

September 30, 2011

Mr. Steven Maijoor, Chair
European Securities and Markets Authority
103 Rue de Grenelle
75007 Paris
France

Re: ESMA's Policy Orientations on Guidelines for UCITS Exchange-Traded Funds and Structured UCITS

Dear Mr. Maijoor,

The Investment Company Institute (“ICI”)¹ appreciates the opportunity to comment on the European Securities and Markets Authority’s (“ESMA’s”) Discussion Paper on policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS (the “Paper”).² Exchange-traded funds (“ETFs”) registered under the U.S. Investment Company Act of 1940 are an important part of both the U.S. fund market and the global ETF market. Many of our members sponsor ETFs both in the U.S. and in the European Union.³ Our comments focus on ESMA’s policy orientations on guidelines for UCITS ETFs and do not address structured UCITS.

As a general principle, we strongly support ESMA’s review of the operation of, and industry practice with respect to, UCITS ETFs following the implementation of UCITS III in order to identify the possible impact on investor protection and market integrity. As ESMA notes, other regulatory bodies, including the Financial Stability Board (“FSB”) and the Bank for International Settlements, are also evaluating ETFs, particularly their potential implications for the stability of the financial system.

¹ ICI is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI encourages adherence to high ethical standards, promotes public understanding, and otherwise advances the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.9 trillion and serve over 90 million shareholders.

² See ESMA/2011/220, Discussion Paper: ESMA’s Policy Orientations on Guidelines for UCITS Exchange-Traded Funds and Structured UCITS (July 2011), available at <http://www.esma.europa.eu/popup2.php?id=7682>.

³ As of June 2011, ETFs registered under the U.S. Investment Company Act of 1940 held \$970 billion in assets under management, or 67% of the global ETF market.

We firmly believe that authorities and market participants must improve their understanding of the potential risks inherent in financial products and the ways in which such risks can be mitigated.⁴

Enhanced Disclosure to Investors

To address concerns about the specific features and risks associated with UCITS ETFs, many of the policy orientations identified by ESMA contemplate enhanced disclosure in a UCITS ETF's prospectus, annual report, and/or other fund documents. In particular, ESMA is contemplating requiring:

- (i) a UCITS ETF to use an identifier in its name and other documents identifying it as an ETF;
- (ii) for index-tracking UCITS ETFs, a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index, specifying particular information that should be included;
- (iii) for synthetic UCITS ETFs, additional disclosure in the prospectus and annual report about underlying exposure, counterparty(ies) and collateral;
- (iv) for actively-managed UCITS ETFs, disclosure (a) informing investors that the ETF is actively managed and not an index tracker, (b) about the main sources of risk due to the investment strategy, (c) of how the ETF will meet its stated investment policy and of its policy regarding portfolio transparency, and (d) on how the indicative net asset value ("iNAV") is calculated; and
- (v) for leveraged UCITS ETFs, disclosure of the leverage policy, including the impact of reverse leverage, how the daily calculation of leverage impacts investor returns, and details of the costs involved.

As a general principle, we support clear disclosure regarding material information for all investment products, including ETFs.⁵ We believe it is critical for investors and potential investors in

⁴ See Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Secretariat of the Financial Stability Board, dated May 16, 2011, responding to the Financial Stability Board's note on Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds, available at <http://www.ici.org/pdf/25189.pdf>.

⁵ The Institute has a long history of promoting and supporting efforts to improve mutual fund disclosure. See, e.g., Letter from Karrie McMillan, General Counsel, Investment Company Institute to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, dated February 28, 2008, available at <http://www.ici.org/pdf/22290.pdf> (regarding enhanced disclosure and new prospectus delivery option for registered open-end management investment companies).

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UCITS, particularly those available to retail investors, to have an accurate understanding of the fund in which they invest or are considering investing. We would not, therefore, object to ESMA's consideration of guidelines that include enhanced (or different) disclosure requirements for UCITS ETFs to ensure adequate information is available to investors. However, we caution ESMA to carefully develop such proposed guidelines so as not to disproportionately impact a particular type or types of UCITS ETF by requiring disclosure that inappropriately suggests or insinuates that a particular type of UCITS ETF is less desirable as an investment option, or leads an investor to draw a conclusion that is otherwise inaccurate.

We recognize ESMA's concerns that investors may not fully understand the differences between types of ETFs and that further disclosure may increase investors' understanding. We note, however, that certain of ESMA's contemplated disclosures for a particular type of UCITS ETF may equally or similarly apply to all types of UCITS ETFs. ESMA should not require disclosure by only one type of product when there is no clear reason to make such a distinction. For example, ESMA's policy orientations for actively-managed ETFs, particularly requiring disclosure of how the iNAV is calculated, should not be considered only with respect to actively-managed ETFs. Likewise, disclosure on the main sources of risks due to the investment strategy is important information for all ETF investors, not just for those considering actively-managed UCITS ETFs. Consequently, we urge ESMA to refrain from singling out one type of ETF for additional disclosure without adequate justification, and to consider additional disclosure in the context of all UCITS ETFs, as appropriate.

Identifier

The Paper states that, although the majority of European ETFs are authorized as UCITS, ETFs have some unique features that are not present in traditional open-ended funds. In addition, the Paper asserts that ETFs are often confused with other types of exchange-traded products, such as exchange-traded notes and exchange-traded commodities, as well as closed-end funds. In order to address this perceived issue, ESMA is considering requiring the use of an identifier in the name of a UCITS ETF and in the prospectus and marketing material to identify the fund as an exchange-traded fund. ESMA is also considering whether the identifier should distinguish between synthetic, physical and actively managed UCITS ETFs.

To the extent that ESMA determines that confusion about ETFs exists in the EU, we understand its desire to mitigate this by requiring a UCITS ETF to use an identifier in its name and fund rules, prospectus and marketing material. We question, however, whether an identifier alerting investors that an ETF is "exchange-traded" adequately distinguishes that product from other exchange-traded products, such as exchange-traded notes, which we understand to be ESMA's goal. Further,

requiring an identifier for UCITS ETFs, but not for other products, would single out ETFs as disproportionately more or less risky in investors' minds when they are compared to other products without such an identifier.

If ESMA determines to proceed with requiring a UCITS ETF to use an identifier such as "ETF" or "Exchange-Traded Fund," we believe that ESMA should not require further distinction between different types of ETFs, such as synthetic, physical or actively-managed ETFs. First, in order to effectively implement such a requirement there would need to be a clear definition of what constitutes each type of ETF for which an identifier is contemplated. This could, in our view, prove very challenging. For example, would an ETF that invests in physical securities, but also uses not an insubstantial amount of derivatives to gain exposure, be considered a "physical" or "synthetic" ETF. Second, identifiers prescribed by ESMA now would not account for other types of ETF strategies or categories developed in the future, which would not be included in an ETF's identifier. Requiring an identifier for some types of UCITS ETFs but not others could magnify investor confusion. Therefore, we believe that it is appropriate and sufficient to require an ETF to describe its investment strategy or policy in its prospectus and not to require that particular terms describing a type of ETF be included in an identifier for a UCITS ETF.

Securities Lending

The Paper states that the use of securities lending by UCITS ETFs is growing in popularity and raises concerns about securities lending including (i) that securities lending activities could potentially give rise to broader systemic risk concerns, (ii) the need for increased disclosure to investors regarding securities lending, and (iii) risks arising from borrower default notwithstanding the provision of collateral. To address certain of these issues, ESMA proposes a number of policy orientations focused on disclosure to investors and, with respect to the collateral received, compliance with the criteria for over the counter derivatives set out in CESR's Guidelines on Risk Management.

As a preliminary matter, we believe that ESMA, as well as other regulators, must be cautious in attributing potential systemic or market risks, or risks to shareholders, to the securities lending activities of UCITS ETFs. Many types of collective investment vehicles, including mutual funds, hedge funds, pension plans, and collective investment trusts, as well as other market participants, engage in securities lending. Any of these collective investment vehicles could potentially encounter unexpectedly high redemption requests or other types of withdrawals in a time of market stress, and need to recall loaned

securities.⁶ Thus, to the extent there is concern about the impact of securities lending activities on the broader markets, it should not be approached as an ETF-specific issue.

We similarly believe that the issues identified by ESMA regarding disclosure to investors about securities lending arrangements and collateral qualifications should be addressed in the context of all types of collective investment vehicles, and not just UCITS ETFs. Imposing enhanced requirements on UCITS ETFs only would unfairly single out one type of fund, while leaving unaddressed the same issues with respect to other collective investment vehicles.

Secondary Market Investors

In the Paper, ESMA describes the purchase and sale of UCITS ETF creation units by market participants and notes that market participants may be the only recognized investors. It further states that rules in the UCITS Directive designed to protect unit holders will not necessarily apply to investors who acquire shares in the secondary market when they are not registered holders. ESMA therefore believes the UCITS ETF's disclosure and marketing material should inform investors of their status and proposes a warning stating the following:

“ETF units are not usually redeemable from the fund other than by authorized participants of creation units. Investors who acquire units on the secondary market must buy and sell shares with the assistance of a stock broker and investors may incur brokerage fees and pay more than the current net asset value when buying units and receive less than the net asset value when selling units.”

As an alternative to this approach, ESMA suggests that UCITS ETFs could be required to give all investors, including those that acquire shares on the secondary market, the right to redeem their shares directly from the UCITS ETF.

As we state above, we believe that it is of paramount importance that investors understand the product in which they have invested or are considering investing. Understanding how shares of a fund may be purchased or sold is fundamental to understanding an investment in the fund. To the extent such information is not already required to be included in a UCITS ETF's prospectus and/or

⁶ Securities may also be recalled for other reasons, such as trading by the lender. In this respect, index-based funds and ETFs actually pose less risks and are preferred lenders, because their trading activities are predictable and limited to times of index rebalancing.

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marketing material, we would not object to ESMA's proposal to require UCITS ETFs to include such a warning.⁷

We are seriously concerned, however, about ESMA's statement that, as an alternative to the proposed disclosure, UCITS ETFs could be required to give all investors the right to redeem units directly from the UCITS. As a threshold issue, we fail to understand how an ETF that provides investors with the ability to buy and sell shares intra-day on the market, as well as the ability to redeem single shares at the end of each business day directly from the UCITS ETF, could operate. For example, the proposal would create significant operational issues, such as whether redemptions would be in cash or in specie. If individual investors are able to redeem shares in small amounts in cash, the UCITS ETF would need to be significantly more liquid, which could impact portfolio management and returns. Alternatively, providing redemptions to individual investors in specie may be unfeasible. How would a UCITS ETF provide an investor his or her proportionate share of a potentially large number of securities (*i.e.*, an S&P 500 Index ETF), some of which individually are expensive, when the amount being redeemed by the investor is small? Further, an investor would need to maintain a brokerage account to accept delivery of the shares, which is not something that all investors typically do. We also question how certain essential features of many ETFs would work under this proposal (*e.g.*, the arbitrage function that helps keep the market-determined price of an ETF's shares close to its underlying value).

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We appreciate the opportunity to provide comments on the Paper. If you have any questions about our comments or would like additional information, please contact me (kmcmillan@ici.org or 202-326-5815) or Susan Olson, Senior Counsel – International Affairs (solson@ici.org or 202-326-5813).

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

⁷ We note that Form N-1A, the disclosure form applicable to open-end ETFs registered under the U.S. Investment Company Act of 1940, requires similar disclosure, *e.g.*, Item 6 (specifies disclosure for ETFs regarding the purchase and sale of fund shares) and Item 3 (Risk/Return Summary and Fee Table - modify narrative for expense example for ETFs to explain that investors may pay brokerage commissions).