ESMA guidelines on ETFs and other UCITS issues – Consequential Changes to Fund Documentation

Summary

ESMA issued guidelines on ETFs and other UCITS issues (Guidelines) on 18 December 2012. The Central Bank of Ireland (Central Bank) has implemented the Guidelines through a series of amendments to the UCITS Notices, Guidance Note 2/07: UCITS – Financial Indices and Guidance Note 3/03: UCITS – Financial Derivative Instruments. The revised Notices, Guidance Notes and the ESMA guidelines are available from the Central Bank website. The Guidelines deal with a variety of matters and will impact all UCITS funds and not just ETFs. The Guidelines apply from 18 February 2013 (the Effective Date). Defined terms have the same meanings here as in the Guidelines.

The Guidelines include updated, and in some cases additional, requirements regarding index-tracking UCITS, ETFs, the use of derivatives, stocklending and other efficient portfolio management techniques, the treatment of collateral and requirements for UCITS eligible financial indices.

The main takeaway for managers is that the Guidelines will impact on a broad range of UCITS funds and not just those styled as ETFs. One of the most controversial changes in the Guidelines is a requirement that all revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs (which are undefined), have to be returned to the Fund. This could have a significant economic impact on managers and promoters, particularly as regards stocklending.

There is some good news for providers of short term money market funds in that they will be deemed suitable investments when a UCITS fund invests cash collateral. Currently UCITS funds can only invest cash collateral in risk free assets which would not include short term money market funds.

The Guidelines are likely to be supplemented by an ESMA Q&A which should issue towards the end of March 2013. The Q&A should add clarity on a variety of issues such as indices, securities lending, and what constitutes operational costs (for example, whether the costs of oversight of a securities lending agent and providing indemnity against loss would be included).

Obligation to include details in Fund documents

We outline below the various requirements in the Guidelines to include matters in fund documentation (eg prospectus, KIIDs, marketing materials etc).

It is important to note that the requirements in the Guidelines relating to the content of fund documentation of an existing UCITS or any marketing communication for an existing UCITS that has been issued prior to 18 February 2013 do not come into effect until the earlier of:

- the first occasion after 18 February 2013 on which the relevant document or communication, having been revised or replaced for another purpose, is published; and
- 18 February 2014.

However, UCITS which update documents for any other reason prior to 18 Feb 2014 will need to include these updates. This is particularly relevant for marketing communications which are often updated regularly. In addition, documentation for any new sub-funds will need to include these disclosures from launch. Requirements to publish information in the report and accounts of an existing UCITS do not apply in respect of any accounting period that ended before 18 February 2013.

Type of UCITS fund effected	Relevant Section of the Guidelines	Detail of the changes required
Index-Tracking UCITS	9	A clear description of the indices including information on their underlying components (the prospectus can direct investors to a website where the exact composition of the indices are published, so as to avoid the need to up-date the prospectus frequently). Information on how the index will be tracked(e.g. full replication model, sample replication model or synthetic replication model) and the implication of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk. Information on the anticipated level of tracking error in normal market conditions. A description of factors that are likely to affect the ability of the index-tracking UCITS to track the performance of the indices such as transaction costs, small illiquid components, dividend reinvestment etc. The information in the second bullet above needs to be included in summary form in the KIID.
Index-Tracking Leveraged UCITS	13	A description of the leverage policy, how this is achieved (i.e. whether the leverage is at the level of the index or arises by the way in which the UCITS obtains exposure to the index), the cost of the leverage (where relevant) and the risks associated with the leverage policy. A description of the impact of any reverse leverage (i.e. short exposure). 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. All this information needs also be included in a summary form in the KIID.
UCITS ETFs	15	Inclusion of the identifier ("UCITS ETF") – this also applies to the fund's name, fund rules or instrument of incorporation as well as the KIID and marketing communication. This information also needs to be disclosed in the KIID and any marketing communications.

UCITS ETFs	17	The policy regarding portfolio transparency and where information on the portfolio may be obtained, including where the indicative NAV, if applicable, is published. This information is also required for the KIID and any marketing communication.
UCITS ETFs	18	Disclose details of how the indicative NAV is calculated, if applicable, and the frequency of calculation.
Actively-Managed UCITS ETFs	19	Include the fact that the fund is an actively managed UCITS ETF. This is also required in the KIID and any marketing communications.
Actively-Managed UCITS ETFs	20	How it will meet the stated investment policy including, where applicable, its intention to out-perform an index. This information is also required for the KIID and any marketing communications.
UCITS ETFs	21 and 22	The risk warning set out in Section 22 of the Guidelines needs to be included where units of a UCITS ETF purchased on a secondary market are generally not redeemable from the fund itself. This information is also required in any marketing communications.
UCITS ETFs	24	The process to be followed by investors who purchase their units on the secondary market should the stock exchange value of the units significantly vary from the fund's net asset value and such investors are then allowed to sell them back directly to the fund (as provided for in Section 23 of the Guidelines). Details of the cost of such arrangements need to be included (the costs cannot be excessive).
All UCITS engaging or which can engage in EPM (including stocklending)	25	Include information regarding intention to use EPM techniques, including a detailed description of the risks involved (including counterparty risk and potential conflicts of interest) and the impact that the techniques will have on the performance of the fund.
UCITS engaging or which can engage in EPM (including stocklending)	28	Details of the policy regarding direct and indirect operational costs/fees arising from the EPM techniques that may be deducted from the revenue delivered to the fund. The disclosure should identify the entities to which the direct and indirect costs and fees are paid and indicate if these entities are related to the fund's management company or depository.
UCITS using total return swaps or other FDIs with the same characteristics	38	Information on the underlying strategy and composition of the investment portfolio or index. Information on the counterparties. A description of the risk of counterparty default and the effect on investor returns. The extent to which the counterparty assumes any discretion over the composition or management of the fund's 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. Identification of the counterparty as an investment manager (this will only arise in certain specific circumstances – see Section 39 of the Guidelines).
UCITS engaging or which can engage in EPM transactions (including stocklending) and/or OTC derivative transactions	47	Details of the collateral policy of the fund, this should include permitted types of collateral, level of collateral required and haircut policy and, in the case of cash collateral, the reinvestment policy (including the risks arising from the reinvestment policy).
UCITS seeking or intending to seek exposure to financial indices	48	Obligation to disclose the intention to make use of the increased diversification limits together with a description of the exceptional market conditions which justify having the one element that may constitute up to 35% of the index in question (if applicable).
UCITS seeking or intending to seek exposure to financial indices	53	Disclosure regarding the rebalancing frequency and its effect on the costs within the strategy.

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