21st July 2014

Dear Sir/Madam,

Response to the CONSOB Consultation Document on the distribution of complex products to retail customers (*Distribuzione di prodotti finanziari complessi presso la clientela al dettaglio*)

Boost, a WisdomTree company and a specialist provider of European Exchange Traded Products ("**ETPs**"), welcomes the initiatives undertaken by ESMA and national competent authorities ("**NCAs**") such as CONSOB to foster the protection of retail investors against the increasing "retailisation" of "complex products". Boost has educated since its formation about hidden risks and non-transparent costs in certain financial products and potential conflicts of interest in their "engineering". Boost has placed in-depth education on the benefits and risks of leverage at the core of its mission statement and dedicated significant resources to this end.

Boost believes NCAs need to carefully consider what should qualify as "complex" and to be mindful of blanket restrictions on retail investor access to valuable investment tools without due regard to sophistication levels and risk. ETPs have greatly benefited retail investors worldwide by providing them with access to common investment strategies at a very low, transparent cost.

Before it launched Boost carried out in-depth research globally on how to improve transparency, risk management and liquidity in its development of its current offering. Boost believes an Exchange Traded Product which is collateralised, with a transparent pay out and multiple third party service providers is a major step forward for all investor types.

For the purposes of this response, we have sought to focus on certain questions in the Consultation.

Executive Summary

We believe that leverage does not in itself bring "complexity". The inclusion of leveraged products to Lists 1 and 2 in the CONSOB Consultation implicitly categorises them as "complex", which is not consistent with ESMA's opinion on what constitutes "complexity".[1] Furthermore, CONSOB's proposed preferential treatment of leveraged products issued in the form of "mutual funds" or UCITS (excluded from Lists 1 and 2) is misplaced, as funds do not possess any structural features that make them superior products in terms of managing the risks of leverage. This view fails to adequately identify the sources of risk posed by leveraged products.

Rather than focus on product structure, we believe NCAs should analyse products on the basis of the sources of "complexity" identified by ESMA which may pose higher risks for retail investors. ETPs are amongst the most heavily regulated and transparent financial products, and address the concerns expressed by CONSOB in the Consultation. As long as ETPs (i) passively track fully transparent indices on major benchmark asset classes, (ii) do not exhibit complex pay-offs and (iii) are listed and traded on regulated exchanges, we believe ETPs should be excluded from Lists 1 and 2.

[1] ESMA's Opinion "*MiFID practices for firms selling complex products*" dated February 7, 2014 (the "**Opinion on Selling Complex Products**")

Questions 1-3: notion of "complexity"

A. Types of "complex products"

We agree with ESMA's opinion on the types of products that should be considered "complex", as laid out in Section 10 of the Selling Complex Products Opinion[2]. In essence, it includes products that:

1. Are made of financial instruments that are hard to value or make it difficult to assess their risks;
2. Use opaque indices;
3. Have complex returns/pay-off structures, embed derivatives or exhibit product features (such as the term) that are conditional on certain events (i.e., embed "optionality" typical of derivatives products).

A couple of noteworthy points from ESMA's Selling Complex Products Opinion are:

- In Section 10, ESMA does not mention "leverage" in its description of "complexity", and instead focuses on opaque indices, hard-to-value instruments and option features that can lead to non-linear pay-offs.
- In Section 11, ESMA includes a list of complex products that would appear to cover the entire universe of investment products (both securitised and OTC), with the exception of ETPs. We believe this omission of ETPs from this list is not unintended, as ETPs have grown to become a distinct, globally-recognised product class in itself due to its unique characteristics and superior investor benefits. Major regulated exchanges (including Borsa Italiana) have acknowledged such uniqueness by creating specific trading segments for ETPs, separate from the trading segments of certificates, derivatives and other securitised financial instruments[3].

B. Characteristics of Exchange Traded Products

An Exchange Traded Product is a financial instrument traded on a stock exchange (much like stocks) that aims to provide a return linked to a specified benchmark or asset (before fees). Although ETPs can take a number of forms, they share some common characteristics:

Characteristics	Benefit
Listed on a stock exchange	▪ Prices continuously quoted on a stock exchange (investors can observe at any time how their investment is performing) and products subject to stock exchange trading rules. ▪ The stock exchange will require a committed liquidity provider ("**LP**"), who will only be able to make markets meeting stringent exchange rules if the underlying is composed of transparent, easy to value instruments. LPs are typically independent from the ETP sponsor.
Trade like shares	Buying and selling as easily as shares any time the market is open through same brokers and platforms as shares. Settlement and clearing is also the same as other tradable securities.
Liquid asset	Authorised Participants, market makers and other market participants provide liquidity. This prevents reliance on a single point of liquidity.
Open-ended	Shares or units can be created and redeemed on demand: ▪ liquidity is not constrained by the supply and demand of the ETP, but rather by the liquidity of the underlying asset. ▪ allows LPs to arbitrage price discrepancies between the ETP and the underlying it tracks.
Tracks an underlying	Aims to provide the return of the underlying, typically indices from major index providers (e.g., FTSE MIB or Eurostoxx 50, indices tracking the price of popular commodities such as gold, etc.).
Low cost	Typically provides passive investment in a benchmark or asset, so fees are generally low.
Losses cannot exceed the initial investment	Unlike some leveraged instruments, losses on ETPs cannot exceed the price paid for them.

[2] See Annex 1 to this Response.
[3] For example, Borsa Italiana maintains separate trading segments for ETPs (ie., "ETFPlus") and Securitised Derivatives including Warrants and Leveraged Certificates (ie., SeDex), the German Stock Exchange maintains a separate ETF/ETP Segment, etc.

ETPs were designed originally with the retail investor at heart, as they provided cheap and liquid access to major investment strategies that were not easily accessible before to retail investors. The original leveraged ETP was issued in Sweden in 2005. Since then, this product has spread worldwide, including the US, Asian and European markets. The total global AUM of Short & Leveraged ("**S&L**") ETPs at the end of May 2014 was approximately $60 billion. If we consider that AUM at the end of 2007 was c.USD 1.6 billion, the growth of S&L ETPs has been phenomenal, a testament to the benefits they bring to the investment community. For example, S&L ETPs can be used:

- To hedge existing positions in one simple trade on exchange and committing a fraction of the value of the portfolio to be hedged (so capital can be used efficiently).
- To short the market/asset class quickly, cheaply and limiting losses (at a minimum) to amount invested.
- Tactically within a broad portfolio where an investor holds strong short term convictions.

C. <u>How "complex" are leveraged ETPs by ESMA's standards?</u>

When we analyse leveraged ETPs using the concept of "complexity" advocated by ESMA, we find that leveraged ETPs:

1. Do not incorporate financial instruments that are hard to value or make it difficult to assess their risks:
    - As ETPs need to be continuously traded to meet stock exchange volume and maximum spread rules, LPs require simple-to-value and transparent indices which can be easily replicated.
    - The assets referenced by the index tracked can be valued, so ETPs are priced each day using inputs which are directly observable from independent and transparent information sources.
2. Do not track opaque indices:
    - Underlying indices are typically major benchmark indices, fully transparent in the way they are calculated and all relevant information is made available to the public.
    - Such indices are calculated by reputable index providers, independently from the ETP sponsor.
3. Do not have complex returns/pay-off structures:
    - Daily returns are easy to understand and predict: they are directly linked to the return of the underlying benchmark index multiplied by the leverage factor, minus applicable fees.
    - They do not embed derivatives or include "optionality" or non-linear, hard to predict, pay-offs. While leveraged ETPs normally get the leveraged exposure to the underlying through a swap with a bank, such swaps are simply a mechanism to deliver the payout, rather than part of the pay-out (which is linked to the index).

Unlike other leveraged products (such as CFDs, spread betting, options and OTC derivatives), ETPs provide leverage that is constant and predictable (they reset daily so their leverage factor remains constant) and cannot lead to losses greater than amount invested, which provides certainty on two key aspects of the products for investors.

D. <u>How risky are leveraged ETPs?</u>

While leverage maximises the return on the investment (both positive and negative), leveraged ETPs:

1. Cannot lead to losses exceeding the amount invested;
2. avoid large, sudden losses through rebalancing mechanisms that are activated to "soften" extreme market movements;
3. are fully collateralised on a daily basis, so as to minimise credit risk; and
4. are often less volatile than a straight investment in individual shares, as most ETPs track a diversified index componsed of a basket of shares.

E. <u>The FCA's approach to promotion of "complex products"</u>

In August 2012, the UK Financial Conduct Authority published a consultation paper proposing to prohibit the promotion to retail investors of unregulated collective investment schemes and close substitutes (which captured a wide range of structured products)[4]. Following analysis of responses, the FCA decided to specifically exempt from the scope of these restrictions ETPs, "*…calibrating our interventions to focus on the products of greater concern*" (the "**FCA Complex Products Retail Promotional Ban**"). [5]

F. Other concerns raised in the CONSOB Consultation

We finally address some of the other points and concerns raised by CONSOB in the Consultation document:

1. *Information asymmetries*: Some of the most important features of ETPs, by design, greatly reduce any information asymmetries between investors and product sponsors, particularly when compared against other financial products:
    (i) ETPs track major benchmarks and asset classes which are continuously observable and traded in liquid markets;
    (ii) they are priced in a transparent and objective manner;
    (iii) the cost or fees of ETPs are among the most transparent in financial markets; and
    (iv) in the case of leveraged ETPs, they offer a constant leverage factor on each day.

    Unlike some derivatives and structured products offering optionality (which is hard to value), ETPs offer their investors a superior level of information on costs, payoffs and risks.

2. *Conflicts of interest*: While CONSOB rightly highlights the presence of various conflicts of interest implicit in the sale of financial products, we would urge CONSOB to consider the following:
    (i) Regulatory initiatives such as the "Retail Distribution Review" in the UK or the evolution of MIFID/MIFID II practices would seem the most balanced approach to dealing with the conflicts of interests inherent in payment structures prevalent in some areas of financial markets.
    (ii) Given the strict requirements related to continuous trading and disclosure and their margin levels (ETP margins are the lowest among financial instruments), ETPs in general would be a rather costly and inefficient mechanism for banks to obtain funding, offload risks or simply increase margins.

3. *Cost and fair value*: CONSOB's recommendation that special attention is paid to the level of information available to clients in relation to the costs implicit in the product and its fair value, is fully supported by Boost. As pointed out, ETPs provide the greatest level of transparency on costs and are fairly valued by virtue of its continuous trading on regulated exchanges and the arbitrage mechanism of the daily creation and redemption process that is the essence of all ETPs.

The ETP industry in general, and Boost in particular, has put a lot of effort and resources in producing education materials tailored for investors with lower levels of sophistication which are freely accessible.[6]

G. CONSOB's view that leverage should be offered through funds is misplaced

We note that CONSOB only excludes from Lists 1 and 2 leveraged products if they are offered through mutual funds ("OICR"). We agree with CONSOB's implicit view that leverage *per se* is not complex or that retail investors should not be prevented from accessing leveraged products, but we also believe that CONSOB's reliance on a "*fund model*" is misplaced. Leveraged ETPs structured as debt securities operate in practice almost identical to funds and, by being fully collateralised, offer virtually the same investment experience as equivalent funds (although there may be differences in the tax and regulatory treatment of the different structures). In fact, leveraged ETPs issued in the form

[4] FSA Consultation Paper 12/19 (published on 22 August 2012)
[5] FCA Policy Statement PS13/3
[6] As an example, see the "Education" section on Boost's website: http://www.boostetp.com/Education/

of debt instruments typically offer greater transparency on fees, reduced costs and lower "tracking error" vis-à-vis the underlying index tracked.

Rather than focus on the structure of the products that delivers the leveraged exposure, we believe CONSOB should, instead, allow leverage that comes with:

1. independent, transparent indices;
2. constant and predictable leveraged exposures;
3. constant liquidity and "fair value" prices that reference the price of the underlying index and fully transparent fees; and
4. stringent disclosure and liquidity rules, as imposed by regulated stock exchanges.

Consequently, we would respectfully urged CONSOB to exclude from Lists 1 and 2 all ETPs meeting the above characteristics.

Question 7: is it possible to categorise retail investors by levels of sophistication using objective criteria?

Yes, it is possible and advisable to categorise retail investors by levels of sophistication. As an example, the FCA Complex Products Retail Promotional Ban contains, together with the blanket exemption for ETPs discussed above, categorisations of retail clients as "High net worth" (which include individuals with an annual income of more than £100,000 or having investable net assets of more than £250,000) and "Sophisticated investor" (which includes self-certified sophisticated investors who meet other criteria assessed by the distributor/promoting firm, such as individuals that have made more than one (direct) investment in an unlisted company in the last two years, etc). Certain types of promotions of "unregulated CIS" (as defined in the FCA Complex Products Retail Promotional Ban) can be directed to these categories of retail investors.

MIFID I and II and the market practices that have evolved from the application (and anticipated application) of these pieces of EU legislation also prove that suitability and redress mechanisms for poor promotional practices constitute the most balanced regulatory policy: one that fosters investor protection without denying investors access to products that are suitable and valuable to investors.

Boost's Conclusions

1. CONSOB is right to include leveraged products when analysing how to best protect retail public from "complex products", but CONSOB should target only those products that pose real concerns: products that (i) exhibit "complex" features (as per ESMA's Opinion), (ii) can lead to losses beyond initial investment and (iii) do not offer full, continuous and independent pricing and valuation, as it is available for ETPs.
2. We agree with CONSOB's views that retail should have access to leverage, but consistently with the above point, we'd recommend that CONSOB shifts its focus from funds (as they do not offer in themselves greater investment protection) to the risks implicit in leveraged products.
3. Consequently, and in line with other NCAs (such as FCA), we believe CONSOB should exclude from the restrictions on leveraged products in Lists 1 and 2 all ETPs (rather than "funds", which may or may not be ETPs). For these purposes, "ETP" may be defined in line with the definition proposed by the FCA in the FCA Complex Products Retail Promotional Ban (see Annex 2).
4. The Italian investor has favoured leveraged products for a long time. The most heavily traded products in Borsa Italiana's *ETFPlus* are leveraged products on the FTSE MIB and Natural Gas indices, often trading more than non-leveraged products on the same indices. Italian investors have proved a high level of knowledge to understand leveraged products and use them naturally.
5. Borsa Italiana's scrutiny of ETP issuers and products before they are admitted to trading in the Italian regulated market is unrivalled among European exchanges. This is proof that investor protection and market integrity is at the heart of Borsa Italiana's mission and operating model. As such, CONSOB's drive to further protect the retail investor may needlessly undermine Borsa Italiana's efforts. The ETP market is international in scope and the same products are easily listed in (and delisted from) different trading venues in response to

competitive pressures. Borsa Italiana has been able to capture a market leading position in the European leveraged ETP segment, with greater volumes than any other exchange.

Further questions from CONSOB

If CONSOB has any questions in relation to this response, please contact Jose Poncela, Head of Legal and Regulatory Affairs at WisdomTree Europe Ltd, on +44 203 207 9453 or jose.poncela@boostetp.com.

Annex 1

Section 10 of ESMA's Opinion on Selling Complex Products

"*Types of "complex products*"

10. Complexity is a relative term, and depends on the risk-reward profile and other characteristics of the product. ESMA is of the opinion that products should generally be considered as 'complex' when:

(i) they are derivatives, or embed a derivative; and/or
(ii) they are made up of one or more underlying financial instrument(s) that are difficult to value, or are combined in such a way so as to make it difficult to assess the risks involved and the likely performance scenarios; and/or
(iii) they use more opaque indices that are for example set up by the product manufacturer, rather than using standard market indices; and/or
(iv) have a fixed investment term of a number of years with barriers to exit (that are not clearly explained) - whether that is due to the lack of a secondary market, or significant penalties or losses on early exit; and/or
(v) have returns/pay-off structures involving multiple variables or complex mathematical formulas; and/or
(vi) include capital protection that may be conditional or partial, or that can be withdrawn on the occurrence of certain events."

Annex 2

Definition of Exchange Traded Product in the FCA Complex Products Retail Promotional Ban

"*exchange traded product*: any of the following *investments*:

(a) a *unit* or *share* in an *exchange traded fund,* a *debt security* or a *contract for differences* which meets all of the following criteria:
   (i) it is traded on a *regulated market* or *designated investment exchange*;
   (ii) it is created and redeemed in response to demand from investors or arbitrage opportunities arising from the difference in price from the *unit, share, debt security* or *contract for differences* and the price of the underlying asset(s) it seeks to track;
   (iii) it aims to closely simulate the performance of a specified index or other benchmark (relating to any assets such as *shares*, *debentures*, *commodities* or currencies), whether or not the simulated performance is delta 1, inverse, leveraged, achieved by physical replication or synthetically through *derivatives*.

(b) a senior, unsubordinated debt security traded on a regulated *market* or *designated investment exchange* featuring no periodic coupon payments and whose return tracks the performance of a specific index or other benchmark (relating to any assets such as *shares*, *debentures*, *commodities* or currencies), minus applicable fees, whether or not featuring delta 1, inverse or leveraged exposure to the index or other benchmark being tracked."