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ESMA's new UCITS guidelines

New requirements to increase transparency and mitigate risk

ESMA's new 'guidelines on ETFs and other UCITS issues' are now finalised and will take effect in February 2013. The new rules will impact not just UCITS ETFs and index-tracking UCITS. They will also affect UCITS investing in financial indices, UCITS using financial derivatives and UCITS using efficient portfolio management (EPM) techniques. Key impacts include new criteria for collateralised transactions, stricter investment rules, new information disclosures and the return of profits from net revenue sharing arrangements.

Background

The UCITS III update in 2002 and extension of the Eligible Assets Directive in 2007 provided UCITS with greater investment freedom, including permission to use financial derivative instruments and invest in financial indices. This greater investment flexibility combined with new product innovation has seen an increase in the use of synthetic and more complex investment structures in UCITS over recent years. With this increase in complexity, regulators became concerned over information deficits, the extent of index tracking errors, securities lending practices and counterparty exposure risks.

The European Securities and Markets Authority (ESMA) started to review ETF practices in 2010 and subsequently extended its review to cover certain practices within a wider UCITS context. On 18 December ESMA officially published its final set of guidelines on 'ETFs and other UCITS issues' (the "Guidelines")[1]. These Guidelines consolidate guidelines previously issued in July 2012, along with the additional guidelines on repo and reverse repo arrangements which issued earlier this month. Official publication of the Guidelines means that the clock is now ticking on the two month notification period after which the Guidelines will take effect.

Further measures in relation to complex UCITS, eligible assets, OTC derivatives and EPM techniques may arise from the European Commission's UCITS VI consultation[2], which closed on 18 October 2012. UCITS management companies will need to keep monitoring developments in this regard.

New requirements

ESMA's review concluded that existing requirements are not sufficient to take account of the specific features and risks associated with certain types of UCITS. The new Guidelines aim to strengthen investor protection, mitigate counterparty risk and harmonise regulatory practices. This is to be achieved through a number of different means, including: increased transparency and disclosure to investors; setting out quantitative and qualitative criteria for collateralised transactions; the wider application of existing UCITS diversification limits; and new, stricter criteria in certain cases. The Guidelines address the areas of index tracking UCITS and UCITS ETFs, EPM techniques, financial derivative instruments (FDIs), collateral management and financial indices. The key requirements in relation to each of these areas are summarised below.

Index tracking UCITS / UCITS ETFs

- The prospectus of index tracking UCITS must clearly describe the indices, including information on their underlying components. In order to avoid frequent updates, the prospectus can direct investors to a website where the exact components are published.

1. Guidelines on ETFs and other UCITS issues, ESMA/2012/832.
2. European Commission Consultation Document (UCITS) on Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments, 26 July, 2012.

- The replication methodology (physical or synthetic) and the associated risks must be disclosed in the prospectus and this information must be summarised in the Key Investor Information Document (KIID).
- The prospectus must disclose the anticipated tracking error and describe factors likely to affect tracking ability (e.g. transaction costs, dividend re-investment etc.).
- The annual and half-yearly reports should state the size of the tracking error during the reference period and provide an explanation of the divergence.
- Index tracking leveraged UCITS must comply with the UCITS limits and rules on global exposure and additionally disclose the leverage policy and related information in the prospectus.
- The identifier "UCITS ETF" must be used in the name of a fund that meets this definition.[3]
- Actively managed UCITS ETFs must disclose this fact and explain how they will meet the stated policy in the prospectus, KIID and marketing communications.
- UCITS ETFs must provide the option of direct redemption from the fund for secondary market investors if the stock exchange value of the ETF significantly varies from its NAV.
- A warning must be included in the marketing documentation where the units of the UCITS ETF purchased on the secondary market are generally not redeemable from the fund.

EPM techniques

- A UCITS must disclose in the prospectus its intention to enter into EPM arrangements and provide detailed information on the risks involved and the identity of entities to which direct and indirect fees are paid.
- The risks associated with EPM techniques must also be adequately captured in the risk management process (RMP).
- All net revenue from EPM should be returned to the UCITS.
- The annual report must disclose exposure through EPM, EPM counterparties, the amount and type of collateral received and revenue received.
- The UCITS should be able to recall securities lent out at any time.
- For repos, a UCITS should be able to recall at any time the assets subject to such arrangements.
- For reverse repos, a UCITS should be able to recall at any time the full amount of cash on either an accrued or a mark-to-market basis.

Financial derivative instruments (FDIs)

- Where a UCITS enters into a TRS (or similar FDI arrangement), the assets held by the UCITS should comply with the UCITS diversification rules. For example, when a UCITS enters into an unfunded swap, the UCITS' investment portfolio that is swapped out should comply with the UCITS issuer concentration rules.
- Underlying exposures to FDIs should be taken into account when determining compliance with UCITS issuer concentration rules.
- Where the counterparty has discretion over the composition or management of the UCITS' investment portfolio or of the underlying of the financial derivative instrument, the agreement between the UCITS and the counterparty is deemed an investment management delegation arrangement. Swap arrangements will consequently need to be reviewed carefully and may require re-structuring.
- New prospectus disclosure requirements have been added for TRS as well as new annual report disclosures for UCITS using FDIs.

Collateral requirements for OTC derivatives and EPM techniques

- ESMA's Guidelines require that the risk exposures arising from both OTC derivative transactions and EPM techniques should be combined when calculating counterparty risk limits.
- ESMA has significantly revised and extended the existing OTC collateral requirements[4] which will, under the new Guidelines, be applicable to EPM techniques as well as OTC derivative transaction. Key changes to the collateral requirements include:
    - A tightening of the rules on liquidity, valuation, issuer credit quality and correlation;
    - New collateral diversification rules with a maximum exposure of 20% of NAV to a single issuer;
    - The RMP should address risks (e.g. legal and operational) of collateral management;
    - Where there is a transfer of title, collateral received should be held by the depositary of the UCITS;
    - New criteria in relation to cash collateral and the re-investment of cash collateral;
    - A UCITS receiving collateral for at least 30% of its assets should have an appropriate stress testing policy in place and conduct regular stress tests under normal and exceptional liquidity conditions;

3. A UCITS ETF is defined as a UCITS with 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 NAV.
4. Box 26 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR/10-788.

- A haircut policy for each class of assets received as collateral, taking into account factors such as account credit standing and price volatility;
- The prospectus should clearly inform investors of the collateral policy, including permitted types of collateral, level of collateral required and the haircut policy.

Financial indices

- Use of the increased diversification limits (including the 'exceptional' 35% limit) must be explained and justified in the prospectus.
- Commodity indices must consist of different commodities (sub-categories, e.g. crude oil/ brent crude/gasoline should be regarded as the same commodity and will not satisfy the diversification requirement).
- An index created at the request of one, or a very limited number of market participants will not be considered an adequate benchmark. This rule could have the effect of prohibiting customised indices.
- UCITS should not invest in a financial index whose rebalancing frequency prevents investors from being able to replicate the financial index.
- UCITS may only invest in financial indices that disclose the full calculation methodology and publish their constituents together with their respective weightings.
- The methodology for the selection and the re-balancing of the index components must be based on pre-determined rules and objective criteria.
- UCITS may not invest in financial indices whose provider accepts payments from potential index components.
- 'Backfilling', i.e. retrospective changes to previously published index values, is not permitted.
- New rules have been added in relation to the documented due diligence that a UCITS should carry out on the quality of an index.
- The index should be subject to independent valuation.

New disclosures in the annual/semi-annual report

Index tracking UCITS

The annual and half-yearly reports of an index-tracking UCITS should state the size of the tracking error at the end of the period under review. The annual report should provide an explanation of any divergence between the anticipated and realised tracking error for the relevant period. The annual report should also disclose and explain the annual tracking difference between the performance of the UCITS and the performance of the index tracked.

Efficient portfolio management techniques

The UCITS' annual report should also contain details of the following:

a) the exposure obtained through efficient portfolio management techniques

b) the identity of the counterparty(ies) to these efficient portfolio management techniques

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

d) the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred

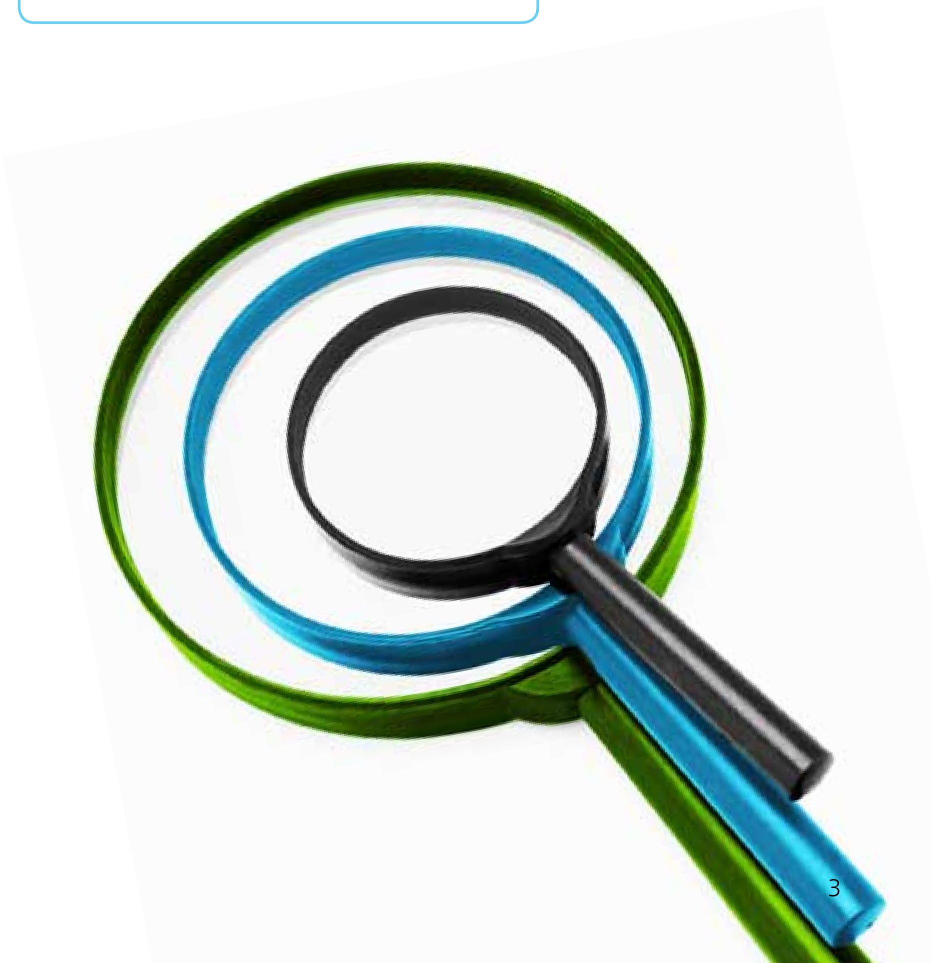
Financial derivative instruments

The UCITS' annual report should contain details of the following:

a) the underlying exposure obtained through financial derivative instruments

b) the identity of the counterparty(ies) to these financial derivative transactions

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



Timeframes for compliance

The official publication of the Guidelines has triggered a two month period within which national supervisors have to declare to ESMA whether they intend to comply with the Guidelines or otherwise explain the reasons for non-compliance. ESMA has clarified that the Guidelines will apply from the end of this notification period, meaning that the Guidelines will take effect in February 2012. Communication from the Central Bank of Ireland on national compliance is anticipated.

Newly created UCITS must comply with the Guidelines immediately. However, there are various transitional provisions for existing UCITS:

- Existing UCITS are not required to comply with the new accounting disclosures for accounting periods that have ended before the application of the Guidelines.
- Structured UCITS that exist before the date of application of the Guidelines are not required to comply, provided they do not accept any new subscriptions after the date of application.
- A 12 month transitional period applies from the date of application to existing UCITS in respect of:
  - Financial indices rules;
  - Collateral requirements, except re-investment of cash collateral;
  - Revenue sharing arrangements;
  - ETF identifier;
  - Fund documentation (KIID, prospectus and marketing communications), unless the documentation is being revised or replaced for another purpose.

Key actions

UCITS management companies should consider a range of actions, depending on their activities, to ensure they are in compliance with ESMA's new Guidelines:

- Review of EPM techniques and arrange for return of EPM profits to the fund
- Review of collateral practices
- Review of derivatives arrangements
- Review of financial indices investments
- Update policies, procedures and the RMP to meet the new requirements
- Build out a website where the exact underlying components of the index tracking UCITS are published and kept up to date
- Arrange for ETF redemptions direct from the fund in cases where the NAV varies significantly from the stock exchange value
- Update the prospectus, KIID and marketing communications as required
- Make arrangements to include the new disclosures in the annual and semi-annual report

How can Deloitte help?

We can conduct a review of your EPM, collateral and derivatives arrangements, update your risk management documentation and provide guidance on meeting the new ESMA Guidelines. We can also provide best practice guidance on collateral arrangements and help put in place procedures to mitigate against risk.

Contacts

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