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A legal update from Dechert's Financial Services Group

ESMA Guidelines on ETFs and Other UCITS: What They Mean for Managers

The weeks leading up to the summer vacation saw a flurry of UCITS activity, including the publication of an ESMA report and guidelines on UCITS, the unofficial release of the draft UCITS V Directive and the publication of a consultation paper on UCITS VI, which, taken together, will significantly impact the UCITS landscape in the years ahead.

Many of these regulatory developments arise from the implementation of the Alternative Investment Managers Directive (AIFMD) and, going forward, it is expected that the regulatory framework for both alternative funds and UCITS will move on a twin track approach. Accordingly, developments in UCITS should be monitored for application to Alternative Investment Funds (AIFs) and vice versa.

In a series of *DechertOnPoints* dedicated to UCITS, each of these important developments will be examined, as well as the impact that they will have on the European funds industry.

The publication that is examined in this *DechertOnPoint* is the Report and Consultation Paper issued by ESMA on 25 July 2012, containing Guidelines on Exchange Traded Funds (ETFs) and other UCITS issues (the Guidelines) and a consultation on recallability of repo and reverse repo arrangements. It will also consider the actions that need to be taken by UCITS, their managers and boards in response to the Guidelines.

It would appear that the Guidelines may not be the only challenge that the ETF industry will face as the European Parliament's European Economic and Monetary Affairs Committee also has ETFs in its crosshairs. Its recently issued draft report on shadow banking provides that it:

> *"Recognises the benefits Exchange Traded Funds (ETFs) provide by giving retail investors access to a wider range of assets (such as commodities, in particular), but stresses the risks ETF carry in terms of complexity, counterparty risk, liquidity of products and possible regulatory arbitrage; invites the Commission, therefore, to submit a legislative proposal at the beginning of 2013 to tackle these potential structural vulnerabilities".*

It will be interesting to see whether the Commission decides that what ESMA has done is enough to deal with ETF concerns, allowing it to focus on money market fund reform.

Guidelines on ETFs and Other UCITS issues

In 2010, on the basis of concerns about the use of hedge fund strategies by UCITS funds and the increasing use of synthetic and more complex structures by ETFs, ESMA initiated a review of the possible impact on investor protection and market integrity caused by the operation of UCITS under the UCITS III Directive (2001/108/EC and 2001/107/EC)

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(UCITS III) and the Eligible Assets Directive (2007/16/EC).

This review process has now culminated in the publication of the Guidelines. It is important to emphasise that while the review process was triggered by concerns relating to ETFs, the Guidelines will apply to all UCITS.

European Union (EU) member states must make every effort to comply with the Guidelines and it is expected that the Central Bank of Ireland (the Irish Central Bank) and the CSSF in Luxembourg will adopt the recommendations in full. The Guidelines contain significant new disclosure requirements and UCITS that are affected will have to look carefully at their prospectus and key investor information documents to ensure that they are in compliance.

Some of the key considerations arising from the Guidelines (notably Guidelines V to XIV) are discussed below, along with suggestions on possible actions that should be taken by UCITS. Guidelines I to IV are general and cover: scope; definitions; purpose; compliance and reporting obligations. The final guidelines, comprising both the Guidelines and the final rules on repo and reverse repo agreements will come into effect two months following the publication on the ESMA website of the translations into the official languages of the EU. It is understood from ESMA that the expected time-frame for the final guidelines to take effect is February/March 2013 – see *Guideline XIV – Transitional Provisions* below. The transitional provisions provide that existing UCITS will be given an additional twelve months to comply with the Guidelines and final rules.

It is worth pointing out that for all of the detail contained in the ESMA consultation, the final Guidelines which are set out at 'Annex III' on page 42 of the ESMA publication run to a comparatively short 11 pages. For the purpose of this *DechertOnPoint*, references to all fund documentation means the prospectus, key investor information document (KIID) and marketing communications.

The application of the Guidelines to marketing communications is a significant development. Article 77 of UCITS Directive (2009/65/EC) provides that:

> *"All marketing communications to investors shall be clearly identifiable as such. They shall be fair, clear and not misleading. In particular, any marketing communication comprising an invitation to purchase units of UCITS that contains specific information about a UCITS shall make no statement that contradicts or diminishes the significance of the information contained in the prospectus and the key investor information referred to in Article 78. It shall indicate that a prospectus exists and that the key investor information referred to in Article 78 is available. It shall specify where and in which language such information or documents may be obtained by investors or potential investors or how they may obtain access to them."*

The UCITS regulatory framework has not been very prescriptive in its treatment of marketing communications to date and the new rules requiring disclosures to be contained in marketing communications does represent a significant departure from existing practice. It will be interesting to see how regulators implement these provisions and, in particular, whether they will require similar confirmations and filings for marketing communications to those currently required for KIIDs.

Guideline V: Index-Tracking UCITS

The ESMA consultation was initially focussed on index-tracking ETFs but was broadened to include all index-tracking UCITS and concentrated on an analysis of the key elements contained in index-tracking UCITS.

An index-tracking UCITS is defined under the Guidelines 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"*.

ESMA's main concern was that, apart from including the name and a short description of the index, index-tracking UCITS do not generally make sufficient disclosures in regard to the policy of the index tracking UCITS, the replication mechanism used and the types of underlying assets and strategies that such UCITS are gaining exposure to.

Accordingly, the Guidelines focus on the prospectus disclosure requirements for index-tracking UCITS and specify that the prospectus must include: a clear description of the index and its underlying components (the exact contents of which can be published on a website); information on how the index will be tracked (e.g., by replication or synthetically) and the impact of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk; information

on the level of tracking error expected in normal market conditions (an objective rather than a hard limit); and a description of the factors likely to affect the ability of the index-tracking UCITS to track the index, such as transaction costs or small illiquid components.

Both the annual and half-yearly reports should state the size of any tracking error during the relevant period and provide an explanation for divergence between anticipated and realised tracking error in the annual report (in addition to the KIID); explaining any difference between the performance of the UCITS and that of the index.

The Guidelines have addressed industry concerns by removing the requirement to disclose ex-ante tracking error and replacing it with a requirement to disclose the anticipated level of tracking error. In addition, ESMA did not proceed with the development of guidelines for the computation of tracking error. However, the Guidelines regarding tracking error are thought to favour synthetic indices which are generally considered to produce less tracking error.

The elephant in the room here is that in a combined response to the consultation, MSCI, Standard and Poor's and FTSE indicated that they *"would be concerned about, and would object to, the underlying components of an index being made publicly available"*.

ESMA did not comment on these objections in their feedback statements. How the Guidelines will make strategy indices more difficult to structure in the future is discussed below, but it may also become more difficult to structure normal index-tracking funds if the concerns of the index providers remain. There may be scope within the Guidelines to provide that publication of the exact composition of the indices would be permitted on a delayed basis.

Possible Action Points

- Update prospectus: index-tracking disclosure
- Update KIID: index-tracking disclosure
- Prepare annual and half-yearly reports: tracking error disclosure

Guideline VI: Index-Tracking Leveraged UCITS

Similar to the case of index-tracking UCITS, the consultation on index tracking leveraged ETFs was originally focussed on ETFs before being broadened to cover all UCITS. The Guidelines provide a definition for index-tracking leveraged UCITS and specifies requirements for prospectus and KIID disclosures and compliance with the UCITS global exposure limits.

An index-tracking leveraged UCITS is defined under the Guidelines as *"a UCITS, the strategy of which is to have a leveraged exposure to an index or exposure to a leveraged index"*.

The prospectus disclosure requirements for index-tracking leveraged UCITS must include a description of the leverage policy — how it is achieved and any attendant costs and risks; a description of the impact of reverse leverage (short exposure); and a description of how the performance of the index may differ significantly from the multiple of the index performance over the medium to long term. These disclosures are also required to be provided in summary form in the KIID.

These provisions did not prove to be controversial during the consultation process and ESMA did not follow up on a suggestion to introduce guidelines on how UCITS achieve leverage, beyond clarifying the requirement to comply with the UCITS global exposure limits.

Possible Action Points

- Update prospectus: index-tracking leveraged UCITS and direct redemption process and costs disclosure
- Update KIID: index-tracking leveraged UCITS disclosure in summary form

Guideline VII: UCITS ETFs – Identifier and Specific Disclosure

Identifier

ESMA had proposed that an identifier — either "ETF" or "Exchange Traded Fund" — be used in the fund name and in all fund documentation.

The Guidelines provide that the identifier "UCITS ETF" is to be used and ESMA decided against providing for any further distinction between synthetic and physical ETFs, on the basis that this information is provided in the prospectus or KIID. In so doing, ESMA took into account industry concerns that this requirement would have been too difficult to put in place in practice, as it would fail to address

situations where replication is partially physical and synthetic.

If the term "UCITS ETF" is to be used, it must be clearly defined. The Guidelines define UCITS ETF 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".*

A UCITS ETF falling within this definition must include the words "UCITS ETF" in its name and, if it does not fall within the definition, it cannot be marketed as such. Questions were asked about whether the identifier must be used at both or either of the umbrella or sub-fund level. This is significant as a name change at the umbrella level or for a single fund of a corporate UCITS ETF requires shareholder approval which should be scheduled to coincide with the fund AGM. The requirement will most likely only apply at sub-fund level.

The big concern is that ESMA appears to suggest that the term "ETF" may not be used for non-UCITS funds and that appropriate actions should be taken to address this issue. This is most likely to arise under the Markets in Financial Instruments Directive, AIFMD and packaged retail investment products review processes.

There is also a concern as to how market makers can 'take action' in circumstances where there is no formal relationship existing between it and the UCITS ETF.

Specific Disclosure

The Guidelines require UCITS ETFs to disclose clearly in the fund documentation *"the policy regarding portfolio transparency and where information on the portfolio may be obtained, including where the indicative net asset value, if applicable, is published"* and in the prospectus only *"how the indicative net asset value is calculated, if applicable, and the frequency of calculation."*

Most UCITS ETFs and their managers have accepted the requirement for portfolio transparency and currently satisfy these requirements.

Possible Action Points
■ Amend name: include "UCITS ETF"
■ Update fund documentation: portfolio policy and indicative net asset value disclosure

Guideline VIII: Actively Managed UCITS ETFs

The requirement for portfolio transparency mentioned above clearly impacts actively managed ETFs to a greater extent, despite arguments regarding the impact on proprietary trading strategies of active ETF managers.

The fact that a UCITS ETF is actively managed must be disclosed clearly in the fund documentation is addition to disclosure on how the UCITS ETF *"will meet the stated investment policy including, where applicable, its intention to outperform an index"*.

Again, most UCITS ETFs and their managers will already meet these requirements.

Possible Action Points
■ Update fund documentation: actively managed UCITS ETFs disclosure

Guideline IX: Treatment of Secondary Market Investors of UCITS ETFs

In its consultation, ESMA queried whether investors who have acquired shares in the secondary market might have the option of redeeming directly from the UCITS ETF. It would appear that ESMA have accepted the substantial operational difficulties that facilitating this would entail.

Accordingly, the Guidelines provide that the option of direct redemption will apply only (in language reflecting UCITS III) *"if the stock exchange value of the units of the UCITS ETF **significantly varies** from its net asset value"* and for the mode of notification in these circumstances.

There is also a requirement for an appropriate risk warning to be in place and for the process for direct redemption and potential (and not excessive) costs to be disclosed in the prospectus.

While most managers will be satisfied with this outcome, they may still have to adapt their

redemption policies to provide for direct redemption and to update their prospectus disclosure.

Possible Action Points
■ Adapt redemption policy: allow for direct redemption ■ Update prospectus: direct redemption process and costs disclosure

Guideline X: Efficient Portfolio Management (EPM) Techniques

Prior to UCITS III, the use of derivatives by UCITS funds was permitted only for the purposes of EPM and not for investment purposes.

EPM techniques and instruments are now taken to refer to securities lending transactions, sale and repurchase agreements (repos) and purchase and resale agreements (reverse repos) transactions.

During the consultation process, ESMA raised a number of concerns on the use of securities lending by UCITS funds. In particular, it referred to the adequacy of disclosure with regard to the use of securities lending and the role of securities lending agents. ESMA highlighted the fact that, in many cases, investors may not be aware of the extent to which such techniques are used or the risks they represent; that in general, the extent to which a UCITS' portfolio can be loaned was not clear; and that matters such as the counterparty risk arising from lending or how income arising through the lending of portfolio assets is shared with the UCITS was not addressed, nor was the question of whether security lending arrangements give rise to issues regarding conflicts of interest.

Disclosure

In order to address these issues, the Guidelines provide clarification on the information that should be communicated to investors when UCITS enter into such arrangements. ESMA recommends a UCITS should clearly inform investors in the prospectus of its intention to use techniques and instruments for EPM, the risks involved in these activities and the impact, if any, that such activities may have on the performance of the UCITS.

ESMA also clarifies that the use of EPM techniques will need to be adequately covered in the UCITS risk management process (RMP) and that the UCITS annual report must contain details of the exposure obtained through EPM, the EPM counterparties, the amount and type of collateral received and details of revenue received. The prospectus should contain disclosures on the policy regarding direct and indirect operational costs/fees and *"the identity of the entity(ies) to which the direct and indirect costs and fees are paid"* (as discussed in more detail under *Revenue-sharing* below).

These disclosure requirements are not expected to be regarded as controversial. However, fund managers will need to review their UCITS prospectuses to ensure compliance with the new disclosure requirements.

In contrast, the provisions regarding revenue-sharing and collateral may raise some concerns.

Revenue-sharing

In its consultation, ESMA raised the prospect of retaining the fee-sharing arrangements between the UCITS and the securities lending agent that is the industry norm, subject to a maximum fee and prospectus disclosure. The industry responded by requesting further clarification on this issue.

However, instead of providing clarification, ESMA included what is probably considered to be the most controversial provision of the Guidelines, stating:

> *"as far as revenue-sharing arrangements are concerned, ESMA recommends that all revenue, net of direct and indirect operational costs, should be returned to the UCITS"*.

The impact of this provision can be seen from Moody's comment that the Guidelines are *"credit negative"* for asset managers and the move is generally seen to be favourable to synthetic ETFs, as synthetic issuers will not have similar revenue or income sharing requirements.

However, securities lending agents must be remunerated and it is likely that, going forward, this remuneration will be wrapped up in *"direct and indirect operational costs"* as opposed to *"revenue-sharing arrangements"*. It is questionable which option provides more transparency. According to research undertaken by Morningstar, asset managers are currently retaining between 45 and 70 per cent of gross revenue from securities lending activities.

Recallability

The Guidelines provide that *"UCITS should have the ability to recall at any time securities lent out"*.

It is worth noting that an issue raised by the Irish Funds Industry Association (IFIA) was not addressed with regard to the fact that, in Ireland, it is normal market practice for *equivalent* securities to be returned to the UCITS rather than the original security.

During the consultation, many respondents remarked that having securities recallable on demand would effectively rule out the entering into of fixed-term securities lending and repo and reverse-repo arrangements.

ESMA took the point regarding repo and reverse repo arrangements into account (but not, it appears, with regard to fixed-term securities lending) and have decided to consult further on this issue. This consultation is reviewed later in this *DechertOnPoint*. Responses to the consultation are due by 25 September 2012.

Collateral

The Guidelines referring to collateral for EPM have been combined under a separate heading with those relating to collateral for OTC financial derivative transactions and will be discussed under Guideline XII below.

Possible Action Points
■ Update prospectus: EPM technique disclosure
■ Update RMP: EPM technique disclosure
■ Prepare annual reports: specific information on EPM techniques
■ Review revenue-sharing agreements

Guideline XI: Financial Derivative Instruments

UCITS often use total return swaps (TRS) or financial derivative instruments (FDIs) as a means of gaining exposure to financial indices or perhaps an underlying reference portfolio of assets. Mangers of UCITS are prohibited from making direct investment in commodities or commodity based FDIs and will often enter into a TRS in order to gain exposure to a commodity index, a portfolio of alternative assets or perhaps an index that provides exposure to more complex investment strategies (strategy indices).

ESMA identified a number of issues arising from the use of TRS and FDIs. These include: investors' lack of awareness of the risk of counterparty default, potential for diverging national rules regarding collateral management, particularly in relation to value; and compliance with the UCITS diversification and eligible assets requirements and the quality and diversification of collateral that may be received by a UCITS for the purposes of limiting counterparty risk (as further described below). Additionally, investors may not be aware of the indirect costs or fees associated with a UCITS entering into TRS or if the transaction gives rise to any issues regarding conflicts of interest.

ESMA expressed the opinion that in regard to the management of a TRS, the counterparty may have discretion in relation to the swap strategy, for example, the counterparty may be entitled (within a framework established by the fund manager) to select assets or the weighting of assets that constitute the underlying reference portfolio of the TRS. This is regarded as a significant development.

In general, the Guidelines contain ESMA's recommendations for enhanced disclosure to investors in terms of the implications of entering into TRS or FDIs possessing similar characteristics. Under the Guidelines, a UCITS prospectus should (i) identify the swap counterparty (and, if applicable, its role as an investment manager); (ii) disclose the risk of counterparty default and its implications; and (iii) identify the underlying swap strategy or the composition of the underlying portfolio or index that the UCITS is gaining exposure to. Similarly, the UCITS' annual report should identify the swap counterparty, the types and amount of collateral received to minimise counterparty exposure and detail the underlying exposure of the TRS and FDIs.

The ESMA feedback statement and the Guidelines do not refer to the relatively strong industry push back on the determination that counterparties may be carrying out a discretionary management function. Most respondents took the view that any flexibility/discretion afforded to counterparties would be within strict limits imposed by the investment manager and could not amount to discretion.

The effect of this relatively innocuous provision will be quite problematical as most fund boards and counterparties would not see themselves as being in a discretionary investment management relationship. The question of when the role of the

investment manager ends and that of the counterparty begins will also be problematical.

Approval of investment managers is a relatively complex task and it is expected that arrangements will be put in place to ensure that counterparties have no role in investment decisions, although this will not be easy to achieve.

Counterparties will also be concerned about ESMA's application of this analysis to other FDIs and to non-UCITS funds.

The Guidelines remind fund managers that underlying exposures to FDIs should be taken into account when determining compliance with UCITS issuer concentration rules. In this regard, to determine the issuer exposure represented by FDIs, a fund manager should convert each FDI into the market value of an equivalent position in the underlying security. CESR's guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (reference CESR 10-788) sets out conversion methodologies for different types of FDIs that should be applied for this purpose.

Possible Action Points

- Update prospectus: TRS and FDIs disclosure
- Review role of TRS counterparty
- Prepare annual report: TRS and FDIs disclosure

Guideline XII: Management of Collateral for OTC FDIs and EPM Techniques

In its consultation, ESMA noted that the existing CESR guidance on the criteria for collateral for UCITS as set out in CESR's Guidelines on Risk Management does not apply to collateral received as part of a securities lending transaction or repurchase agreement.

In seeking to remedy this omission, ESMA revisited the existing criteria and combined it to develop one set of criteria for the management of collateral for both OTC FDIs and EPM techniques.

While some may argue about the requirement to add counterparty risk created by EPM techniques to the counterparty risk linked to OTC FDIs, most managers will generally regard the outcome in relation to FDIs as positive.

In particular, ESMA resisted the temptation to introduce quantitative criteria for the assessment of collateral and opted instead for new collateral rules which do:

- **not** require re-investment of cash collateral in risk-free assets, although the Guidelines require reinvestment in very high quality assets, including short-term money market funds;
- **not** require diversification in line with UCITS diversification rules, but adopt a requirement of *"sufficient diversification"*, meaning that aggregate collateral received should not have exposure to a single issuer of greater than 20% of net asset value;
- **not** require a high level of correlation between the collateral provided and the assets subject to EPM (the Guidelines set out the prospectus disclosure requirements for a UCITS collateral policy, which should include permitted types of collateral, the level of collateral required, haircut policies and, in the case of cash collateral, the re-investment policy (including the risks arising from the policy));
- require a UCITS receiving collateral for at least 30% of its assets to implement an appropriate stress testing policy and carry out regular stress tests (under normal and exceptional liquidity conditions) in order to assess the liquidity risk attached to the collateral; the Guidelines also set out the minimum requirements that such policies will be required to fulfil; and
- require a UCITS to establish a clear haircut policy adapted for each class of assets received as collateral.

These changes represent a less stringent approach by ESMA and its implications should be reviewed by all UCITS using OTC FDIs. RMPs will also need to be updated.

Given the importance of the question of how collateral is to be held in the debate on depositary liability under the AIFMD, the requirements on how collateral is to be held are interesting.

Where there is a title transfer, collateral must be held by the depositary and for other types of collateral arrangement, it may be held by a third

party regulated custodian unrelated to the provider of collateral.

Currently, collateral for repo or stock lending transactions may be held by Central Securities Depositaries and clarification will have to be sought as to whether these types of tri-party collateral management arrangements will be permitted to continue.

In the context of the depositary liability provisions coming down the track with UCITS V, depositaries will demand a say with regard to the third parties with whom collateral is held and will generally be satisfied that the third party must be unrelated to the provider of the collateral. However, prime brokers will need to study the operational implications of these requirements in detail.

Possible Action Points

- Update prospectus: collateral management policy disclosure
- Update RMP: collateral management policy disclosure
- Align collateral with the Guidelines
- Align reinvested cash collateral with the Guidelines

Guideline XIII: Financial Indices

As noted by the Irish Central Bank in its guidance on financial indices, their use in more complex and innovative ways has been a relatively recent development, facilitated by the ability for UCITS to use derivatives, and it is true to say that much of the innovation in terms of utilisation of hedge fund strategies in UCITS has been through the use of financial indices.

ESMA initiated its discussion by focussing on strategy indices that aimed to replicate a quantitative or trading strategy, but the final Guidelines apply to all financial indices.

Most of the Guidelines reflect the practice that has emerged since the Eligible Assets Directive, which in the case of Irish UCITS is the subject of well established industry guidance.

Before moving on to the more contentious provisions, it is worth considering the more straightforward provisions. For example, a financial index may have a single component with a weighting of up to 35% of the index where justified by *"exceptional market circumstances"*. While previously, these circumstances had to be explained to the regulator, the Guidelines now require clear prospectus disclosure. These limits must be respected in the case of leveraged UCITS.

Financial indices were the area that gave rise to most industry pushback on the ESMA proposals. However, in most cases, ESMA has stuck to its guns and, in so doing, has significantly altered the landscape for investable index UCITS, although some of the industry feedback suggests that the Guidelines *"are not necessarily seen as a game changer"*.

Commodity Indices

Given the prohibition on UCITS investing in commodities and commodity derivatives, commodity indices represent the principal method by which UCITS can gain exposure to this very important asset class and UCITS CTA Funds will need to monitor these changes closely.

The proposed Guidelines provided that commodity indices must consist of different commodities. Using oil as an example, ESMA also confirmed their position that sub-categories of the same commodity should be considered as being the same commodity for diversification purposes, citing WTI Crude and Brent Crude as examples of sub-categories. An exemption to this applies if the sub-categories can be shown to be *"not highly correlated"*.

Adequate Benchmark

ESMA slipped in to the Guidelines what looks like a prohibition on customised indices with the requirement 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"*.

This is a difficult one. Presumably, regulators will implement this requirement by asking the UCITS to confirm that the index has not been created on the basis set out above and will rely on this confirmation. However, it is not the UCITS that will be able to properly give this confirmation but the index provider. The requirement may give rise to a form of reverse enquiry taking place between index providers and market participants and indeed a lot

of the innovation in this area has come from the index providers. Two further questions arise. How is the objective question of whether an index is an adequate benchmark of a market impacted by the manner of its creation? It is either an adequate benchmark or it isn't. The second question is whether the Dow Jones Industrial Average or FTSE Index (in its original form) would have passed this test? All indices have to start somewhere!

Rebalancing

During the consultation, ESMA commented that strategy indices can rebalance on a daily or an intra-day basis giving rise to concerns about transparency and the ability of investors to replicate the index. As a result, the Guidelines provide that UCITS cannot invest in financial indices whose rebalancing frequency prevents investors from being able to replicate and they confirm that indices that rebalance on a daily or intra-day basis do not satisfy this criterion with an exception for technical adjustments to indices, such as leveraged indices or volatility target indices. While it would appear that this requirement is targeted at highly active hedge fund strategies, it was pointed out during the consultation process that more traditional market capitalisation based indices would also be affected. The prospectus should disclose both the balancing frequency and its effect on costs. Many CTA managers will consider that their indices typically take the form of long term trend following models with monthly or weekly rebalancing and that any daily rebalancing that might occur will come within the "technical adjustments" exemption.

This will have a significant impact on many of the financial indices currently invested in by UCITS and those UCITS affected will need to have regard to the transition provisions referred to below.

Publication and Calculation Methodology

Despite strong pushback, ESMA maintained its position with regard to the disclosure of the calculation methodology of financial indices and with regard to publication of the constituents of the index and their weightings. The pushback came principally from index providers concerned to protect their "secret sauce recipe". It is worth noting that ESMA indicated that it would consider the possibility of developing further guidance should further clarity be needed on the precise information to be disclosed. It is expected that those providers most impacted by this Guideline will look for such clarity to be given, particularly around the level of detail to be provided in the methodology.

For Irish UCITS, the Guidelines go considerably beyond existing guidance, e.g., the requirement to provide *"detailed information on the index constituents"* as opposed to *"data on constituent selection criteria"*.

The Guidelines also require that financial indices have methodologies for the selection and rebalancing of components to be based on pre-determined rules and objective criteria. This may serve to rule out more aggressive index strategies that permitted an element of flexibility and subjectivity with regard to the selection and rebalancing criteria. However, it may be possible to deal with these requirements by having clearly stated index rules with clear guidance on how rebalancing might occur. The Guidelines provide that UCITS should carry out appropriate documented due diligence on the quality of the index and on matters relating to index components.

Other Prohibitions

The Guidelines contain a number of further guidelines for investing in financial indices (which derive from previous guidelines for hedge fund indices) including due diligence on the quality of the index and prohibitions on:

- index providers accepting payments from index components for inclusion; and
- backfilling, i.e., indices that permit retrospective changes to previously published index values.

Possible Action Points
▪ Review financial indices: ensure they are permitted by the Guidelines
▪ Undertake due diligence: the quality of the index
▪ Update prospectus: increased diversification and rebalancing frequency disclosure

Guideline XIV: Transitional Provisions

The Guidelines state that competent authorities of EU member states must implement the Guidelines two months after the publication of the Guidelines on ESMA's website and their translations into the official languages of the EU.

While the Guidelines relating to ETFs and other UCITS issues have already been published, ESMA will be treating both these and the Guidelines on

Repo and Reverse Repo Arrangements (the Repo Guidelines) as a single package and, accordingly, implementation will be driven by the timeline for the Repo Guidelines.

The consultation period for the Repo Guidelines will run until 25 September 2012 and ESMA expects the consolidated guidelines to be formally published on its website by the end of 2012/ beginning of 2013. Following this publication, EU member states will have two months to comply, meaning a likely implementation date of February/March 2013 (the implementation date).

Regulators have a number of options in terms of how the Guidelines will be implemented. It is likely that most will implement the Guidelines in full without amendment, but also without further clarification on issues such as what might be considered to be "direct and indirect operational costs" for securities lending activities.

The following are the key transitional provisions:

1. UCITS established after the implementation date will have to comply immediately;
2. Existing structured UCITS (UCITS which possess a pre-determined maturity date) are not required to comply with the Guidelines and may continue to be actively managed, provided that they close to new subscriptions from the implementation date;
3. Existing UCITS ETFs are required to comply with the Guidelines on treatment of secondary market investors from the implementation date;
4. Existing UCITS are only required to comply with the requirements to publish information in their report and account for accounting periods after the implementation date; and
5. A 12-month implementation period from the implementation date applies to:
   - (i) existing UCITS that invest in financial indices to enable alignment of investments;
   - (ii) existing UCITS which must comply with the collateral requirements of the Guidelines, provided that any reinvestment of cash collateral must comply from the implementation date;
   - (iii) existing UCITS that have entered into revenue sharing arrangements;
   - (iv) existing UCITS ETFs which must comply with the identifier guidelines, unless there is an earlier reason to change the fund name; and
   - (v) the fund documentation disclosure requirements, unless there is an earlier reason to amend the fund documentation.

ESMA Consultation Paper on the Treatment of Repurchase and Reverse Repurchase Agreements

As indicated above, ESMA have issued a further consultation on the treatment of repurchase and reverse repurchase agreements (repo agreements).

The principal Guidelines on EPM provide that *"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 is entered"*. This is important for the purposes of ensuring that UCITS have the ability to meet redemption requests as they arise.

While most respondents to the ESMA consultation accepted that securities lent should be recallable at any time, ESMA had also taken the view that the Guidelines as applied to securities lending activity should also apply to repo and reverse repo transactions.

While this was broadly accepted by most of the respondents to the consultation, some were concerned that providing for the ability to recall fixed term repos and reverse repo arrangements at any time would be unduly restrictive to UCITS. ESMA's acceptance of this point has led to the consultation.

The proposed Repo Guidelines permit UCITS to enter into repo and reverse repo arrangements provided that:

- the arrangements do not compromise the UCITS' ability to meet redemption requests; and
- *"the value of assets that are subject to arrangements of terms that they do not allow the assets to be recalled at any time"* (long recall assets) should not exceed a percentage of the net asset value of the UCITS that will be determined following the consultation.

The Repo Guidelines indicate how ESMA might interpret the term *"allow the assets to be recalled at any time"* (short recall assets) and these will include overnight repo agreements and repo arrangements that permit the UCITS to:

- *"recall the full amount of cash on an accrued basis or terminate on an accrued basis the reverse repo which is entered"*; and
- *"recall any securities subject to the repo transaction or terminate the repo transaction which was entered"*.

The Repo Guidelines also suggest that there should be a balance between short term and medium term arrangements when fixed term arrangements are used; that there should be diversification for counterparties to repo agreements involving long recall assets; and that the collateral received should comply with the guidelines.

These guidelines are to be reviewed within a year.

The consultation is seeking industry data and information rather than comment, in particular:

- what is the average percentage of UCITS assets subject to repo agreements;
- the extent to which UCITS have long recall assets;
- the maximum and average maturity of repo arrangements;
- views on the appropriate percentage of long recall assets;
- suggestions for mitigating measures if repo arrangements with long recall assets are used; and
- views on the minimum number of counterparties for repo arrangements with long recall assets.

■ ■ ■

This update was authored by Declan O'Sullivan (+353 1 436 8510; declan.osullivan@dechert.com), with thanks to Gemma Burke for her contributions to this article.

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