

Clarification on  
leverage used  
by UCITS

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## CLARIFICATION ON LEVERAGE USED BY UCITS

Following significant lobbying from the Irish funds industry and the recent publication of a Questions and Answers Paper relating to the Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS by ESMA<sup>1</sup>, the Central Bank of Ireland (the “Central Bank”) has recently issued a letter to the Irish funds industry in relation to UCITS which use VaR to calculate global exposure in which it clarifies:

- its position in relation to leverage disclosure in a UCITS prospectus;
- that it will not impose leverage limits; and
- that it will not impose minimum subscription requirements or additional board reporting requirements on UCITS which use significant leverage.

This is a welcome development.

### **Disclosure relating to leverage in fund documentation**

Guidelines issued by CESR on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS in July 2010 required all UCITS funds which use VaR to calculate global exposure to disclose the expected levels of leverage (and the possibility of higher leverage levels) in their prospectus.

These guidelines also provided that leverage was to be calculated using the sum of the notionals of the derivatives used.

Many industry participants were concerned that the sum of the notionals calculation methodology did not give a true picture of leverage employed by a UCITS and in many cases produced misleading results. In its letter, the Central Bank has acknowledged that it is aware of limitations relating to this calculation methodology and it has confirmed that it will raise this matter within ESMA for discussion.

In its Q&A Paper, ESMA confirmed that UCITS using VaR to calculate global exposure need to make a prospectus disclosure as to leverage, calculated using the sum of the notionals of derivatives used but that they could also include a leverage disclosure based on the Commitment Approach.

The Central Bank has confirmed that, consistent with the ESMA Q&A Paper, it will allow such UCITS to make a prospectus disclosure on leverage using both the Commitment Approach and the sum of the notionals approach or alternatively just the sum of the notionals, as the UCITS may determine.

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<sup>1</sup> 2012/ESMA/429

This allows those UCITS who feel that the sum of the notionals calculation methodology is misleading to provide investors with what they consider to be probably a more meaningful disclosure.

In addition, the Central Bank will no longer require the disclosure of an upper limit on leverage within a UCITS prospectus<sup>2</sup>.

### **Minimum Subscription Requirement and Limitations on Leverage**

Over the last 12 months, the Central Bank began to apply a €100,000 minimum subscription requirement on UCITS which generated leverage of 500% or more when calculated using the sum of the notionals of all derivatives used. It also considered applying a restriction on the level of leverage which could be employed by UCITS and a requirement that the board of directors of the UCITS confirm to the Central Bank on a semi-annual basis that the disclosed leverage figures have not been breached during the relevant period.

In its recent letter, the Central Bank has made it clear that it will not impose any such requirements on UCITS<sup>3</sup>.

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<sup>2</sup> UCITS Notice 8 requires all UCITS to disclose the level of leverage employed during the relevant reporting period in its annual and semi-annual reports. Leverage for such purposes must be calculated using the sum of the notionals of derivatives used.

<sup>3</sup> For existing UCITS which are currently subject to a minimum subscription of €100,000 as a result of their use of leverage and/or which disclose a maximum level of leverage which may be generated, fund documentation will have to be revised to avail of the flexibility introduced by the Central Bank.

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