



Press Release

Nice, London, Singapore, January 30, 2012

EDHEC-Risk Institute welcomes conclusions of ESMA consultation paper on ETFs and UCITS issues

Following the publication on January 30, 2012, of the European Securities and Markets Authority's (ESMA) consultation paper on ETFs and other UCITS issues (ESMA/2012/44), EDHEC-Risk welcomes the broadened focus of the new ESMA consultation, which approaches important issues in a horizontal way across all UCITS rather than in a vertical way limited to UCITS ETFs; as underlined in its recent contribution*, EDHEC-Risk believes that continued adherence to a silo approach would have increased the risks of adverse selection by investors and regulatory arbitrage by issuers.

Among the points addressed by the consultation paper which EDHEC-Risk feels are particularly important:

Tracking error

- ❖ EDHEC-Risk welcomes the amended definition of tracking error for index-tracking UCITS compared to the previous discussion paper of July 2011. The definition of tracking error as the volatility of the difference between the return of the index-tracking UCITS' portfolio and the return of the benchmark or index corresponds more closely to academic standards and will better enable investors to compare different funds.
- ❖ EDHEC-Risk has also welcomed the inclusion of additional information in the prospectus of an index-tracking UCITS: the fund's policy regarding the *ex-ante* tracking error, including its target level, together with the size of the tracking error *ex-post* and an explanation of any divergence between the target and actual tracking error for the relevant period; and details of whether the index-tracking UCITS will follow a full replication model or use, for example, sampling or synthetic replication.
- ❖ EDHEC-Risk's recommendation for the definitive ESMA guidelines is that the risks of sampling replication, which is not always robust, notably in diversified geographical universes, be fully documented.

Identification

- ❖ With regard to labelling, the regulator has avoided the error of recommending the application of identifiers that would have created artificial and misleading distinctions between funds on the basis of the tools or techniques they use, including to replicate indices.
- ❖ Moreover, EDHEC-Risk agrees with ESMA's decision to specify when the "ETF" label can be used for UCITS.
- ❖ It was important to highlight, as ESMA has, the differences between passively managed and actively managed UCITS ETFs. One might regret, however, that ESMA did not set maximum levels of tracking error which would enable investors to differentiate between passively and actively managed funds.

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Counterparty risk and securities lending

- ❖ Concerning counterparty risk, the ESMA guidelines are in line with the results of the EDHEC-Risk study, which found that both physical and synthetic replication ETFs can be subject to counterparty risk. Communication leading investors to believe that synthetic replication was subject to counterparty risk while physical replication was not (despite securities lending activities) was misleading. ESMA recognises that securities lending allows a fund to take more unmitigated counterparty risk exposure than OTC derivatives and that it is subject to fewer constraints in the area of risk management; it notably does not benefit from European guidelines on collateralisation of the type mandated for the management of counterparty risk arising from the use of OTC derivatives. From that viewpoint, EDHEC-Risk is in total agreement with ESMA's conclusion that it is important to impose additional requirements for the management of securities lending activities undertaken by UCITS.
- ❖ In the light of the guidelines and conclusions drawn from the comprehensive and rigorous analyses performed by both ESMA and EDHEC-Risk, industry actors should refrain from communicating on the relative levels of risk of physical and synthetic replication, which is misleading to investors.
- ❖ EDHEC-Risk agrees with ESMA that investors should be informed of the revenues from securities lending and the rules on the distribution of fee income should be clarified.

Indices

- ❖ As EDHEC-Risk stressed in its study, the consultation on ETFs also concerns passive investment in general, and highlights the risk of index tracking, so ESMA's references to the necessary due diligence are positive. EDHEC-Risk regrets nonetheless that ESMA stopped short of requiring that all information concerning indices be made freely available, notably to allow investors to recalculate their track records. This information is already difficult to obtain for cap-weighted indices, even though the rules of the latter are simple, but in the case of strategy indices it is almost impossible to procure, at reasonable cost, the historical composition of the indices and to check both the accuracy of the implementation of the ground rules and the performance of the indices. This is despite the fact that these elements enable industry actors to perform requisite due diligence. ESMA has addressed this problem but progress remains to be made.

* A copy of the EDHEC-Risk study can be found here:

[EDHEC Position Paper What are the Risks of European ETFs?](#)

An ETFs roundtable entitled “Perceived Risks and Benefits of ETF Investments and Regulators’ Considerations: Towards More Regulation for ETFs?” will be held as part of the EDHEC-Risk Days Europe 2012 conference at The Brewery conference centre in London on March 27, 2012, enabling this subject to be discussed with numerous industry representatives and regulators.

Contact:



For further information, or to receive a press pass to the EDHEC-Risk Days Europe 2012 conference in London on March 27, please contact **S verine Anjubault**:
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About EDHEC-Risk Institute

Since 2001, EDHEC has been pursuing an ambitious policy in terms of international research. This policy, known as “Research for Business”, aims to make EDHEC an academic institution of reference for the industry in a small number of areas in which the school has reached critical mass in terms of expertise and research results.

Among these areas, asset and risk management have occupied privileged positions, leading to the creation in 2001 of a major research facility: EDHEC-Risk Institute. This institute now boasts a team of 80 permanent professors, engineers and support staff, as well as 18 research associates from the financial industry and 6 affiliate professors.

EDHEC-Risk Institute is located at campuses in Singapore, which was established at the invitation of the Monetary Authority of Singapore (MAS), the City of London in the United Kingdom, and Nice, France. In addition, it has a research team located in the United States.

The research projects managed at EDHEC-Risk Institute receive the support of several financial companies representing some thirty different sponsors (including AXA Investment Managers, BNP Paribas Investment Partners, CME Group, Deutsche Bank, Eurex, iShares, NYSE Euronext, HSBC, Pictet, Robeco, Rothschild & Cie, Russell Investments, Newedge, SocGen, State Street, UBS, and many others).

The philosophy of the institute is to validate its work by publication in prestigious academic journals, but also to make it available to professionals and to participate in industry debate through its Position Papers, published studies and conferences. Each year, EDHEC-Risk organises two conferences for professionals in order to present the results of its research, one in London (EDHEC-Risk Days – Europe) and one in Singapore (EDHEC-Risk Days – Asia), attracting more than 2,000 professional delegates.

To ensure the distribution of its research to the industry, EDHEC-Risk also provides professionals with access to its website, www.edhec-risk.com, which is entirely devoted to international risk and asset management research. The website, which has more than 50,000 regular visitors, is aimed at professionals who wish to benefit from EDHEC-Risk’s analysis and expertise in the area of applied portfolio management research. Its monthly newsletter is distributed to more than 1,000,000 readers.

EDHEC-Risk Institute also has highly significant executive education activities for professionals. In partnership with CFA Institute, it has developed advanced seminars based on its research which are available to CFA charterholders and have been taking place since 2008 in New York, Singapore and London.

EDHEC-Risk Institute has an original PhD in Finance programme which, in addition to its highly selective residential track for young talents worldwide, has an executive track for high level professionals who already have masters degrees from prestigious universities and significant industry experience. Complementing the core faculty, this unique PhD in Finance programme has highly prestigious affiliate faculty from universities such as Princeton, Wharton, Oxford, Chicago and CalTech.