

## ESMA UCITS Q&A update March 2019

### UCITS KIID benchmark disclosure

The ESMA UCITS Q&A updated on 29 March 2019 clarifies benchmark and past performance disclosure obligations in UCITS KIIDs. While the Q&A is guidance, the Central Bank of Ireland is likely to expect managers of Irish UCITS to align their KIIDs with these requirements.

- UCITS KIIDs should indicate if the fund's strategy is "active" or "actively managed" or "passive" or "passively managed"
- a UCITS managed in reference to a benchmark is to be viewed as one where the benchmark plays a role in the management of the UCITS
- investors should be provided with an indication of how actively managed the UCITS is compared to its reference benchmark index
- Where UCITS name a target in their investment objectives and policies, the performance must be disclosed against the target even if the comparator is not called a benchmark
- performance disclosed in the KIID regarding a benchmark index should be consistent with performance disclosure (a) in other investor communications such as marketing material and the prospectus (b) across distribution channels and (c) across investor types

#### When do the changes need to be made to the KIID?

Changes to the KIIDs are to be made as soon as practicable or by the next KIID update. This means the latest possible date to consider whether these changes require an update to a UCITS' KIID will be the annual KIID update in February 2020.

We are aware that UK based investment managers may already be reviewing the language used in their KIIDs in view of the guidance and policy issued as a consequence of the Asset Management Study conducted by the UK Financial Conduct Authority. Such managers may want to align that review with their consideration of the updated ESMA Q&A.

#### What about the prospectus?

Four of the questions in the Q&A now state that "information disclosed in the UCITS

KIID should be consistent with the UCITS investment objective in the prospectus". It is worth considering whether any KIID changes will also trigger a review and possible update to the UCITS' prospectus.

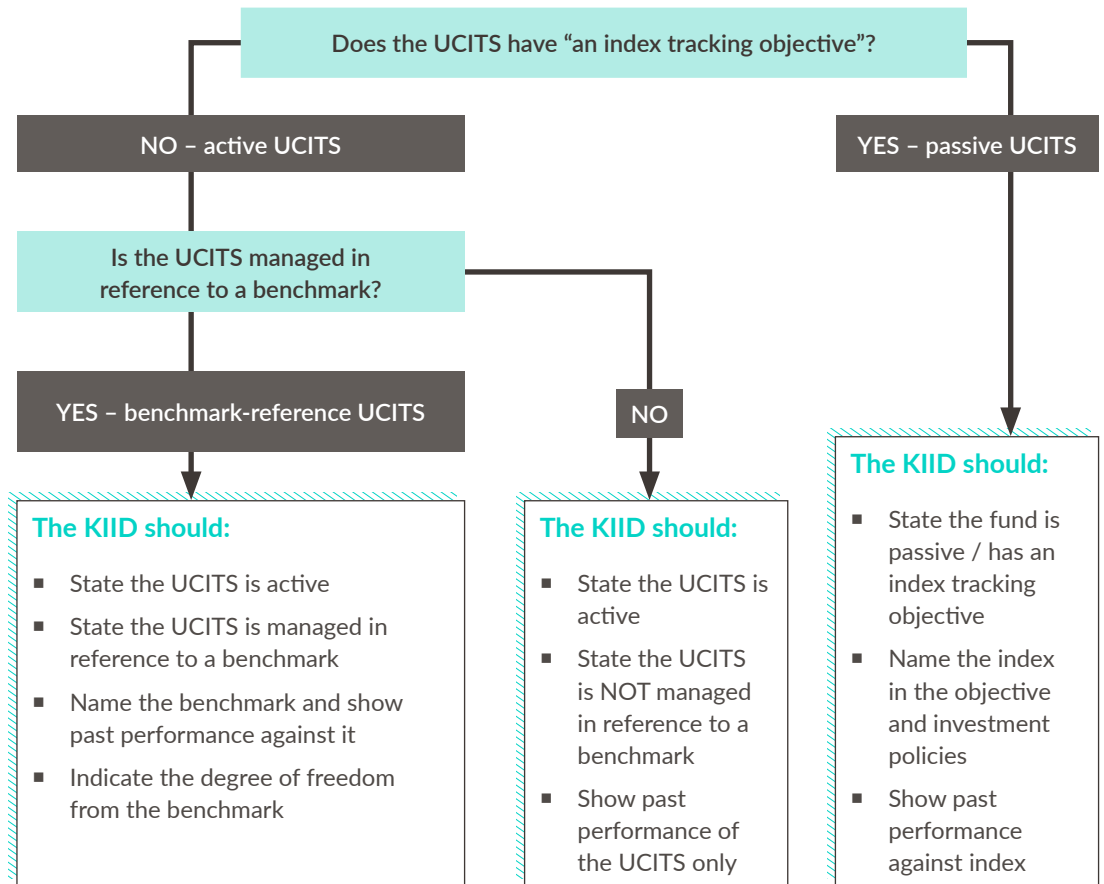
#### Active – v – passive

The requirement to label strategies "active" or "actively managed" or "passive" or "passively managed" is likely to prompt debate.

Passive funds are likely to have disclosed that they are passively managed. Actively managed funds may not have been specifying this to date. The Q&A does not address an investment strategy which has elements of both approaches. It is arguable that the terms "active" or "actively managed" or "passive" or "passively managed" are not helpful given the range of index or strategy tracking or systematic products which may not neatly fall into either.

Below is a decision tree from the updated ESMA UCITS Q&A

**Articles 7(1)(d) and 18(1) – UCITS KIID Regulation**



**How many changes were made on 29 March 2019 to the ESMA UCITS Q&A?**

The Q&A changes run to over 7 pages. The changes all relate to KIID disclosure. It breaks down into 1 amended question, 1 deleted question and 1 new question on past performance, and 3 new questions on disclosure of the benchmark index in the objectives and investment policies.

The length of the accompanying explanatory text sparks a renewed challenge to include compliant consumer-friendly explanations of technical investment terms within the confined space of the UCITS KIID.

**Summary of the changes**

**Modified Q 4b on Past Performance**

Where a UCITS refers to an index in its investment

objectives and policy as a benchmark and will measure the performance against that index, but does not intend to track it, is it necessary to show the performance of the benchmark index in the past performance section of the KIID?

**Answer Q 4b**

The answer was always “Yes” and still is. The answer has been expanded to explain where the comparator is not named a “benchmark” but it is clear that the fund aims to outperform it, the requirement applies. For example: outperform cash e.g. 3-month EURIBOR, or outperform a target “plus X%” then performance against the enhanced target should be shown. Where the UCITS targets outperformance of the benchmark index over a period of time (e.g. X per annum over 4 years) annualized performance of the benchmark index should be shown alongside the UCITS even if the target is to beat it over 4 years.

**Deleted Q 4c on Past Performance**

The old 4c was deleted because of the new Q 8b. Old Q4c was: Where a UCITS refers to an index in its investment objectives and policies (for example as an indication of the universe from which investments may be selected) but does not intend to measure performance against that index, is it necessary to show the performance of the index in the past performance section of the KIID? The answer was no.

**New Q 4c on Past Performance**

Does the overall requirement for the UCITS KIID to be 'fair, clear and not misleading' under Article 3(2) mean that performance disclosed in the KIID regarding a benchmark index should be consistent with performance disclosure in other investor communications, including marketing?

**Answer Q 4c**

Yes. Consistency across offering documents, including the prospectus, and marketing material should be ensured. The benchmark used should be consistent. Consistency across distribution channels should be ensured e.g. if the index is referred to as a benchmark in online platforms it should also be used in the KIID. All types of investors should receive consistent information about whether the UCITS has a benchmark index. For example, if professional investors are told there is a benchmark index but it is not in the KIID then all investors may not be receiving the same information.

**New Q 8a on disclosure of the benchmark index in the objectives and investment policies**

Does Article 7(1)(d) of Commission Regulation (EU) No 583/2010 require a UCITS to provide a clear indication of whether it is actively or passively managed?

**Answer Q8a**

Yes. Article 7(1)(d) requires that a UCITS either has an index tracking objective, or alternatively allows for discretionary choices. In both cases this must be disclosed in the objectives and investment policy section of the KIID. In the case of index-tracking UCITS, using the terms 'passive' or 'passively managed' in addition to 'index-tracking' is recommended. An actively managed UCITS

is one where the manager has discretion over the composition of its portfolio, subject to the stated investment objectives and policy. Explicitly using the terms 'active' or 'actively managed' is recommended practice.

As opposed to a passive UCITS, an active UCITS does not have an index-tracking objective, although it may include or imply reference to a benchmark. A spectrum exists regarding the level of discretion active UCITS may wish to take or be permitted to take against a benchmark index. The decision tree provided above is included in this Q8a.

Active UCITS which are managed in reference to an index must provide additional disclosure on the use of the benchmark index and show past performance against it. They must also indicate the degree of freedom from the benchmark (see Q&A 8c). Active UCITS managed in reference to a benchmark index must display past performance against that benchmark.

It should be clear which benchmark index (or indices) the UCITS is tracking or is being managed in reference to. Where more than one version of a benchmark index is published (for example a total return version, price return version, etc.), it should be clear which version is being used by the UCITS.

To assist investor understanding, it is recommended practice that active UCITS which are not managed in reference to any benchmark should also make this clear to investors (see Q&A 8b).

**New Q 8b on disclosure of the benchmark index in the objectives and investment policies**

What is the meaning of 'whether this approach includes or implies a reference to a benchmark' in Article 7(1)(d) of Commission Regulation (EU) No 583/2010?

**Answer Q8b**

A UCITS managed in reference to a benchmark index is one where the benchmark index plays a role in the management of the UCITS. A benchmark index may refer to an individual index or composite index comprised of more than one index / a basket of indices. Ultimately, the onus is on the UCITS management company to identify whether the UCITS is in practice managed in reference to a benchmark index.

Examples given in the answer are:

- where the UCITS uses a benchmark index as a universe from which to select securities
- the UCITS' holdings are based upon the holdings of the benchmark index
- the UCITS invests in units of other UCITS or AIFs in order to achieve similar performance to a benchmark index
- performance fees are calculated based on a performance against a reference benchmark index
- contracts between the UCITS management company and third parties (such as the investment manager) state the portfolio manager must seek to outperform a benchmark index
- The individual portfolio manager(s) receive(s) an element of performance-related remuneration based on the fund's performance relative to a benchmark index.
- The UCITS is constrained by internal or external risk indicators that refer to a benchmark index (e.g. tracking error limit, relative VaR for global exposure calculation).
- Marketing materials issued by the UCITS management company to one or more investors or potential investors shows the performance of the fund compared with a benchmark index.

**New Q 8c on disclosure of the benchmark index in the objectives and investment policies**

What is the meaning of indicating 'the degree of freedom from the benchmark' in Article 7(1)(d) of Commission Regulation (EU) No 583/2010?

**Answer 8c**

For actively managed UCITS whose investment approach includes or implies a reference to a benchmark index, investors should be provided with an indication of how actively managed the UCITS is, compared to its reference benchmark index. The UCITS or management company should at least take into account when indicating the degree of freedom (a) the description of the underlying investment universe of the UCITS should indicate to what extent the target investments are part of the benchmark index or not (b) the degree of deviation of the UCITS from the benchmark index e.g tracking error or the narrowness of the investment universe. Numerical limits such as tracking error do not have to be quantified, unless stricter requirements apply in a particular member state. Two examples of wording for the KIID are provided in the Q&A. Where a UCITS has a defined strategy to vary the risk it will take against an index, this should be disclosed e.g. where a UCITS can be managed in alignment with an index during periods of market volatility.

**Recommended next steps**

UCITS' KIIDs should be reviewed in light of the updated ESMA UCITS Q&A guidance to see if an update is required. The review should be undertaken as soon as practicable or, at the very latest, in time to include amended disclosure in the annual KIID update. If a KIID is being updated imminently for another reason then this may accelerate the review process. Prospectuses and any separate marketing materials may also need to be reviewed for disclosure consistency.

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