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ESMA Guidelines on ETFs and Other UCITs

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ICI GLOBAL MEMBERS RE: ESMA GUIDELINES ON ETFS AND OTHER UCITS

In late July, the European Securities and Markets Authority ("ESMA") issued a report and consultation paper on Guidelines on ETFs and other UCITS issues and a consultation on recallability of repo and reverse repo arrangements. Based on its review of the current regulatory regime, ESMA determined that existing requirements are not sufficient to take account of specific features and risks associated with particular types of products and practices. ESMA states that it has, therefore, developed Guidelines to strengthen investor protections and ensure greater harmonization in regulatory practices.

The Guidelines apply to competent authorities, UCITS management companies and UCITS taking the form of self-managed investment companies, which must make every effort to comply with the Guidelines. The Guidelines, together with final rules on repo and reverse repo agreements, will be effective two months following publication in the official EU languages on ESMA's website (expected early 2013). UCITS established after the implementation date will be required to comply immediately. Existing UCITS will have an additional twelve months to comply with most of the requirements. Existing UCITS ETFs, however, are required to comply with the provisions on treatment of secondary investors as of the implementation date.

The Guidelines contain significant new requirements, some of which are described below. They are generally adapted to the type of UCITS, management technique or financial instrument in question.

Index-tracking UCITS and Index-tracking Leveraged UCITS

The Guidelines provide that index-tracking [1] and index-tracking leveraged [2] UCITS should communicate certain information to investors in the prospectus and KIID in relation to the index tracked, such as a description of the index and its underlying components, the replicating model and the associated risks, and the anticipated tracking error. The annual and half-yearly report of an index-tracking UCITS should also state the size of any tracking error during the relevant period and contain an explanation for divergence with the anticipated tracking error. Index-tracking leveraged UCITS should comply with the UCITS global exposure limits.

UCITS ETFs

Identifier and Specific Disclosure. The Guidelines include a definition of UCITS ETFs, and state that a UCITS ETF should use the identifier “UCITS ETF” in its name, fund rules or instruments of incorporation, prospectus, KIID and marketing communications. [3] ESMA determined not to require further distinction between physical and synthetic ETFs.

Under the Guidelines, a UCITS ETF should disclose its policy on portfolio transparency and where information on the portfolio can be obtained, as well as how the indicative NAV is calculated (and how frequently).

Actively-managed UCITS ETFs. The Guidelines provide that actively-managed UCITS ETFs should clearly inform investors of this fact in their prospectus, KIID and marketing communications, and disclose how the UCITS ETF will meet the stated investment policy, including its intention to outperform an index.

Treatment of Secondary Market Investors of UCITS ETFs. The Guidelines state that, if the stock exchange value of the shares of the UCITS ETF significantly varies from its NAV, investors who have acquired their shares on the secondary market should be allowed to sell them directly back to the UCITS ETF. They also provide that a UCITS ETF should include a warning if it is not generally redeemable from the fund and for the process for direct redemption and potential costs to be disclosed in the prospectus.

Efficient Portfolio Management Techniques

The Guidelines provide clarification on the information that should be communicated to investors when UCITS engage in efficient portfolio management techniques. [4] Specifically, a UCITS should inform investors clearly in its prospectus of its intention to use such techniques and should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS.   In addition, a UCITS annual report should contain details of the exposure obtained through EPM and the EPM counterparties, as well as the amount and type of collateral received and details of the revenue received. The Guidelines also provide that UCITS should disclose in the prospectus the policy regarding direct and indirect operational costs/fees arising from EPM techniques that may be deducted from the revenue delivered to the UCITS.

Notably, the Guidelines specify that all the revenues arising from EPM techniques, net of direct and indirect operational costs, should be returned to the UCITS. With respect to securities lending the Guidelines state that, a UCITS should 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.

Financial Derivatives Instruments ("FDI")

The Guidelines address UCITS' use of FDI, such as total return swaps. The Guidelines include recommendations for enhanced disclosure to investors regarding the implications of entering into these transactions. The prospectus should identify the swap counterparty, disclose the risk of counterparty default, and identify the underlying swap strategy or index that the UCITS is gaining exposure to. In addition, the annual report should identify the swap counterparty, the types and amounts of collateral received, and detail the underlying exposure of the total return swap or FDI.

The Guidelines also clarify that the underlying exposures of the FDI should be taken into account to calculate investment limits in Article 52 of the UCITS Directive.

Management of Collateral for EPM Techniques and OTC FDIs

The Guidelines set out qualitative and quantitative criteria for collateral received by UCITS for both OTC financial derivative transactions and EPM techniques, amending certain aspects of existing Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS. In particular, the Guidelines require: (1) reinvestment of cash collateral in very high quality assets, (2) "sufficient diversification" (meaning that aggregate collateral received should not have exposure to a single issuer of greater than 20% of net asset value), (3) prospectus disclosure regarding permitted types of collateral, level of collateral, haircut policies, and re-investment policy, (4) an appropriate stress testing policy and regular stress tests if the UCITS receives collateral for at least 30% of its assets, and (5) the establishment of a clear haircut policy for each class of assets.

Financial Indices

With respect to financial indices, the Guidelines cover information that should be disclosed on the calculation methodology of the index, restrictions on the rebalancing frequency, and how diversification rules should be assesses in the context of commodity indices. Regarding adequate benchmarks, the Guidelines appear to prohibit customized indices. [5] In addition, the Guidelines provide that UCITS cannot invest in financial indices whose rebalancing frequency prevents investor from being able to replicate the index. The prospectus should disclose both the balancing frequency and its effect on costs. On commodity indices, the Guidelines provide that commodity indices must consist of different commodities.

The Guidelines require the disclosure of the calculation methodology of the index and publication of the constituents of the index and their weightings. ESMA acknowledged, however, that it would consider further guidance in this area if needed. In addition, financial indices must have a methodology for the selection and rebalancing of components based on pre-determined rules and objective criteria.

Consultation on Repo and Reverse Repo Arrangements

The paper also includes a consultation on the treatment of repo and reverse repo arrangements (which closed on September 25th).

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endnotes

[1] An index-tracking UCITS is defined 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.”

[2] An index-tracking leveraged UCITS is “a UCITS, the strategy of which is to have a leveraged exposure to an index or exposure to a leveraged index.”

[3] A UCITS ETF is defined 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.”

[4] EPM techniques generally refer to securities lending transactions, sale and repurchase agreements (repos), and purchase and resale agreements (reverse repos).

[5] The Guidelines provide that “an index shall not be considered as being an adequate benchmark of a market if it has been created and calculated at the request of one, or a very limited number of market participants and according to the specifications of those market participants.”