Guidelines on Exchange Traded Funds and other UCITs issues. July 2012.

ESMA published, on the 24 of July, a setr of guidelines about information disclosure regarding Exchange Traded Funds (hereinafter ETFs) and Index Tracking UCITS, about the specific rules applicable when UCITs carry out operations in OTC derivatives and/or use efficient portfolio management techniques, and about the criteria that financial indices in which the UCITs invest must meet.

Index Tracking UCITS. The leaflets must contain: a) a clear description of the indices with information on the components (a web page can keep the exact compositions of the indices up to date), b) the replication of the index (for example, if the replica is physical – based on a sample or the total, or if it is synthetic), and the implications of the replication method chosen for the investors; c) the expected level of tracking error in normal market conditions, and d) a description of factors that may affect the ability to replicate the performance of indices, such as transaction costs, reinvestment of dividends, illiquid assets, etc. The information in letter b) above must also be included in summary form in the Key Investor Information (KII) document. The annual and periodic reports must state the size of the tracking error at the end of the reference period. The annual report will also include an explanation of any difference between the projected and the real tracking error, and disseminate and explain the annual difference between the behaviour of the UCITS and the replicated index.

Leveraged UCITs that replicate indices. This type of UCIT must comply with the limits and stipulations on overall exposure, set out in article 51.3 of the UCITs Directive. To calculate the overall exposure, one can use the commitment approach or Relative VAR approach in accordance with standards set out in the guidelines on risk measurement and calculation of overall exposure and counterparty risk for UCITs. The leaflet shall contain the following information: a) description of the leveraging policy and how it is done (leverage on the index or on the type of exposure to the index), costs if relevant, and associated risks; b) description of the impact of any inverse leveraged (short exposure), and c) description of how the behaviour of the UCIT can differ significantly from the multiple of the index in the medium to long term. This summary information is also included in the KII.

Exchanged Traded Funds. ETFs should use the identifier "UCITS ETF" (in English in the document) in all EU languages, and they cannot use it if they are not guideline-based ETFs. The identifier shall be included in the name, constitutional rules, leaflet, KII and promotional material; all these documents include information on the composition of the portfolio including the indicative NAV when applicable, how it is calculated and the frequency of this calculation.

Actively managed ETFs. The leaflet and other documentation must inform investors that it is a fund with such characteristics and how to comply with the fixed investment policy including, if applicable, its intention to exceed the returns of an index.

Treatment of secondary market investors' Exchanged Traded Funds. When the shares of an ETF are purchased on a secondary market they are generally not reimbursable from the fund and the leaflet and all promotional material must include a warning about it stating that investors should buy and sell the shares with the assistance of an intermediary who may charge commission for doing so, and that the buyers may pay a purchase price higher than the NAV and the sellers may receive a lower selling price. In cases of very significant variations in the NAV, the market will be informed that the ETF market will deal with the reimbursements, the the process and the potential costs of the same being described in the leaflet.

Derivative financial instruments. If a UCIT contracts for a Total Return Swap (TRS) or other derivative instruments, both the assets and the underlying exposures must be taken into account in calculating the investment limits of the UCITS Directive. The leaflet shall contain information about: a) strategy regarding the underlying strategy and composition of the portfolio or index, b) counterparty, c) risk of failure of the counterparty and effect on the earnings of the investor d) extent of the discretion of the counterparty with respect to the composition or the portfolio management or underlying, e) identification of the counterparty in cases of delegation of management. The annual report will describe the exposure of the underlying, the identity of the counterparties, and the kind and amount of collateral received by the UCIT to reduce counterparty risk.

Management of collateral for OTC derivatives and efficient management techniques. The collateral or guarantees received by the UCIT to cover counterparty risk must meet the following criteria: a) liquidity (if not effective, it must be admitted to trading and prices must be public), b) evaluation at least daily; c) high credit quality of the issuer; d) issued by an entity independent which is of the counterparty; e) diversified in terms of country, markets and issuers; f) adequately managing the risks they give rise to; in the name of the depositary, if there is a transfer of property; g) executable by the UCIT without the intervention of the counterparty; h) assets (not cash) may not be sold, reinvested or put up as security; i) cash may only be invested in bank deposits, high quality government bonds in the purchase with a resale agreement with certain financial institutions or in Money Market Funds. If a UCIT receives guarantees worth at least 30% of its assets, it should have a policy regarding stress tests to ensure that in any circumstances, it can assess the risk of liquidity which is the collateral for the IIC. The leaflet must clearly inform regarding the collateral policy of the UCIT.

Financial indices. A UCIT reports in the prospectus to be exposed to a financial index and a description of the exceptional market conditions that justify the investment. A UCIT should not invest in an index if: a) a component of the index have an impact on the overall return rate of over diversification requirements (20% / 35%) of the regulation; b) if an index on commodities , also apply diversification; c) readjustment frequency (rebalancing) does not allow investors to replicate the index, d) the calculation method to replicate the index is not provided by the index provider, e) if the index does not publish components with their respective percentages; f) if there are no previous rules on the method of selection of components and rebalancing; g) if the provider accepts payments from potential index components for inclusion, h) if retrospective changes to allow valuations and published index. The pamphlet report of the rebalancing frequency and its effect on the costs of the strategy. The UCIT should demonstrate the suitability of the index represents UCITs Directive when appropriate market benchmark referred to, perform due diligence on the quality index and at the same time, ensure that you are subject to an independent assessment.

If you want to read the full document, please click on: http://www.esma.europa.eu/system/files/2012-474_0.pdf