ESMA guidelines on ETFs and other UCITS issues

Summary

ESMA issued guidelines on ETFs and other UCITS issues (**Guidelines**) on 18 December 2012. This publication consolidates the guidelines on ETFs and other UCITS issues (ESMA/2012/474) which issued in July and the guidelines on repo and reverse repurchase agreements (ESMA/2012/722) which issued in December.

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 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 publication triggered the period of two months within which national supervisors had to declare to ESMA whether they intend to comply with the Guidelines or otherwise explain the reasons for non-compliance. The Guidelines apply from 18 February 2013, which is the end of this notification period (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 impact on a broad range of UCITS funds and not just those styled as ETFs. On the positive side, ESMA have not brought forward some of the more controversial draft proposals published in their earlier consultation paper which will be a relief to certain managers.

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.

In greater detail

The Guidelines set out detailed requirements which need to be considered by managers of affected funds. They include:

Index-tracking UCITS

The Guidelines include more detailed prospectus disclosure requirements, requirements for the KIID and disclosure requirements in the annual and half yearly reports.

Index-tracking leveraged UCITS

The Guidelines provide that such funds must calculate global exposure using either the commitment approach or the relative VaR approach (which sounds reasonable) and must comply with the limits on global exposure. Again there are additional prospectus and KIID disclosure requirements, particularly regarding the leverage policy, any impact of reverse leverage (i.e. short exposure) and a description of how the performance of the fund may differ significantly from the multiple of the index performance over the medium to long term (which has been a significant disclosure issue for regulators globally regarding leveraged and, in particular, reverse leverage, index-tracking funds).

UCITS ETFs

The Guidelines introduce an identifier which must be used in the fund name and related documentation and also a prohibition on funds that do not come within the definition of a "UCITS ETF" as provided in the Guidelines from using the identifier "ETF" or "Exchange-Traded Fund". Again additional disclosures are required.

Actively managed ETFs are subject to further disclosure requirements as regards the prospectus, KIID and marketing documentation.

Secondary Market issues for ETFs

The Guidelines include additional requirements regarding secondary market investors. This has been an area of much discussion and the Guidelines provide for a risk warning to be included (which will not be a problem per se) but also requires that if the stock exchange value of units or shares in the ETF significantly varies from its net asset value, investors who acquire their units or shares on the secondary market should be allowed to sell them directly back to the ETF. In addition, the ETF is obliged to communicate the fact that it is open for direct redemptions to the regulated market in question. An ETF is permitted to charge costs, provided these are not excessive and are disclosed in the prospectus. How this will work in practice has yet to be seen and may take a certain amount of interaction with market makers and others. One point of relief is that ESMA has decided not to recommend a minimum number of market makers for ETFs.

ESMA has noted in their Feedback Statement, that accompanies the Guidelines, that they are concerned with the use of the "ETF" name in other exchange traded products and ESMA believes that appropriate action should be taken to address this, though no detail has been provided as yet.

Efficient Portfolio Management (EPM) techniques

Again the Guidelines provide for additional disclosure requirements and also clarify that the risks arising from EPM techniques should be addressed in the risk management process of the fund. In addition, there are requirements regarding disclosure of fees including identifying entities to whom direct and indirect costs and fees are paid and whether these parties are related to the management company or depository.

Crucially, as noted above, the Guidelines provide that all revenues arising from EPM techniques, net of direct and indirect operational costs (which are undefined), should be returned to the fund. This could have a material economic impact on managers and promoters.

The Guidelines confirm that the fund must be able to recall any security that has been lent out or terminate any securities lending agreement into which it has entered, at any time.

Finally, there are disclosure requirements for the annual report in respect of EPM techniques, counterparties, types of collateral and costs and fees.

Financial Derivative Instruments

The Guidelines include additional detail regarding disclosure requirements for funds using total return swaps or other financial derivative instruments with the same characteristics. In addition, assets held by a fund and swapped out under such arrangements must comply with the UCITS investment limits and the underlying exposure provided by the FDIs must also be taken into account for the 5/10/40 and related diversification requirements.

Where the counterparty to such FDIs has discretion over the composition or management of the fund's investment portfolio or of the underlying of the FDI itself, the agreement between the fund and counterparty should be considered as an investment management delegation arrangement and must comply with the UCITS requirements in that regard.

The Guidelines provide for various disclosures in the annual report regarding exposure, identity of counterparties and the types and amount of collateral received.

When calculating counterparty exposure for UCITS investment restriction purposes, exposure arising from both OTC FDIs and EPM techniques should be combined. This modifies the current ESMA requirements set out in their 2010 Guidelines on Risk Measurement and Global Exposure.

Collateral

The Guidelines replace the existing requirements regarding collateral that may be taken into account by a fund to reduce counterparty exposure for the purposes of UCITS investment restrictions. For non-cash collateral, the Guidelines provide more detailed criteria as well as a specific diversification limit. This limit provides that maximum exposure to an issuer of collateral received by a fund from its counterparties (measured on an aggregate basis across counterparties) cannot exceed 20% of the net asset value of the fund in question. Thankfully, ESMA did not proceed with earlier suggestions which would have required collateral to respect the detailed UCITS investment restriction limits (e.g. the 5/10/40 rule etc.) and would have required that collateral be combined for such measurement purposes with assets already held in the fund. In any case, the more limited diversification requirement introduced is new and so will need to be monitored.

On a more positive note, the Guidelines have removed the requirement that cash collateral can only be invested in risk free assets which had a very limited scope. The Guidelines provide significantly more detail and, in particular, provide that cash collateral can be invested in short term money market funds which will be a significant boost to that industry. Reinvested cash collateral has to be diversified in accordance with the diversification requirements applicable to non-cash collateral as discussed earlier.

The Guidelines also provide for the fund to have in place stress testing where it receives collateral for at least 30% of its assets. In addition, funds are obliged to have a clear haircut policy adapted for each class of assets received as collateral though no quantitative or prescriptive rules have been set out for such haircuts. Finally, the Guidelines set out additional prospectus disclosure requirements regarding collateral.

Financial Indices

The Guidelines set out more prescriptive requirements for financial indices to be considered UCITS eligible. In particular, indices which rebalance on an intra-day or daily basis will not be eligible (though the Guidelines do make allowance for technical adjustments made to financial indices such as leveraged indices or volatility target indices according to publicly available criteria).

A UCITS will not be allowed to invest in financial indices for which the full calculation methodology is not disclosed by the index provider. This could prove difficult for certain UCITS funds. The financial indices will also need to publish their constituents together with their respective weightings though the weightings can be published after balancing on a retrospective basis.

The Guidelines reconfirm that the methodology for selection and rebalancing of components must be based on a set of pre-determined rules and objective criteria, that the index must have a single clear objective in order to represent an adequate benchmark for the relevant market and the universe of index components should be clear. Interestingly, the Guidelines provide that an index should not be considered as being an adequate benchmark if it is created and calculated on the request of one or a very limited number of market participants and according to the specifications of those market participants.

The Guidelines include other requirements, a number of which are already applied to certain types of financial indices (e.g. hedge fund indices) which will now apply more broadly.

The Guidelines provide that sub-categories of one commodity should be considered to be the same commodity (for diversification purposes) unless they are not highly correlated. As regards correlation, two components of the commodity index are not highly correlated if 75% of the correlation observations are below 0.8 calculated (i) on the basis of equally-weighted daily returns of the corresponding commodity prices and (ii) from a 250-day rolling time window over a 5-year period.

Repurchase and Reverse Repurchase Agreements

Key elements of the Guidelines on repurchase and reverse repurchase agreements for UCITS funds are as follows:

- For repurchase arrangements, UCITS should be able to recall at any time the assets subject to such arrangements.
- For reverse repurchase agreements, UCITS should be able to recall at any time the full amount of cash on either an accrued or a mark-to-market basis. However, when cash is recalled on a mark-to-market basis, the mark-to-market value of the reverse repurchase agreements should be used for the calculation of the net asset value of the UCITS.
- ESMA considers fixed-term repurchase and reverse repurchase agreements that do not exceed seven days as arrangements that allow the assets to be recalled at any time by the UCITS.

Effective Date and Transitional Provisions

Transitional provisions for the Guidelines are as follows (Existing UCITS means UCITS that exist before the Effective Date).

- New UCITS created after the Effective Date must comply with the Guidelines immediately.
- Existing UCITS that invest in financial indices which do not comply with the Guidelines must align their investments within 12 months of the Effective Date.
- Existing Structured UCITS are not required to comply with the Guidelines if they do not accept new subscriptions after the Effective Date. However, in order to be able to continue offering the underlying payoff to existing investors, they can actively manage their financial contracts.
- Existing UCITS must align their portfolio of collateral with the Guidelines within 12 months of the Effective Date. However, any reinvestment of cash collateral after the Effective Date must comply with the Guidelines immediately.
- Existing UCITS that have entered into revenue-sharing arrangements must comply with rules on prospectus disclosure of costs/fees arising from efficient portfolio management within 12 months of the Effective Date.
- An Existing UCITS ETF is not required to comply with Guidelines relating to identifiers until the earlier of a change to the fund name or twelve months after the Effective Date.
- Existing UCITS ETFs must comply with the provisions related to the treatment of secondary market investors from the Effective Date.
- Requirements relating to the contents of the fund documentation of an existing UCITS which it has issued prior to the Effective Date do not come into effect until the earlier of the update of that documentation or twelve months after the Effective Date.
- 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 the Effective Date.

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 have outlined 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.

Table of changes to (i) the Prospectus and (ii) other documents (where noted below):

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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