FINANCIAL REGULATOR
Rialtóir Airgeadais

Guidance Notes - UCITS:

- Financial Indices
- Structured Products and Complex Trading Strategies – Prospectus Disclosure Requirements

Consultation Paper | CP 24

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Undertakings for Collective Investment in Transferable Securities (UCITS)

Financial Indices

Background and Overview

UCITS have generally used financial indices for simple replication purposes, benchmarking investment performance and hedging investment risk. The use of indices in more complex and innovative ways has been a recent development, primarily achieved through the use of financial derivative instruments ("FDI"). The purpose of this Guidance Note is to clarify the circumstances under which a UCITS must seek approval from the Financial Regulator before using a particular index and to describe the information that must be submitted. It also clarifies other related areas such as the use of indices composed of ineligible assets and prospectus disclosure requirements.

The following is the key legislation and relevant documentation in this area:

- European Communities (UCITS) Regulations 2003 ("the Regulations")
- CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS (January 2006) (Ref: CESR/06-005)

1. Regulatory Requirements

1.1 Regulatory Overview

Regulation 49 (1) (a) of the European Communities (UCITS) Regulations 2003 provides that a UCITS may invest no more than 10% of its assets in transferable securities or money market instruments issued by the same body provided that the total value held in the issuing bodies in each of which it invests more than 5% of its net assets must not then exceed 40% of the net asset value ("NAV") – the "5/10/40" rule. Regulation 49A (1) allows the 10% limit mentioned above to be increased to 20% per issuer where a UCITS intends to replicate a financial index comprised of equity or debt securities and the index is recognised by the Financial Regulator. The "5/10/40" rule is no longer applicable in these situations. Also, the 20% limit may be raised to 35% for a single issuer within the index in exceptional circumstances. UCITS may also gain exposure to a financial index through the use of financial derivative instruments ("FDI").

1.2 Circumstances where an index submission is not required

A UCITS that proposes to use a financial index for replication, investment or efficient portfolio management purposes ("EPM") is not required to submit that index to the Financial Regulator for approval if the index meets the following criteria:

- The constituents of the index meet the "5/10/40" rule; and
- The constituents of the index are eligible assets.

A financial index comprised of eligible assets that does not comply with either the "5/10/40" rule or the diversification rules introduced by Regulation 49A (1) may still be used by the UCITS once a look-through approach is used to consolidate the exposure of the individual constituents of the index with the rest of the UCITS portfolio in order to meet the requirements of Regulation 49. A UCITS that applies a look-through approach for any index is not required to submit that index to the Financial Regulator for approval.

Where a UCITS uses an index solely as a performance benchmark, the Financial Regulator does not review the index.

1.3 Circumstances where an index submission is required

A UCITS that proposes to take advantage of Regulation 49A (1), or gain exposure to an index through the use of FDI and where the index does not meet with the criteria above, must make a submission to the Financial Regulator. In the case of direct investment, the index must be comprised of eligible assets. A UCITS may also invest in an FDI based on a financial index comprised of ineligible assets, such as commodities or property, but may only do so once the index complies with the criteria in paragraph 1.4 below[1].

1.4 Summary of Index Assessment Criteria

A submission to the Financial Regulator must be sufficient to demonstrate that the index:

- Is sufficiently diversified;
- Represents an adequate benchmark for the market to which it refers;
- Is published in an appropriate manner; and
- Is independently managed from the management of the UCITS.

Where a UCITS uses multiple indices as part of its investment objectives, each index must meet these requirements.

[1] It should be noted that, as of the date of this guidance note, indices based on the returns of hedge funds are not allowed. The Committee of European Securities Regulators (CESR) is currently reviewing this matter and is expected to make a recommendation in 2007. Should exposure to hedge fund indices be allowed in the future, this guidance note will be updated.

The documentary evidence that should be provided with respect to each of these criteria is discussed in Section 2 below. Additionally, Appendix I provides a checklist to assist applicants prepare their submissions.

2. Index Assessment Criteria

A submission will be reviewed under each of the following headings. The Financial Regulator requires sufficient documentary evidence to assess the submission and so it is important that all the relevant data and information is included. Review of an index will be delayed in the event of an incomplete submission.

2.1 Sufficiently Diversified

The index must be sufficiently diversified. The individual constituents of the index may not represent more than 20% of NAV. On a case-by-case basis, and where adequate written explanation is provided to the Financial Regulator[2], one constituent of the index may have an individual weighting of up to 35% of NAV.

In assessing the diversification ratios for commodity indices, components that are highly correlated (e.g. futures on oil traded on different regulated markets) will be treated as giving exposure to the same commodity.

2.2 Adequate Benchmark

The index must measure the performance of the group of assets it is purporting to represent. The submission must therefore provide the rationale as to how the proposed index achieves the objective of being a benchmark for the market to which it refers.

[2] On the basis of such factors as exceptional market conditions and market dominance.

The methodology used to construct the index should be adequately described, including data on constituent selection criteria, constituent price collection procedures, asset allocation rules and guidelines for altering and re-balancing the index, its constituents and their weights. In this regard, it is expected that the index is revised and rebalanced periodically to ensure that it continues to reflect the performance of the assets to which it refers and to ensure that regulatory requirements with regard to allowed concentration limits are satisfied[3].

Details must also be provided as to how the index calculation methodology is independently verified. Finally, information should be provided on any fees embedded in the index.

2.3 Publication

The index must be published in an appropriate manner. This means that an investor should be able to access relevant information on the index with ease, for example, via the internet. The index performance and its constituents must be freely and continually available. This will include information on matters such as index calculation and re-balancing methodologies, index changes and information relating to any operational difficulties in providing timely or accurate information.

2.4 Independently Managed

The index must be independently managed from the management of the UCITS. The Financial Regulator will take into account the relationship, if any, between the UCITS management and the index sponsor. The performance of the index must be calculated in an independent environment, free from any external influences. If the UCITS

[3] The Financial Regulator accepts that passive breaches may occur periodically due to market movements. However it is expected that indices are re-balanced on a frequent basis to ensure that such breaches are of a limited duration.

management and the index sponsor are related parties, the Financial Regulator must be satisfied that independence can be demonstrated, for example through the existence of adequate Chinese walls.

3. Disclosure Requirements

If an index is being used for EPM purposes, there is no requirement to disclose details of the index in the prospectus other than the fact that the UCITS will gain exposure to indices for such purposes. Where indices may be used for investment purposes, the prospectus must provide sufficient disclosure to allow a prospective investor understand the market that the index is representing, why it is being used as part of the UCITS investment strategy, how the investment will be made (i.e. directly through investment in the constituents or indirectly through FDI) and where additional information on the index may be obtained such as that mentioned in paragraph 2.2 above.

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APPENDIX I

Index Review Checklist

The following is a checklist to assist in the completion of the Index submission. Additional information may be requested in the context of a particular index.

Supporting documentation must be provided for each criteria below.

A Sufficiently Diversified

1 Provide details of index constituents and weightings
2 Provide written submission if 20% concentration level exceeded

B Adequate Benchmark

1 Provide details of market index is purporting to represent
2 Provide rationale why index represents said market
3 Describe how the index will be constructed/asset allocation rules
4 Describe how index constituents are selected
5 Describe price collection procedures
6 Describe index re-balancing rules and procedures
7 Provide details on any embedded fees
8 Confirm how the index methodology is verified on an ongoing basis
9 Confirm whether the index has been constructed for UCITS strategy

C Publication

1 Provide internet-address where index performance is published
2 Provide internet-address where index rules are published
3 Provide details on the length of time the index has been in existence

D Independently Managed

1 Describe the relationship between the index sponsor and the investment manager
2 If part of the same group, provide details of how independence is enforced

Guidance Note -/07

Undertakings for Collective Investment in Transferable Securities (UCITS)

Structured Products and Complex Trading Strategies – Prospectus Disclosure Requirements

Background and Overview

The amendments to the UCITS Directive, by Directive 2001/108/EC (the "Product Directive"), introduced more investment options for UCITS, particularly in allowing financial derivative instruments ("FDI") to be used to increase investment exposure and risk. An increasing number of UCITS are now availing of these provisions. This has resulted in the use of more innovative and complex products by UCITS, including investment strategies pursuing structured returns[1].

This Guidance Note applies, inter alia, to the use by UCITS of the following investment techniques:

- Financial Indices;
- Structured Notes (e.g. collateralised debt obligations);
- Financial Derivative Instruments;
- Systematic Trading Models (e.g. algorithmic trading strategies);
- Capital Protection Strategies.

The purpose of this Guidance Note is to provide clarification with regard to the disclosure of such trading strategies in the prospectus and supplements in order to ensure that the important principle of investor-

[1] Structured products may be described as financial instruments that are engineered to meet specific investment objectives and whose value is linked to, or "derived" from, such underlying assets as stocks, bonds and currencies. This definition is not meant to encompass all such product types.

protection continues to be given primacy. It must be stressed that UCITS are retail products and so must ensure that their investment strategies are suitably disclosed to enable retail investors to make an informed decision. Unsophisticated investors may not fully understand the different risk and return characteristics of these products, notwithstanding that some complex strategies may in fact be less risky than some traditional long-only structures.

Disclosure Requirements

Notice UCITS 6 of the UCITS Notices – Prospectus - sets out the information that the full prospectus must contain with regard to investment objective and policy (paragraph 12 (xv)). It specifically requires that the descriptions *"must be comprehensive and accurate, readily comprehensible to investors and sufficient to enable investors make an informed judgement on the investment proposed to them"*. With regard to complex products and trading structures the minimum information that should be included should clearly explain:

- *What* the underlying exposure obtained through the strategy is; and
- *How* the strategy will be executed (e.g. via FDI, indices, model etc.).

The description must be carefully drafted and written in a logical and non-confusing manner. The UCITS must make a judgement as to the amount of information that is relevant. The Financial Regulator will require that poorly drafted prospectuses are re-submitted, thus delaying authorisation.

The order of information in the prospectus may be adapted to reflect the UCITS specific investment objectives and policy. It is critical that these sections are written in plain English and in a clear and concise manner, avoiding common mistakes such as the use of unnecessary jargon, a lack of logical sequence in the narrative, the provision of too much or too little information, referencing defined terms to other defined terms and generally using opaque language and format.

Investors in UCITS which adopt more complex strategies, and use some or all of the investment techniques mentioned on page 1, may also need to be provided with information on the commercial rationale behind the strategy. It is often unclear, due to the complexity of the structure proposed, what the underlying strategy is in commercial terms. This may be due to the number of sophisticated financial instruments being used to gain exposure to the underlying assets. An example could be a UCITS offering a capital protected product with an underlying credit exposure. This could be structured via a total return swap on the return of a number of credit default swap indices where the allocation of exposure to those indices is directed by the use of a systematic trading model, and capital protection is provided by notional exposure to a zero-coupon bond. In such a case it would be helpful to provide a short description as to why an investor would consider investing in such a product as this message can get lost in the technical description of the structure used.

Additional Risk Disclosures

It is important that an investor understands, in broad terms, the risks they have to face in relation to their investment. The specific degree of leverage that is expected to be generated through the use of FDI should, in all cases, be clearly disclosed, notwithstanding that such use will be within permitted levels. The use of complex trading strategies may also require additional risk disclosures, for example in relation to high levels of expected volatility[2] or the use of sophisticated risk measurement models such as value at risk. Disclosure should only be made where such risks are relevant and material, based on risk impact and probability.

[2] Article 24a (3) of Council Directive 2001/108/EC specifies that where the NAV of a UCITS is likely to have a high volatility due to its portfolio composition or the portfolio management techniques that may be used, its prospectus must include a prominent statement drawing attention to this characteristic.

Description of Payout Profile

Investors are also interested in the question "Given the risks, what might I get back?" It is desirable to therefore describe the level of risk exposure and payout profile of the strategy in terms of, say, comparison to a benchmark index, or describing potential levels of volatility, or otherwise informing investors through the use of simple tables, schematics or graphs[3].

Use of Appendices

It is also possible, through the use of appropriate appendices, to provide more detail in the prospectus. Such appendices must also, however, be capable of being readily understood by a retail investor. They must therefore not contain too much technical data that may not be easily understood by the average retail investor, such as the inclusion of detailed swap agreement terms.

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[3] If used, these should illustrate situations that result in both profit and loss to an investor.

FINANCIAL REGULATOR
Rialtóir Airgeadais

PO Box No 9138
College Green,
Dublin 2, Ireland

T +353 1 410 4000
Consumer help-line
lo call 1890 77 77 77
Register of Financial Service Providers help-line
lo call 1890 20 04 69
F +353 1 410 4900
www.financialregulator.ie
www.itsyourmoney.ie
Information Centre: 6-8 College Green, Dublin 2