ESMA Guidelines on ETFs and other UCITS Issues

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EMSA Guidelines on ETFs and other UCITS Issues

Introduction

On 30 January, 2012 the European and Securities Markets Authority (**ESMA**) published a consultation paper on future guidelines for certain types of Undertakings for Collective Investment in Transferable Securities (**UCITS**), including UCITS Exchange-Traded Funds (**ETFs**), and other UCITS-related issues (the **Consultation Paper**). The Consultation Paper was published following a review by ESMA of the current regulatory regime and it's assessment that existing requirements were not sufficient to take into account the specific risks associated with such funds.

Following review of over sixty responses to the Consultation Paper from stakeholders including the Irish Funds Industry Association, ESMA published its Guidelines on ETFs and Other UCITS Issues (the **Guidelines**) on 25 July 2012. The Guidelines can be found here. The aim of the Guidelines is to strengthen investor protection and increase harmonisation in regulatory practices, with the concept of improved disclosure to investors running consistently throughout the Guidelines.

The Guidelines cover the following matters, each of which are summarised below:

- Index-Tracking UCITS
- UCITS ETFs
- Efficient Portfolio Management Techniques
- Management of Collateral for OTC Financial Derivative Transactions and EPM Techniques
- Total Return Swaps and Similar Financial Derivative Instruments
- Financial Indices

Application Date

The Guidelines apply from two months after the date of official publication of the Guidelines on the ESMA website (the **Application Date**). The Central Bank of Ireland (the **Central Bank**) has outlined it expects the official publication on the ESMA website at some stage in October, 2012.

All new UCITS created after the Application Date should comply with the Guidelines immediately.

Existing UCITS benefit from transitional provisions giving them in certain circumstances up to 12 additional months from the Application Date to comply. Any grandfathering provisions relating to existing UCITS which apply in specific cases are outlined in the applicable section below. Amendments required to the fund rules/instrument of incorporation, prospectus, key investor information document (**KIID**) and marketing communications that issued prior to the Guidelines do not come into effect until the earlier of (i) the first occasion after the Application Date on which the relevant document (having been revised or replaced for another purpose) is published, or (ii) 12 months after the Application Date. Requirements to publish information in the annual report do not apply in respect of any accounting period that has ended before the Application Date.

Index-Tracking UCITS

The Guidelines define an Index-Tracking UCITS as "*a UCITS the strategy of which is to replicate or track the performances of an index or indices e.g. through synthetic or physical replication.*" In keeping with ESMA's enhanced disclosure focus, the Guidelines outline specific information which must be included in the prospectus, KIID, annual and semi-annual reports for such Index-Tracking UCITS.

A prospectus for an Index-Tracking UCITS will now need to include the following information:

(a) a clear description of the indices including information on their underlying components. To avoid the need to update the prospectus regularly, it is possible to include disclosure in the prospectus which directs investors to a website where the exact components of the indices are published;

(b) information on how the index will be tracked and the implications of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk;

(c) information on the anticipated level of tracking error in normal market conditions;

(d) a description of factors that are likely to affect the ability of index-tracking UCITS to track the performance of the indices, including transaction costs, small illiquid components and dividend re-investment.

The KIID of the Index-Tracking UCITS should include the information provided in (b) above in summary form.

An Index-Tracking UCITS must include the size of the tracking error at the end of the period under review in its annual and semi-annual accounts. The annual report must also include an explanation of (i) any divergence between the anticipated and realised tracking error for the relevant period and (ii) the annual tracking difference between the performance of the UCITS and the performance of the index it is tracking.

Disclosure requirements for Index-Tracking leveraged UCITS are also outlined. The Guidelines define an Index-tracking leveraged UCITS as "*a UCITS the strategy of which is to have a leveraged exposure to an index or exposure to a leveraged index*." Where the Index-Tracking UCITS is leveraged, ESMA has confirmed it must comply with the limits and rules on global exposure outlined in Directive 2009/65/EC (the **UCITS Directive**). Global exposure should be calculated using either the commitment approach or relative Value at Risk approach in accordance with the Committee of European Securities Regulators (**CESR**) *Guidelines on Risk Management and the Calculation of Global Exposure and Counterparty Risk for UCITS*.

The global exposure limitation also applies to UCITS replicating leveraged indices.

The Guidelines state the following must be included in the prospectus and summarised in the KIID of the Index-Tracking leveraged UCITS:

(i) a description of the leverage policy, how this is achieved (i.e. at the level of the index or arising from instruments used to obtain exposure to the index), the cost of the leverage and the risks associated with the policy;

(ii) a description of the impact of any reverse leverage (i.e. short exposure);

(iii) a description of how the performance of the UCITS may differ significantly from the multiple of the index performance over the medium to long term.

UCITS ETFs

The Guidelines define a UCITS ETF as "*a UCITS at least one unit or share class of which is traded throughout the day on at least one regulated market or Multilateral Trading Facility with at least one market maker which takes action to ensure that the stock exchange value of its units or shares does not significantly vary from its net asset value and where applicable its Indicative Net Asset Value*."

A UCITS ETF will now need to use the identifier "UCITS ETF" in its name, fund rules/instrument of incorporation, prospectus, KIID and marketing communications. Where the UCITS ETF is passported across EU jurisdictions, the identifier "UCITS ETF" should be used in all EU languages. It is important to note that the Guidelines confirm that a UCITS which is not a UCITS ETF may not use the identifier "UCITS ETF", "ETF" or "exchange traded fund".

In terms of the disclosure requirements for UCITS ETFs pursuant to the Guidelines, the prospectus, KIID and marketing communications should clearly disclose the policy regarding portfolio transparency, where portfolio information may be obtained and details on where the indicative net asset value (**iNAV**), if applicable, is published. The prospectus must also disclose how the iNAV is calculated, if applicable, and the frequency of calculation.

For actively-managed UCITS ETFs, which the Guidelines define as "*a UCITS ETF, the manager of which has discretion over the composition of its portfolio, subject to the stated investment objectives and policies (as opposed to a UCITS ETF which tracks an index and does not have such discretion). An actively-managed UCITS ETF generally tries to outperform an index* ", the prospectus, KIID and marketing communications should clearly disclose this fact. Such documents should also disclose how the actively-managed UCITS ETF will meet the stated investment policy including, if applicable, its intention to outperform the index.

The Guidelines also deal with the treatment of secondary market investors of UCITS ETFs. In circumstances where the shares of the UCITS ETF are purchased on the secondary market but are generally not redeemable directly from the UCITS ETF, the prospectus and marketing communications of the UCITS ETF need to include the following warning:

> *"UCITS ETF's units / shares purchased on the secondary market cannot usually be sold directly back to UCITS ETF. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them."*

In addition, UCITS ETFs must also now allow secondary market investors to redeem shares directly from the UCITS ETF in circumstances where the stock exchange value of the shares significantly varies from its net asset value. In such situations the UCITS ETF is obliged to issue a communication to the regulated market indicating that the UCITS ETF is open for direct redemptions. The prospectus of the UCITS ETF must also clearly disclose the process to be followed in such circumstances together with indicative costs (which should not be excessive).

Transitional Provisions: Existing UCITS ETFs must comply with the Guidelines relating to identifiers on the earlier of (i) the first occasion after the Application Date on which the name of the fund is changed for another reason, or (ii) 12 months after the Application Date.

Note: Existing UCITS ETFs should comply with the provisions relating to the treatment of secondary market investors from the Application Date.

Efficient Portfolio Management Techniques

Pursuant to the UCITS Directive and the Eligible Assets Directive, UCITS are authorised to employ techniques and instruments relating to transferable securities and money market instruments under the conditions laid down by the applicable EU Member State provided that such techniques and instruments are used for efficient portfolio management (**EPM**) purposes. EPM techniques typically include repurchase and reverse repurchase agreements and securities lending. CESR has previously outlined in its "Guidelines for Eligible Assets in UCITS" that EPM techniques should not "*result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in the applicable sales document*."

The Guidelines re-iterate CESR's above-mentioned requirement and introduce additional disclosure and operational requirements on UCITS which utilise these techniques. It is also important to note that the Guidelines state the use of EPM techniques should be in line with the best interests of the UCITS.

The additional disclosure requirements are as follows:

(i) The prospectus should inform investors of the intention to use EPM techniques including a detailed description of the risks involved (i.e. counterparty risk and conflict of interest risk) and the impact they will have on the UCITS performance.

(ii) The prospectus should also disclose the policy regarding direct and indirect operational costs/fees arising from EPM techniques that may be deducted from the revenue delivered to the UCITS. The costs/fees should not include hidden revenue and the identity of entities to which such fees are paid should be disclosed (also indicating if such entities are related to the UCITS management company or depositary).

(iii) The Risk Management Process document of the UCITS must adequately capture the risks arising from EPM techniques.

(iv) The annual report of the UCITS should also now include:

 (a) the exposure obtained through EPM techniques;

 (b) the identity of the counterparties to the EPM techniques;

 (c) the type and amount of collateral received by the UCITS to reduce counterparty exposure;

(d) the revenues arising from EPM techniques for the entire reporting period together with direct and indirect operational costs and fees.

The operational requirements are as follows:

(i) All revenues arising from the EPM techniques, net of direct and indirect operational costs, should be returned to the UCITS.

(ii) The UCITS must ensure that it is able at any time to recall any security that has been lent out or terminate any securities lending agreement into which it has entered.

(iii) Certain of the stakeholder responses to the Consultation Paper outlined this requirement was against market practice and prevents a UCITS from entering into fixed term securities lending or repurchase agreements.

(iv) UCITS entering EPM transactions should take into account these operations when developing their liquidity risk management process in order to ensure they are able to comply at any time with their redemption obligations.

Transitional Provisions: Existing UCITS with revenue sharing arrangements relating to EPM must comply with the new disclosure rules within 12 months of the Application Date of the Guidelines.

Management of Collateral for OTC Financial Derivative Transactions and EPM Techniques

The UCITS Directive outlines that risk exposure to a counterparty of the UCITS in an Over-the-Counter (**OTC**) derivative transaction shall not exceed either (a) 10% of its assets when the counterparty is a credit institution as defined in the UCITS Directive, or (b) 5% of its assets in other cases. The Guidelines confirm that the risk exposures to a counterparty arising from OTC derivative transactions and EPM techniques should be combined when calculating the counterparty risk limits.

Collateral may be used by UCITS to reduce counterparty risk exposure provided the collateral complies with certain criteria. CESR's *Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* outlines the criteria currently applicable for acceptable collateral. The Guidelines amend the criteria. The revised criteria are:

(a) *Liquidity* – any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the applicable provisions of the UCITS Directive.

(b) *Valuation* – collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.

(c) *Issuer credit quality* – collateral received should be of high quality.

(d) *Correlation* – the collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty.

(e) *Collateral diversification (asset concentration)* – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of EPM and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its net asset value. When UCITS are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer.

(f) Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed and mitigated by the risk management process.

(g) Where there is a title transfer, the collateral received should be held by the depositary of the UCITS. For other types of collateral arrangement, the collateral can be held by a third party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.

(h) Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.

(i) Non-cash collateral received should not be sold, re-invested or pledged15.

(j) Cash collateral received should only be:

- placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive;

- invested in high-quality government bonds;

- used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis;

- invested in short-term money market funds as defined in the CESR *Guidelines on a Common Definition of European Money Market Funds*.

All assets received by a UCITS in the context of EPM techniques will be considered as collateral and should comply with the criteria outlined above. In addition, re-invested cash collateral needs to be diversified in accordance with the diversification requirements applicable to non-cash collateral.

The Guidelines outline policies that the UCITS should have in place for collateral. Where a UCITS is receiving collateral for at least 30% of its assets it should have an appropriate stress testing policy in place. This should ensure that regular stress tests are carried out under normal and exceptional liquidity conditions to enable the UCITS to assess the liquidity risk attached to the collateral. The liquidity stress testing policy should at least prescribe:

(a) design of stress test scenario analysis including calibration, certification & sensitivity analysis;

(b) empirical approach to impact assessment, including back-testing of liquidity risk estimates;

(c) reporting frequency and limit/loss tolerance threshold/s; and

(d) mitigation actions to reduce loss including haircut policy and gap risk protection.

In addition, the UCITS will also need a documented haircut policy in place for each class of assets received as collateral. Factors such as the credit standing or the price volatility of the assets and the outcome of the stress tests should be taken into account when devising the haircut policy. The policy should record and justify each decision to apply a specific haircut, or to refrain from applying a haircut, to a certain class of assets.

The Guidelines also prescribe that the prospectus of the UCITS needs to clearly inform investors of the collateral policy of the UCITS including permitted types of collateral, level of collateral required and haircut policy and, in the case of cash collateral, the re-investment policy.

Transitional Provisions: Existing UCITS are required to align their collateral portfolio with the Guidelines within 12 months of the Application Date.

Note: Any reinvestment of cash collateral after the Application Date must comply with the Guidelines immediately.

Total Return Swaps and Similar Financial Derivative Instruments

The Guidelines confirm that where a UCITS enters into a total return swap (**TRS**) or similar financial derivative instruments (**FDI**) then the assets held by the UCITS must comply with the investment limits and diversification requirements outlined in the UCITS Directive. This confirmation has been provided by ESMA as questions have previously arisen on the extent to which the investments of a UCITS might not be required to comply with the diversification requirements of the UCITS Directive in circumstances where the UCITS has invested in a TRS giving exposure to an underlying UCITS compliant index or diversified basket of UCITS compliant instruments. The Guidelines include the example of an unfunded swap whereby the UCITS undertakes to pay the return on the UCITS portfolio to the swap counterparty. For such transactions the UCITS investment portfolio that is swapped out should comply with the investment limits and diversification requirements outlined in the UCITS Directive.

The Guidelines further confirm that where a UCITS enters into a TRS or similar FDI, the underlying exposures of the TRS of similar FDI must be taken into account to calculate the investment limits and diversification requirements of the UCITS Directive.

Consistent with the increased disclosure requirement within the Guidelines, the prospectus of a UCITS using TRS or similar FDI should include the following:

(i) information on the underlying strategy and composition of the investment portfolio or index;

(ii) information on the counterparty(ies) to the transactions;

(iii) a description of the risk of counterparty default and the effect on investor returns;

(iv) the extent to which the counterparty assumes any discretion over the composition or management of the UCITS investment portfolio or over the underlying of the financial derivative instruments, and whether the approval of the counterparty is required in relation to any UCITS investment portfolio transaction; and

(v) identification of the counterparty as an investment manager (where relevant, as described below).

The annual report of the UCITS must contain:

(i) the underlying exposure obtained through FDI;

(ii) the identity of the counterparty(ies) to these FDi; and

(iii) the type and amount of collateral received by the UCITS to reduce counterparty exposure.

The Guidelines further require that where the counterparty to the TRS (or similar FDI) has discretion over the composition or management of the UCITS' investment portfolio or of the underlying of the TRS (or similar FDI), the agreement between the UCITS and the counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation. It remains to be seen how the Central Bank will regulate this requirement. Currently, where an entity seeks authorisation from the Central Bank to act as an investment manager for Irish collective investment schemes it must first complete an application process. The Central Bank also expects that an investment manager will be an authorised entity subject to prudential regulation and have the necessary expertise, integrity and adequacy of financial resources.

Transitional Provisions: Structured UCITS (as defined in EU Commission Regulation 583/2010) in existence before the Application Date are not required to comply with the Guidelines provided they do not accept any new subscriptions after the Application Date. However, in order to be able to continue offering the underlying payoff to existing investors, such existing UCITS can actively manage their financial contracts.

Financial Indices

ESMA has issued clarification within the Guidelines on several matters relating to investment in financial indices given the expanding universe of indices being created.

The UCITS Directive allows EU Member States to raise the maximum limits for investment in shares or debt securities issued by the same body from 5% to 20% when the aim of the UCITS is to replicate the composition of an index which meets certain requirements. The requirements are that (a) its composition is sufficiently diversified, (b) the index represents an adequate benchmark for the market to which it refers, and (c) it is published in an appropriate manner.

The UCITS Directive further outlines that the 20% limit may be further raised to 35% for one single issuer where justified by exceptional market conditions. The Guidelines prescribe that where a UCITS intends to avail of these increased limits then this should be clearly disclosed in the prospectus together with an explanation of the exceptional market conditions justifying the investment.

The Guidelines further outline that a UCITS should not invest in a financial index which has a single component that has an impact on the overall index return which exceeds the relevant diversification requirement (i.e. 20%/35%). Leveraged indices must respect the same rules, after having taken into account leverage.

In terms of commodity indices, a UCITS should not invest in commodity indices that do not consist of different commodities. It is important to note that sub-categories of the same commodity are considered as being the same commodity for the purpose of calculating diversification limits. The Guidelines outline an example that WTI Crude Oil, Brent Crude Oil, Gasoline or Heating Oil contracts are all sub-categories of one commodity, oil. However sub-categories of a commodity should not be considered as being the same commodity if they are not highly correlated and the Guidelines outline criteria for determination of the correlation.

In respect of the necessity for the index to be a benchmark for the market to which it refers, the Guidelines outline that for this purpose:

(a) the index should have a clear, single objective;

(b) the universe of the index components and basis on which these components are selected for the strategy should be clear to investors and competent authorities;

(c) if cash management is included as part of the index strategy, the UCITS should be able to demonstrate that this does not affect the objective nature of the index calculation methodology.

In addition, if the index has been created at the request of one, or a very limited number of, market participants and according to specifications requested by those market participants then the Guidelines clarify such an index is not considered as being an adequate benchmark of a market.

The following is also outlined within the Guidelines with respect to the use of indices:

(i) A UCITS should not invest in a financial index whose rebalancing frequency prevents investors from being able to replicate the financial index.

(ii) UCITS should not invest in financial indices for which the full calculation methodology to, inter alia, enable investors to replicate the financial index is not disclosed by the index provider.

(iii) A UCITS should not invest in financial indices that do not publish their constituents together with their respective weightings. This information should be easily accessible, free of charge, by investors and prospective investors, for example, via the internet.

(iv) A UCITS should not invest in financial indices whose methodology for the selection and the re-balancing of the components is not based on a set of pre-determined rules and objective criteria.

(v) A UCITS should not invest in financial indices whose index provider accepts payments from potential index components for inclusion in the index.

(vi) A UCITS should not invest in financial indices whose methodology permits retrospective changes to previously published index values ('backfilling').

(vii) The UCITS should carry out appropriate documented due diligence on the quality of the index.

(viii) The UCITS should ensure that the financial index is subject to independent valuation.

Transitional Provisions: Existing UCITS that invest in financial indices and which do not comply with the Guidelines should align their investments with the Guidelines within 12 months of the Application Date.

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