Questions and Answers

ESMA's guidelines on ETFs and other UCITS issues

European Securities and Markets Authority

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Contents

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I. Background

1. The revised Undertakings for Collective Investment in Transferable Securities (UCITS) Directive puts in place a comprehensive framework for the regulation of harmonised investment funds within Europe. The extensive requirements with which UCITS must comply are designed to ensure that these products can be sold on a cross-border basis. The Directive of 2009 also introduces a management company passport.

2. The UCITS framework is made up of the following EU legislation:

   a. Directive 2009/65/EC, which was adopted in 2009. It is a 'framework' Level 1 Directive which has been supplemented by technical implementing measures.

   b. Directive 2007/16/EC[1]; Directive 2010/43/EU[2]; Regulation No 583/2010[3]; Directive 2010/42/EU[4]; and Regulation No 584/2010[5].

3. ESMA is required to play an active role in building a common supervisory culture by promoting common supervisory approaches and practices. In this regard, the Authority develops Q&As as and when appropriate to elaborate on the provisions of certain EU legislation or ESMA guidelines.

II. Purpose

4. The purpose of this document is to promote common supervisory approaches and practices in the application of the UCITS Directive and its implementing measures, with a specific focus on the guidelines on ETFs and other UCITS issues (ESMA/2012/832). It does this by providing responses to questions posed by the general public and competent authorities in relation to the practical application of those guidelines.

5. The content of this document is aimed at competent authorities under UCITS to ensure that in their supervisory activities their actions are converging along the lines of the responses adopted by ESMA. However, the answers are also intended to help UCITS management companies by providing clarity as to the content of the UCITS rules, rather than creating an extra layer of requirements.

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[1] COMMISSION DIRECTIVE 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions

[2] COMMISSION DIRECTIVE 2010/43/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a depositary and a management company

[3] COMMISSION REGULATION (EU) No 583/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards key investor information and conditions to be met when providing key investor information or the prospectus in a durable medium other than paper or by means of a website

[4] COMMISSION DIRECTIVE 2010/42/EU of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards certain provisions concerning fund mergers, master-feeder structures and notification procedure

[5] COMMISSION REGULATION (EU) No 584/2010 of 1 July 2010 implementing Directive 2009/65/EC of the European Parliament and of the Council as regards the form and content of the standard notification letter and UCITS attestation, the use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities

III. Status

6. The Q&A mechanism is a practical convergence tool used to promote common supervisory approaches and practices under Article 29(2) of the ESMA Regulation.[6]

7. Therefore, due to the nature of Q&As, formal consultation on the draft answers is considered unnecessary. However, even if they are not formally consulted on, ESMA may check them with representatives of ESMA's Securities and Markets Stakeholder Group, the relevant Standing Committees' Consultative Working Group or, where specific expertise is needed, with other external parties.

8. ESMA will review these questions and answers on a regular basis to identify if, in a certain area, there is a need to convert some of the material into ESMA guidelines and recommendations. In such cases, the procedures foreseen under Article 16 of the ESMA Regulation will be followed.

IV. Questions and answers

9. This document is intended to be continually edited and updated as and when new questions are received. The date each question was last amended is included after each question for ease of reference.

10. Questions on the practical application of the guidelines on ETFs and other UCITS issues may be sent to the following email address at ESMA: ETF@esma.europa.eu

[6] Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC Regulation, 15.12.2010, L331/84.

Question 1: Information to be inserted in the prospectus

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Question: Can the prospectus of an index-tracking UCITS mention both replication methodologies (physical and synthetic replication)?

Answer: Yes. If the UCITS intends to use both replication methodologies either at the same time or alternatively, this should be reflected in the prospectus.

Question 2: UCITS ETF label

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Question 2: In the case of umbrella UCITS, does the requirement to use the label "UCITS ETF" apply to both the umbrella level and the sub-fund level?

Answer 2: If all the sub-funds are UCITS ETFs, the labelling requirement applies to the sub-fund level and the UCITS may decide to apply it to the umbrella level as well. However, if not all the sub-funds are UCITS ETFs, the labelling requirement only applies to the relevant sub-funds.

Question 3: Secondary market

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Question 3: If a UCITS ETF is open for direct redemption for secondary market investors, what should be the redemption price?

Answer 3: If secondary market investors are given the possibility to redeem directly at the level of the UCITS ETF, the redemption price should be the Net Asset Value (NAV) from which costs may be deducted. According to paragraph 24 of the guidelines the costs of direct redemptions should not be excessive.

Question 4: Efficient portfolio management techniques

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Question 4a: According to the guidelines, all revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS. Does this mean that securities lending agents should not be paid for their services?

Answer 4a: No. The guidelines do not prohibit the deduction from gross revenues arising from efficient portfolio management techniques of fees paid to securities lending agents as a normal compensation for their services in the context of such techniques. However, pursuant to paragraph 35 of the guidelines, the annual report of the UCITS should contain details on the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred.

Question 4b: In some jurisdictions, UCITS management companies may also act as securities lending agents. In this case, what information should be provided to investors?

Answer 4b: First, pursuant to paragraph 28 of the guidelines, it should be disclosed to investors that the UCITS management company acts a securities lending agent. Also, according to paragraph 35 of the guidelines, the annual report of the UCITS should provide investors with details on the amount of fees paid to the UCITS management company that may be deducted from the gross revenues arising from efficient portfolio management techniques.

Question 4c: According to paragraph 28 of the guidelines, UCITS should disclose the identity of the entity(ies) to which the direct and indirect costs and fees are paid and indicate if these are related parties to the UCITS management company or the depositary. Where should this information be disclosed?

Answer 4c: UCITS management companies may disclose this information in the prospectus of the UCITS or in the annual report of the UCITS.

Question 5: Financial derivative instruments

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Question 5a: When a UCITS enters into an unfunded swap, should the exposure swapped into the UCITS be considered in combination with the assets that are swapped out to assess the compliance with investment limits laid down in Article 52 of the UCITS Directive?

Answer 5a: No. If the UCITS swaps the performance of its assets against the performance of another portfolio of assets, the UCITS should not combine both the assets swapped out and the exposure swapped into the UCITS when assessing the investment limits laid down in Article 52 of the UCITS Directive because the ultimate exposure of the UCITS is not a combination of the two portfolios.

However, pursuant to paragraphs 36 and 37 of the guidelines, when a UCITS enters into an unfunded swap, both the UCITS' investment portfolio that is swapped out and the portfolio that is swapped into the UCITS should comply with the investment limits laid down in Article 52 of the UCITS Directive.

Question 5b: Section XI of the guidelines on financial derivative instruments refers to total return swaps or other financial derivative instruments with similar characteristics. What types of instrument are covered here?

Answer 5b: First of all, the purpose of paragraphs 36 and 37 is to clarify that total return swaps should be treated like any other financial derivative instrument. This means that, in accordance with Article 51(3) of the UCITS Directive, the UCITS' investment portfolio as well as the final exposure of the UCITS resulting from the investment in financial derivative instruments should comply with the UCITS investment limits laid down in Article 52 of the UCITS Directive.

As far as paragraph 36 is concerned, ESMA's intention is to make sure that the guidelines are not circumvented via the use of financial derivative instruments that are not total return swaps but that have similar characteristics.

Question 5c: What is the scope of application of paragraphs 37, 39 and 40 of the guidelines?

Answer 5c: Paragraphs 37, 39 and 40 of the guidelines apply to any financial derivative instrument by which UCITS gain exposure to an asset.

Question 5d: Would the following arrangement constitute a delegation of investment management? Both the UCITS and the counterparty to a financial derivative instrument must agree the changes made to the underlying to the financial derivative instrument.

Answer 5d: Yes. As the counterparty to the financial derivative instrument has discretion over the composition of the underlying to the financial derivative instrument, notwithstanding that the UCITS must agree to any change, the agreement between the counterparty with the UCITS should be considered as an investment delegation.

Question 6: Collateral management

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Question 6a: Do the requirements on collateral only apply to the fraction of assets that reduces the counterparty risk of the UCITS to the limit imposed by the UCITS Directive?

Answer 6a: No. The requirements on collateral apply to all the assets received in the context of OTC financial derivative transactions and efficient portfolio management (EPM) techniques to cover counterparty risk. This means that assets received in excess (i.e. after the application of haircuts) should also comply with the same requirements.

Question 6b: Should re-invested cash collateral comply with the 20% issuer limit of paragraph 43 (e)?

Answer 6b: Yes. According to paragraph 44 of the guidelines, re-invested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral. This means that the 20% issuer limit applies to:

- entities prescribed in Article 50(f) of the UCITS Directive at which UCITS may place cash collateral;
- high-quality government bonds and Short-Term Money Market Funds in which cash collateral may be reinvested;

If UCITS reinvest cash collateral in reverse repo transactions, the reverse repo transactions should comply with sections X and XII of the guidelines on efficient portfolio management techniques and collateral management.

Question 6c: Which types of asset do not comply with the requirement of correlation of paragraph 43 (d) of the guidelines?

Answer 6c: According to paragraph 43 (d) of the guidelines, collateral received by the UCITS should be issued by an entity that is independent from the counterparty and is expected not to display a high correlation with the performance of the counterparty. Therefore, collateral issued or guaranteed by the counterparty of an OTC financial derivative transaction or EPM technique or by one of its subsidiaries or by a parent company, or more generally by an entity belonging to the same issuer group should not be considered compliant with paragraph 40 (d) of the guidelines.

Question 6d: Are tripartite agreements for collateral management in the context of efficient portfolio management techniques and OTC financial derivative transactions forbidden by paragraph 40(g) of the guidelines?

Answer 6d: No. Tripartite agreements are possible under paragraph 40(g) as long as there is no title transfer and the collateral is held by a third party custodian subject to prudential supervision and that is unrelated to the provider of the collateral.

Question 6e: When there is transfer of title, can the collateral be held by a custodian that is not the depositary of the UCITS?

Answer 6e: Yes, but only if the UCITS' depositary has delegated the custody of the collateral to a sub-custodian and the depositary remains liable if the collateral is lost by the sub-custodian.

Question 6f: Paragraph 43(e) refers to "a basket of collateral with a maximum exposure to a given issuer of 20% of its net asset value". Does this diversification requirement refer to the basket of collateral or to the net asset value of the UCITS?

Answer 6f: The diversification refers to the net asset value of the UCITS. Therefore, collateral received should be diversified so that exposure to any issuer does not exceed 20% of the net asset value of the UCITS. This means that where the amount of collateral received by a UCITS does not exceed 20% of its net asset value, the collateral can be issued by a single issuer.

Question 6g: In the case of government bonds, can the 20% limit be deemed to apply to each different issue of bonds of the same issuer?

Answer 6g: No. The limit applies to the issuers and not to the issue. Accordingly, exposure to any one government issuer, or any individual issuer, is limited to 20% of the net asset value of the UCITS.

Question 6h: Do the ESMA guidelines require that counterparty risk exposures be aggregated across both financial derivative instruments and efficient portfolio management techniques?

Answer 6h: Yes. According to paragraph 41 of the ESMA guidelines, both exposures should be combined when calculating the counterparty risk limits of Article 52 of the UCITS Directive.

Question 6i: Are government bonds exempt from the provisions laid down in paragraphs 43(a) and paragraphs 43 (e) of the guidelines?

Answer 6i: No, paragraphs 43(a) and 43 (e) apply to all types of collateral received by the UCITS in the context of over-the-counter financial derivative transactions and efficient portfolio management techniques.

Question 6j: Can cash collateral received by UCITS in the context of EPM techniques or OTC financial derivative transactions be used by UCITS for clearing obligations under EMIR?

Answer 6j: No. Cash collateral received by UCITS can only be placed or invested in the assets listed in paragraph 43(j) of the guidelines.

Question 6k: When assessing the diversification of the collateral, should re-invested cash collateral be aggregated with non-cash collateral?

Answer 6k: Yes. UCITS should aggregate non-cash collateral and re-invested cash collateral when assessing the diversification requirements of collateral received by UCITS.

Question 7: Financial indices

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Question 7a: Do the guidelines on financial indices also apply to UCITS that only use financial indices as performance benchmark?

Answer 7a: No. The guidelines on financial indices apply only to UCITS that are using financial indices for investment purposes.

Question 7b: Do the guidelines on financial indices apply only to index-tracking UCITS?

Answer 7b: No, the guidelines on financial indices apply to any UCITS investing in financial indices and not only to index-tracking UCITS.

Question 7c: Paragraph 56 of the guidelines recommends that all levels of an index should be subject to transparency requirements. What does this mean?

Answer 7c: This means that if a financial index is comprised of other financial indices, the transparency requirements also apply to the underlying indices.

Question 7d: According to the guidelines, index components' weightings should be published after each re-balancing on a retrospective basis. What is the timetable for such publication?

Answer 7d: Weightings of index components should be published before the next rebalancing of the index. For example, if an index rebalances on a monthly basis, information on the weightings of the index components should be provided as soon as possible after the rebalancing but within one month of the rebalancing.

Question 7e: Paragraph 54 of the guidelines prohibits investment in financial indices which rebalance on an intra-day or daily basis but notes that technical adjustments made to financial indices (such as leveraged indices) according to publicly available criteria should not be considered as rebalancing in the context of the guidelines. What is meant by "technical adjustments"?

Answer 7e: Technical adjustments in the context of the guidelines are adjustments which:

- are based solely on algorithmic non-subjective frameworks;
- are generally published on an ex-ante basis;
- draw on publicly available criteria (or data); and
- do not rely on the judgement of the index-provider, for example, indices which follow mechanical rebalancing formulae.

Question 8: Transitional provisions

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Question 8a: From when are the requirements set out in paragraphs 43, 44, 45 and 46 of the guidelines applicable for UCITS existing before the guidelines apply?

Answer 8a: UCITS existing before the guidelines apply should comply with the provisions of paragraphs 41, 43, 44, 45 and 46 within 12 months of the date of application of the guidelines. However, pursuant to paragraph 65 of the guidelines, any new reinvestment of cash collateral made by UCITS existing before the guidelines apply should comply with the guidelines immediately.

Question 8b: With respect to the tracking error, what type of information should existing UCITS provide for accounting periods that end within 12 months of the date of application of the guidelines if the prospectus has not been amended according to the guidelines?

Answer 8b: In this situation, existing UCITS only need to provide information on the realised tracking error; information on the anticipated tracking error and any difference between the two can be reported as from the next accounting period.

Question 8c: Are EPM techniques concluded by UCITS before the date of application of the guidelines subject to transitional provisions?

Answer 8c: UCITS that exist before the date of application of the guidelines should amend the agreements governing EPM techniques in accordance with Sections X and XII of the guidelines as soon as possible. At the latest, 12 months after the date of application of the guidelines any EPM techniques should comply with the provisions of Section X and XII of the guidelines.

Question 8d: Are structured UCITS created after the entry into force of the guidelines and which are compartments of an umbrella UCITS created before the guidelines take effect subject to the grandfathering rule set out in paragraph 64 of the guidelines.

Answer 8d: No. The transitional provisions apply to compartments of umbrella UCITS and not to umbrella UCITS themselves.