines in relation to the identifier?
We agree with the proposed guidelines that requires a UCITS ETF to use an identifier and to a UCITS which does not fall under the definition of UCITS ETF not to use the "ETF" identifier. As indicated in the explanatory test, we would like the same rules for the identifier to be extended in the future to other products sold to retail investors that do not deal with UCITS.

Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?
We disagree that the identifier should further distinguish between synthetic and physical ETFs. We deem that this information would give too much emphasis on technical aspects or management techniques that are not specific to ETFs, but concern all UCITS. In fact almost all UCITS managed could be exposed to counterparty risk and to collateral risk coming from the use of derivatives contracts

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or securities lending activities. These information are included in the KIID or in the prospectus where there is enough space to explain better these concepts. Further this identifier should address also the mixed situation where a UCITS uses both synthetic and physical replication.

Q9: Do you think that the use of the words 'Exchange-Traded Fund' should be allowed as an alternative identifier for UCITS ETFs?
We agree that it could be used as identifier both "ETF" and "Exchange-Traded Fund". To harmonize its use around Member States and avoid complication in the translation of words "Exchange-Traded Fund" we propose to consider using always the English version and avoiding translation in national languages.

Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?
We do not think that there should be stricter requirements on the minimum number of market makers. It is important that the market maker is not a "formal" market maker, but it is an actual one. A legal obligation to have "formally" more market makers would not necessarily improve volume and reduce the spread between bid-offer prices. It would only impose unnecessary cost on UCITS without benefit for the final investor.

Actively-managed UCITS ETFs

Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in the prospectus, the KIID or any marketing communications of the UCITS ETF?
We agree with the proposal and we have no suggestion of any additional matters that should be disclosed in the offering material.

Secondary market investors
Q12: Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?
In general, we think that neither option 1 nor 2 adequately deal with the cost that the final investor will pay where redemption are directly requested to the UCITS. UCITS can set a high redemption fee to discourage the redemption of shares directly from the UCITS.

However we consider option 2, informing investors of the possibility to redeem directly form the UCITS, preferable.

Granted the principle that the pricing policy is a discretional decision of the UCITS management company, we suggest a provision envisaging the charging of a "fair" fee for redemption in case of the events indicated in paragraph 2 of option 1, for both options.

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Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.
We have no comments.

Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.
We have no comments.

Q15: Can you provide further details on the relationship between the ETF's register of unit-holders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?
We have no comments.

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

In general, we are in favour of improving transparency regarding the EPM techniques and of requiring collateral received in the context of EPM techniques to comply with Box 26 of CESR/10-788, but we have some remarks.

<u>Paragraph 2 (collateral policy disclosure)</u>
We are of the opinion that the required information on the UCITS' collateral policy should not be too detailed in order to avoid frequent updates to the prospectus in case of minor amendments or periodic updates to the collateral policy. It should be possible to include in the prospectus a reference to an external source (e.g. website) where the relevant policy would be disclosed in more details.

In any case, we are not in favour of disclosing in the prospectus the level of collateral required; indeed this information should be given only on an ex post basis in the UCITS' annual report, as suggested in point 10 (c). The level of collateral varies over time depending on market and credit conditions, and these changes will reflect in a frequent update of the prospectus or of the external source.

<u>Paragraph 3 (transparency on fees)</u>
We appreciate ESMA work on fee transparency, but we have some consideration on the general rule "*Fees arising from EPM techniques should be [...] ,as general rule, returned to UCITS*".

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It should be clarified that the cost of such activity is admissible not only with external agents involved in the lending activities with a fee-sharing agreement but also for a UCITS management company or its affiliate, when the securities lending agents may be a related party to the UCITS. This to avoid that a UCITS should always deal with third parties when this activities is well done and in a cost effective way also from an entity related to the UCITS. Further, the proceeds of securities lending should be considered as a further cost that could be imposed on UCITS also in addition to management fee.

The criteria governing the fee arising from security lending should be disclosed in an appropriate way in the fund rules and in prospectus, as for example performance fee: the income received i.e fee or interest may not be always expressed as the management fee. It also essential to clarify that the prospectus should always disclose whether the UCITS reinvests the collateral received also in assets other than risk free (please refers to Q17).

As general rule, investor should always be informed about the cost and the potential risk also arising from securities lending activities, also to allow for comparison between different UCITSs.

Indeed, we believe that the pricing policy of UCITS as well the allocation of the proceeds among all parties involved in the securities lending should remain under the responsibility and judgement of UCITS management company, in line with UCITS directive that do not deal with this issue.

In any case, it should be clarified the meaning of "third party": is it indented to be only external agents involved in the lending activities or third parties related to UCITS can also be admitted? Doubts arise from the combination of guidelines and the explanatory text n.44.

Even if out of scope of this consultation, we ask also to address the issues regarding disclosure in the KIID of the calculation of the ongoing cost of securities lending. It should be clarify that the part of the lending revenues that is retained by the manager or its affiliate, i.e. the lending agent, should be disclosed as ongoing cost, regardless that the lending fees received would not be considered as a fee-sharing agreement from a legal point of view.

<u>Paragraph 6 (collateral)</u>
We are in favour of requiring collateral received in the context of EPM techniques to comply with Box 26 of CESR/10-788, but we disagree with the requirement that "cash-collateral can only be invested in risk-free asset" (please refer to below Q17 and Q18).

In addition, we ask for a clarification, as regard the concept of collateral "diversification" for reducing counterparty risk, used in paragraph 5. and 6. (please refer to below Q20.2 specific consideration).

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Box 26 of CESR/10-788 states that correlation between the OTC counterparty and the collateral received must be avoided. For avoidance of any doubt, in case of securities lending, it should be clarified, that where the counterparty is the facilitator or the securities agent, the UCITS is not required to know the final borrower but rather can regard the facilitator as the counterparty.

Paragraph 7 (UCITS diversification rules)
We have strong concerns with the propose set in paragraph 7 as regards the combination between the collateral and the assets not subject to the EPM techniques that should comply with the UCITS diversification rules (please refer to Q20) .

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If no, please justify.
Q18: Do you see merit in the development of further guidelines in respect of the reinvestment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?
Paragraph 6 (criteria for collateral)
In general, we agree with a horizontal approach with respect to collateral requirements and agree that collateral received in the context of EPM techniques should comply with the criteria for collateral received in the case of OTC derivatives set out in Box 26 of CESR/10-788.

We believe that the guidelines on collateral in Box 26 of CESR/10-788 set already good standard in ensuring that the collateral received, in any contest, is of good quality, but we have some remarks regarding the limitation of investing cash collateral only in risk-free assets for EPM techniques.

According to Box 9 of CESR/10-788, the risk associated with any leverage linked to EPM techniques should be included in the calculation of the global exposure of the UCITS, where UCITS reinvest the collateral in financial assets that provide a return in excess of the risk-free return. A consistent risk management policy, as requested in Directive 2010/43 and detailed in the CESR/10-788 guidelines should be considered sufficient to manage also the risk arising from these techniques. Please consider this provision would devoid the use of these EPM techniques of any financial meaning as the cost and risk incurred would be above the level of risk free return. For example, for a repo the UCITS will incur a financing cost and need to reinvest the cash proceeds in financial instruments that provide a return greater than the financing cost incurred.

As regards the definition of risk free assets, we suggest to leave it to the judgement of UCITS management company, except if a competent Authority defines it. In case of the latter, we encourage a further ESMA work with the aim of harmonising the rules and maintain a level playing field. With this regards, Bank of Italy in the draft regulatory framework on implementing measures of UCITS IV has proposed some definition. At the moment we are attending their final publication.

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

No, as regards the type of assets constituting the collateral we disagree on the close consistency between the collateral and the index. The guarantee function of the collateral is not necessarily achieved if the assets used as guarantee are highly correlated with the performance of the underlying of the financial derivatives. Indeed a strong positive correlation could potentially have a negative effect on the guarantee function. In our view and as indicated in art. 43 of Directive 2010/43, collateral received should be sufficiently liquid so that it can be sold quickly at a price that is close to its pre-sale valuation. This could not be the case for example for an UCITS that tracks an emerging markets index and has, as collateral, equities of an emerging market issuer.

The key driver for collateral is the speed at which collateral can be liquidated. In case of securities lending, it is used in order to buy back lent assets upon a failure of redelivery.

The risks that the proceeds of the collateral sale do not cover the loss arising from the default of the counterparty have to be managed through the identification of appropriate haircut together with qualitative principles of diversification.

In addition, and in particular in relation to securities lending activities, the obligation to request collateral correlated to the securities held in the portfolio (and therefore object of the loans) may also significantly reduce the attractiveness of the securities lending programmes and therefore negatively impact the potential returns for the UCITS".

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

Q.20.1 General consideration

Even if the question seems addressed only for securities lending activities, we deem important to give an answer that cover all EPM techniques.

We are in favour of requesting diversification of collateral as requested in paragraph 6., but we strong disagree with the introduction of this paragraph 7.

This paragraph propose to create a new portfolio - "*combination of the collateral received by UCITS and the assets of the UCITS not subject to EPM techniques*"-, that to our opinion could became real only when all EPM techniques counterparties defaults in the same time, and this new portfolio (hypothetical default portfolio), should comply any time with all UCITS diversification limit.

We have strong concern on this proposal that gives the same emphasis and the same risk to the portfolio assets and to collateral assets and can influence, in a indirect way, the strategy of asset manager. Additionally this rule would require a complex management of the assets received as collateral. Further the

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implementation of the envisaged calculation method would increase administrative and compliance burdens also where the EPM techniques are concluded only in relation to a fraction of the UCITS portfolio and more than one counterparty.

The proposal raises concerns essentially for the following reasons.

Due the different purpose of the asset received as collateral and the portfolio assets, it is possible that the UCITS has already in its portfolio the asset received also by collateral. UCITS will be for example in breach if they already hold significant holdings of the high quality government bonds and cash which typically make up collateral schedules.

It is important to bear in mind that collateral is received from a third counterparty and the UCITS investment company usually does not choose the single financial instruments that could be received as collateral but set, more in general, the characteristics of solvency and diversification of the collateral that it can receive. Then the third parties, within the limits established by contract, will identify the single financial instruments used as collateral. Frequently in the contractual agreement between UCITS and the counterparty there are clauses obliging the counterparty to replace the collateral in case of loss, over time, of the minimum acceptable solvency characteristics (such as an investment grade credit ratings). In other cases the collateral is constantly updated by a third part (Tri-Party Agents) based on certain characteristics of solvency and diversification established by contract (Tri-Party Agreement) between the UCITS, the counterparty and the custodian. These types of contract allow to maintain a collateral in line with its guarantee function.

In addition, the third party should have the “right” financial instruments that allow the UCITS to comply with UCITS diversification rule. For example, a UCITS that invests 8% in a bond issued from a high quality corporate X and engages in reverse repo on other financial instruments should ask to the counterparty to exclude bonds issued by X as collateral to avoid any potential effect on the investment policy (breach of 10% issuer limit). The construction of this potential list should be based not only on the positions held in the portfolio but should also take into account the possible strategies that the manager can implement. The complexity of this procedure increases when a UCITS uses more than one counterparty.

Collateral diversification and UCITS assets diversification rules have two distinct objectives which should not be confused: the purpose of the collateral diversification is to reduce counterparty risks while the purpose of the assets diversification is to prevent excessive concentration of investments. The assets constituting collateral have a guarantee function as they constitute a secondary guarantee after the first guaranteed formed by the counterparty.

In case of counterparty default we deem essential that the collateral assets can be liquidated in a very short time to eventually reconstitute the position in line with the UCITS investment objective (i.e. in a securities lending agreement the UCITS lend equities and receives bonds as collateral). We strongly believe that haircut policy

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together with the liquidity of the collateral are criteria much more important than diversification, especially where the diversification rule is intended to be the 5/10/40% rule.

Those qualitative principles are clearly and already indicated in Box 26 of CESR Guidelines 10/788 and, we think, are been identified precisely on the consideration that those assets constitute a secondary guarantee and the risk management policy should have developed robust risk management procedures. CESR, in particular, already ask to investment management to consider together the characteristics of the direct investments and the collateral through definition of appropriate discount rules. In fact the point 82. of the explanatory text of CESR Guidelines 10/788 indicates that for "*the collateral presenting a risk of value fluctuation, prudent discount rates can be determined by simulating the valuations of both securities held in portfolio and collateral over multiple holding periods*".

The guidelines seems also disregard that many UCITS may use also different counterparties to mitigate the risk of their simultaneous default or that the EPM techniques could be concluded only in relation to a fraction of the UCITS portfolio. Even if EPM techniques are run under the principle that it should not added substantial supplementary risk in comparison to the concerned fund's general risk policy, in some situation the EPM techniques guaranteed by collateral seems to be considered riskier than that ones without collateral. For more detailed consideration, please see also our response to Q37.

The proposal raises also further practical difficulties. The collateral management policy requests a dynamic management of the collateral. The definition of the eligibility criteria of the collateral allow an automated and an efficient management of the collateral and avoids incurring in burden compliance cost. This well efficient system should no longer be applied where a UCITS should redefine the types and the amount of the single financial securities that should be received as collateral in order to comply, together with the assets of the UCITS not EPM, with UCITS diversification rules.

Finally, we deem important to point out that UCITS asset management company has to change its procedures, operating and risk management systems involving an increase of cost that seems do not pay due regard to the principle of proportionality.

Where the consideration above are not in line with ESMA objectives we ask to valuate:

- the possibility to limit the application of this paragraph only where EPM techniques are used on substantial basis, due the fact that the "hypothetical default portfolio" is a not real portfolio until all the EPM counterparties default. The proposal aim to introduce a criteria of proportionality;
- to subject only the collateral to the rule 5/10/40% in order to implement also these rules in the limit established in the contractual agreements and reduce administrative and compliance burdens to comply with the guidelines;

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- a more flexible enforcement of the diversification limit, with specific regard to the 5/10/40% rule, could allow for more efficient management of the boundaries and temporary breaches, other than those caused by market condition (passive breaches). In particular, where the breach is determined by operational reasons related to the way collateral financial instruments were selected (technical breaches), a breach of the concentration limits should be allowed. In a similar way, also a breach coming from the decision of an asset manager on the UCITS portfolio should be allowed (active breach). The asset manager usually does not know each constituent of the collateral (that can change every day): for example, an asset manager increase the investments in a bond X issued from a high quality corporate from 6 to 8% and he does not know that, at the same day, there is in the collateral coming from a EPM techniques already a 3% position in X. In any case, return to compliant limits should be made in a short period (not below of 7 days).

Q.20.2 Specific consideration
The proposal raises doubts and concerns as regards the scope and method of calculation that seems to be requested. We invite ESMA developing further guidelines on this issues to insure harmonisation and avoid incorrect interpretation; to this regards we strongly suggest the inclusion in the guidelines with specific and quantitative examples for each EPM techniques.

Although different EPM techniques have similar financial effects, from an accounting point of view, each technique has a different impact on the UCITS and hence on the calculation of limits. For example, in reverse repo the securities, bought spot (and sold forward at the same time and at a prefixed price) as collateral, are not considered as UCITS asset while credits to the third counterparty are. In the securities lending, the securities lent remain in the portfolio and the collateral received from third party is not included in assets of the UCITS. In reverse repo, the funding is included in the UCITS asset, and the securities given as collateral to third party remain in portfolio. Any further use of the collateral should also be taken in due consideration.

Concerning the scope of the proposal.

Paragraph 7 requires that the "hypothetical default portfolio" complies at all times with UCITS diversification limits. It should be clarified whether:

A. both the "standard" UCITS portfolio and the "hypothetical default portfolio" must be subject to UCITS diversification rules or
B. only the "hypothetical default portfolio" must be subject to UCITS diversification rules.

By UCITS diversification rules we are here referring to the main rules set in :

- Art. 52(1)(1° paragraph)(b): the deposit limit (20% rule) or "DL";
- Art. 51(1)(2° paragraph)(a,b): counterparty limit for OTC transaction (10% bank, 5% others) or "OCL"
- Art. 52(2)(1° paragraph): the single issuer concentration limit (the 5-10-40% rule) or "SICL":

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- Art. 52(2)(2° paragraph): the total concentration limit of 20% (i.e. the combined limit rule on single issuer + counterparty limit) or "<u>TCL</u>".

while is excluded

- Art. (83) (2): temporary borrowing

Even if we are not in favour of paragraph 7, we deem that while interpretation A could be applicable, with some adaptation, for reverse repo (please see below concerning the method of calculation), it cannot be used, for example, in case of securities lending. In this case, the performance of the UCITS is based on the "standard" UCITS portfolio and the replacement of the risk generated by the swap of the shares held in the standard UCITS portfolio with the collateral one would eliminate the control over the risk linked to the "standard "UCITS portfolio. In the event of default of the issuer, the value of the securities hold in the portfolio fall to zero, and UCITS has no right to claim against the collateral, as this occurs only if the counterparty to the transaction fails and not where equity issuer defaults. In addition, where only the "hypothetical default portfolio" should comply with UCITS diversification rules, the securities lending would allow circumventing the SICL. For example, UCITS invest in a 15% of one equity issuer, but it lends 10% of these securities, the "standard" UCITS portfolio is not compliant (15%), indeed the "hypothetical default portfolio" is compliant.

In order to comply with the TCL, the concept of collateral "diversification" for reducing counterparty risk, as used in paragraph 5. and 6. of the guidelines, should be clarified. Paragraph 5 requires collateral to comply with qualitative criteria (Box 26 to CESR/10-788) while paragraph 6 identifies the concept of diversification for the "hypothetical default portfolio" that should comply with quantitative criteria (UCITS diversification rules). In particular, there are the following possible interpretations:

A. where the collateral complies with qualitative principles set in Box 26 of CESR/10-788, it may be used to reduce counterparty risk exposure, regardless whether the collateral complies with the SICL or not. If the qualitative test is passed, the net exposure, being understood as the amount receivable by the UCITS less any collateral provided to the UCITS (paragraph 2 of Box 27 CESR/10-788), has to comply with the TCL;
B. where the collateral respects the SICL, it could be used to reduce counterparty risk exposure; if the quantitative test is passed, the net exposure has to comply with TCL.

In both cases, if the test failed, the gross exposure coming from EPM techniques should be, as a whole, accounted to the EPM techniques counterparty and this counterparty should respect the TCL.

We ask to clarify that the interpretation A. is the right interpretation.

<u>Concerning the method of calculation.</u>

It should be clarified whether the guidelines require, in practise, the calculation of two types of NAV: the standard NAV without collateral and the second one which include collateral. Issuers' limits and more in general all limits are calculated as the

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ratio of the value of the securities held in portfolio and the total asset of the UCITS ; the collateral, as general rule, is not included in the UCITS portfolio.

Paragraph 7. indicates the criteria to calculate the dividend of the division (collateral and asset not subject to EPM techniques) and does not clarify which is the divisor.
We believe that ESMA should clarify:
- the division: is it the collateral gross or net from “haircut”?
- the divisor: is it the total asset of the “standard” UCITS or something else?

Where the divisor is the “standard” UCITS, we note that the swaps of the assets included in the dividend could lead to a breach of the diversification limit due to the inconsistent base of calculation and could cause problems in case of overcollateralization.

As an example:
- UCITS set a reverse repo with counterparty Y with collateral X for a nominal value of 100. Where at time t = 1, the collateral security increased (100,5) and exceeds the nominal amount plus the accrued interest, the ratio between the dividend (calculate at MTM value) and divisor (nominal value) is incoherent (100,5/100,01).
- In a securities lending, usually is always requested a overcollateralization of the securities lent (105%). If UCITS lent securities for 100, at time T, at the same time, the ratio between the dividend (105) and divisor (100) is incoherent (105/100).

Problems could also arise when positions are rolled over, in the period between the trade date and the settlement date, and, for repo, when funding is accounted on settlement date.

In addition, further indication should be given on how to calculate the “hypothetical default portfolio” when asset managers hedge some risk coming also, but not necessarily only, from asset subject to EPM techniques that are been swapped.

As above indicated in the general consideration, a more flexible enforcement of the diversification limit, with specific regard to the rule 5/10/40%, could allow for more efficient management of the boundaries and temporary breaches, other than those caused by market condition (passive breaches). In particular, where the breach is determined by operational reasons related to the way collateral financial instruments were selected (technical breaches), a breach of the concentration limits should be allowed. In a similar way, also a breach coming from the decision of an asset manager on the UCITS portfolio should be allowed (active breach). Return to compliant limits should be made in a short period (not below 7 days).

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

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We prefer a list of qualitative criteria as set out in CESR's guidelines on risk measurement.

Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.
We prefer a list of qualitative criteria that could be then adapted by the UCITS management company in line with CESR guidelines 10/788.

In any case, where a list is indicated, we ask to clarify that with the definition "Shares or units of UCITS that offer daily dealing;" are meant shares or units of UCITS that calculate daily NAV.

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?
We disagree that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivatives transaction under Art. 52 (1) of the UCITS Directive (counterparty risk limit of max 5% for a normal counterparty and 10% for banks).

We suggest that the exposure generated through EPM techniques should be subject to a higher limit. The UCITS Directive set the limit only for OTC derivatives; it should be verified whether such limit is large enough to allow also for the counterparty risk created by EPM techniques to be included.

We propose therefore to subject these operations to the overall higher issuer concentration limit of 20% i.e. the combined limit rule (issuer + counterparty limit) laid down in the second paragraph of Article 52 of Directive 2009/65/EC.

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

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?
No, we believe that ESMA should not set a limit on the amount that can be lent. A possible limitation may also have adverse effects on the performance received by the final investors.

Q26: What is the current market practice regarding the proportion of assets that are typically lent?
We have no comments.

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Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?
We have no comments.

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?
No, such information should not be included, provided that it is already disclosed in the prospectus.

A UCITS needs flexibility in the collateral management policy and it is possible that it should update its policy over time. Frequently update of the fund rules should be avoided. In Italy, the updating of the investment policy fund rules, where it is considered substantial, is subjected to a transitional period which could immobilize the collateral asset management activity. Updating is also expensive as it has to be communicating to investors individually.

It could eventually be useful to include in the fund rules a general provision regarding the intention to engage in EPM techniques but more specific information should only be part of the prospectus.

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

Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interests? If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps
We believe that the existing regulation applicable to conflicts of interests is appropriate to efficiently manage (and, as the case may be, disclose to investors) potential conflicts of interest in relation to valuation of the collateral.

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.
No comments.

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V. Total return swaps

Q32: Do you agree with the proposed guidelines?

General consideration
Point 58 of the explanatory indicates, as regards the use of TRS derivatives,: "*[...] This investment can reprsent up to 100% of the assets, in which case the UCITS can be qualified as a structured UCITS*".

We ask to clarify that a UCITS can be qualified as a structured UCITS only when it complies with definition set in Art. 36(1a) of Regulation 583/2010 (KIID): "*structured UCITS shall be under-stood as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the perfor-mance, or to the realisation of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features.*"

Paragraph 1
We do not consider that UCITS diversification rules should apply to the swap underlying. Instead, Box 26 of CESR's guidelines should apply. It is essential, but also sufficient to adhere to the diversification rules with regard to the UCITS portfolio, as risks taken by investors are the real exposure of the fund, after the effect of derivatives. We therefore strongly advocate not considering the underlying baskets in separation but allowing for delta adjustment of the relevant swap underlying in the assessment of compliance with UCITS diversification rules.

UCITS diversification rules are meant to avoid the possibility that exposure to a given issuer would have too significant an impact on the performance of the fund. However, the portfolio swapped in a TRS has no impact on the performance of the UCITS, since it is swapped. Instead, the UCITS has counterparty risk on the counterparty to the TRS, and the risk is subject to a 10% limit. The investment portfolio should therefore be subject to Box 26 of CESR's guidelines.

Paragraph 1 and 2
We disagree with the requirement that the combination of the collateral received by UCITS and the assets of the UCITS should comply any time with UCITS diversification limit. Please refer to below answer to Q37.

Paragraph 5
We consider that the information to be provided further to this paragraph is too specific in order to be fully included in the prospectus. It seems that this information is tailored for structured UCITS, as definite in the Regulation UE n. 583/2010 (KIID) when the strategy used is well know and use of TRS is close to 100% of the assets. Indeed, when a UCITS use also TRS as a part of its investment policy we find that this information is too much where details of counterparties and type of collateral may change very frequent.

As an exemplification regarding the disclosure of counterparty(ies), we believe that such detailed disclosure could cause problems during the negotiation in the

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selection on the counterparty(ies): often the counterparty(ies) is not known when a fund is launched. Further the change of one counterparty would cause a cost in the updating of the prospectus. As alternative proposal we suggest to give only general information on the characteristics of the counterparty(ies) such as the type of counterparty and its eventually connection to the management company.

Criteria choosing counterparties and determination of eligible criteria should only be described in the prospectus in a generic manner. A disclosure of this information is provided in the annual report (in accordance with paragraph 6 of the Box 7)

We disagree with the principle, that the TRS counterparty should, under certain conditions, be treated and disclosed as an investment manager. Indeed, as a matter of principle, the counterparty should not have discretion on investments that have an impact on the performance/portfolio of a UCITS.

Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return is of good quality? If not, please justify.
Generally speaking yes, but please see our remarks to above answer to Q32

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?
No, please refers to above answer to Q28

Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?
Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.
We support a list of qualitative criteria as set in CESR's guidelines 10-788. Please refer also to above answer to Q17 and Q18.

Q37: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?
Collateral provides only secondary guarantee in case of a counterparty default. Therefore collateral should be sufficiently diversified as requested in Box 26 of CESR/10-788 guidelines, but it should not be treated as part of the fund portfolio and be subject to the UCITS diversification rules in combination with other assets.

Please refer to above answer to Q20 related to EPM techniques (Box 6). In addition, we point out two more specific issues.

<u>Concerning the risk</u>
The guidelines indicate that the new aggregation ("hypothetical default portfolio"), that should comply with UCITS diversification limit, is the sum of the "standard"

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UCITS portfolio position and the collateral position. This would mean that in some situation investments in OTC derivatives guaranteed by collateral would result as riskier than those without collateral (please refers to the example below). This rule could therefore lead to the unintended consequence of discouraging the use of collateral on OTC derivatives where UCITS engages this transaction with multiple counterparties or for a part of the portfolio.

Example:
UCITS makes TRS with a bank giving an counterparty exposure of 100. The investment complies with the counterparty limit for OTC transaction of 10% Art. 51(1)(2° paragraph)(a).

- case A, UCITS receive collateral for 100, composed by financial instruments and deposit,
- case B, UCITS does not receive any collateral.

	UCITS invests in a TRS	
UCITS diversification limit	**Case A: UCITS receive collateral**	**Case B: UCITS does not receive collateral**
Art. 52(1)(1° paragraph)(b): the deposit limit (20% rule)	Verify that the cumulated position of "standard" UCITS portfolio + collateral comply with the limit	No verification is need
Art. 51(1)(2° paragraph)(a,b): counterparty limit for OTC transaction (10% bank, 5% others)	Verified by hypothesis	Verified by hypothesis
Art. 52(2)(1° paragraph): the single issuer concentration limit (the 5-10-40% rule)	Verify that the cumulated position of "standard" UCITS portfolio + collateral comply with the limit	No verification is need
Art. 52(2)(2° paragraph): the total concentration limit of 20% (i.e. the combined limit rule on single issuer + counterparty limit).	Where the collateral comply with qualitative criteria of Box 26 of CESR/10-788 = 0 Where the collateral does not comply with qualitative criteria of Box 26 of CESR/10-788 = 100	100

<u>Concerning the method of calculation</u>
It should be also clarified, in order to define the method of calculation of limits, where the divisor comes from the UCITS or the "hypothetical default portfolio". Where the hypothetical default portfolio should be divided by the UCITS total asset, that not include any collateral, the dividend of the division would grow (due to collateral) while the divisor would not. We believe that this could lead to breach due only to the method of calculation. Further, we disagree also with the correction of the divisor with the amount of the collateral position because it would cause a dilution of all diversification limits. Again, collateral has a guarantee function and should not be confused with the portfolio assets.

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Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?
We reiterate our strong reservations concerning the new guidance on how the diversification of the collateral should be assessed (please see our answer to Q20 and Q38). Indeed, we agree that should apply to all OTC derivative transactions the indication on haircut policies.

VI. Strategy indices

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

<u>General consideration</u>
To better address the impact of this guideline, the scope of application should be clarified.

We deem important to clarify if this Box should apply only to index-replicating UCITS or to all UCITS that gains exposure to strategy index.

Further, the term "strategy index" ("*index which aims at replicating a quantitative strategy or a trading strategy*") should be clearly defined to determine whether the guidelines apply solely to strategy indices or pertain also to other financial indices eligible for UCITS. In particular, it is also unclear whether the specification regarding commodity indices (paragraph 3) apply only to commodity indices qualifying as strategy indices or to all forms of commodity indices.

We deem important that this guideline should be interpreted in line with the principles set in art. 9(1) in the Eligible Asset Directive and with the indication set in the point 22 of the CESR/07-044 guidelines. Where, "*if derivatives on the index <u>are used for risk-diversification purposes</u>, provided that the exposure of the UCITS <u>to the individual indices</u> complies with the 5/10/40% ratios, there is <u>no need to look at the underlying components</u> of the individual indices to ensure that they are sufficiently diversified.*"

In this context, UCITS can invest in an strategy index that does not respect this guidelines only for diversification purposes. In our opinion, the possibility of investing a small part of the portfolio is consistent with the purpose of asset diversification limits i.e. the prevention of excessive concentration of investments.

As a general issue and in line with article 53 (1) of Directive 2009/65 we suggest ESMA also to consider publishing a list of the eligible index recognised by the competent Authorities. Such list, to be regarded by UCITS investment companies as a purely indicative list and not be as a comprehensive list, would help the due diligence process and a harmonised view on this issue.

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Paragraph 3 (commodity indices)
As regards the composition of Dow Jones Commodity Index (an index of the most diversified and representative) and the related sector indexes, it should be clarified whether a future on the Agriculture index (composed by 2 sub-categories "Soybean oil" and "Soybean") or a future on Energy index (composed by 2 sub-categories "Brent crude" and "WTI crude oil") is considered as a diversified index or it is considered as not compliant with the diversification requirement and can hence be only eligible for diversification purposes (with the 5/10/40% limit rule).

	Dow Jones-UBS Commodity Index as of 02/22/2012	Agriculture	Energy
Aluminum	6,14%	x	x
Brent Crude	5,43%	x	**17,08%**
Coffee	2,22%	7,51%	x
Copper	7,48%	x	x
Corn	6,29%	21,33%	x
Cotton	1,79%	6,06%	x
Gold	10,15%	x	x
Heating Oil	3,47%	x	10,93%
Lean Hogs	2,15%	x	x
Live Cattle	3,75%	x	x
Natural Gas	9,48%	x	29,81%
Nickel	2,62%	x	x
Silver	3,14%	x	x
Soybean Oil	3,41%	**11,56%**	x
Soybeans	7,16%	**24,29%**	x
Sugar	3,77%	12,79%	x
Unleaded Gas (RBOB)	3,79%	x	11,93%
Wheat	4,85%	16,45%	x
WTI Crude Oil	9,62%	x	**30,25%**
Zinc	3,30%	x	x
	100,00%	100,00%	100,00%

Paragraph 4 (benchmark for the market)
Further indication regarding the appropriate due diligence that a UCITS investment company should undertake to identify if the index represent an adequate benchmark for the market which it represents would be also useful. In particular, we ask some exemplification clarifying how can a strategy index represent the market to which it refers or what is the meaning of "single objective".

Paragraphs 7 and 8 (disclosure)
We ask to clarify the meaning of "*investor*" when paragraph 7 foreseen "*[...] disclose the full calculation methodology to [...] investor*". It is not clear where investor is the UCITS or the UCITS final investor.

Further clarification is required as to what is exactly meant by disclosing full calculation methodology. More generally, it is important to protect intellectual

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property; the implementation of such guidelines would threaten proprietary indices and undermine the incentives to develop strategy indices. Providing all of the components, constituents and calculation methodologies would mean that all indices are freely available to those capable of replicating them. This also raises the issue of how this information can be made available in a retail format. The calculation of indices often involves mathematical formulae which are too complex for retail investors to understand.

Therefore, a reasonable level of the re-balancing methodology (timing, factors, potential limits) and of the index constituents with an appropriate time lag would be more appropriate.

Q40: Do you think that further consideration should be given to potential risks of conflict of interests when the index provider is an affiliated firm of the management company?
No comments.

VII. Transitional provisions

Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.
As a general remark, we wish to underline that the appropriateness of the transitional provisions can only be assessed once the extent of the changes to the regulatory framework will be clearly established. Indeed, since ESMA is seeking to harmonize issues which are currently regulated at national level, it may well be that national laws or regulations have conflicting requirements and would therefore need to be amended to be aligned on ESMA's guidelines. In such cases, there should first be sufficient time to adopt national laws/regulations and second appropriate time for market participants to adapt to such changes. Otherwise, market participants may be facing an uncomfortable situation in which they would have to choose between violating ESMA's recommendations or national regulations.

We believe that these guidelines require implementation of several policies such as diversification policy and collateral policy which need considerable preparation in order to become operational.

Therefore, we believe that it is neither reasonable nor feasible to bring the guidelines into effect in 2012.

Therefore, the guidelines should generally come into effect not before twelve months after their final publication. Additional time should be available in order to reflect the content of the new policies in the marketing materials and fund documents.

<u>Paragraph 2 (new investments)</u>
We ask to clarify the meaning of "new investments" in paragraph 2 of Box 9.

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In this respect, we believe in particular that a grandfathering clause should be granted to structured UCITS, as defined by Regulation 583/10 (KIID), which are closed to any new subscriptions from the public. Under such a grand-fathering clause, structured UCITS authorised prior to the implementation of the new guidelines would not need to comply with paragraph 7 of Box 6 and paragraphs 1 and 2 of Box 7.

Such grand-fathering clause would be granted in recognition of the fact that these new guidelines were not in place when these UCITS where launched and if the UCITS portfolio were adjusted to comply with the new guidelines, this would affect the pre-defined payoff to investors at maturity. This would not be in the best interests of investors as they invested in the UCITS on the basis of the pre-defined payoff. Structured UCITS can only benefit from this grandfathering provision using their current payoff profile; where a UCITS makes any changes to the derivative which results in a new payoff profile or scenario it must comply in full with the guidelines.

Paragraph 5

We ask to reconsider the transitional period needed to update the offering documents in line with the rules that were adopted for KIID. In particular, UCITS management companies should have until XX 2013 to update their offer documents in line with the guidelines.

Where the transitional period is in force, management companies should have the choice whether to update the offering documents at the first occasion or decide to delay it. There may be specific operational reasons that make it more practical or cost-effective not to update at the first occasion.

We suggest therefore to rewording the paragraph 5 as follows:

"5. Requirements relating to the contents of the fund rules or instrument of incorporation of an existing UCITS, its prospectus, its KIID, or any marketing communication that it has issued prior to these guidelines coming into effect, do not come into effect until ~~the earlier of:~~
~~a) The first occasion after XX 2012 on which the document or communication, having been revised or replaced for another purpose, is published; or~~
b) XX 2013 ~~(twelve months after these guidelines come into effect)~~. "

We hope that our observations will be of help and remain at your disposal for any clarification on the comments made in this response.

Yours sincerely

IL DIRETTORE GENERALE

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