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ESMA publishes revised Q&A on UCITS and AIFMD

Background

In conjunction with the work that it is carrying out on closet index-tracking funds, the European Securities and Markets Authority (“**ESMA**”) has published a [revised Q&A on UCITS](#) (the “**ESMA UCITS Q&A**”) setting out how it expects UCITS management companies¹ to comply with the disclosure obligations relating to benchmarks and past performance set down in Commission Regulation (EU) No 538/2010 (the “**KIID Regulation**”).

Closet index-tracking funds – where the fund manager claims, in the prospectus, key investor information documents (“**KIIDs**”) and/or marketing documentation of a UCITS, to manage the portfolio actively when in reality the fund stays close to a benchmark and is therefore more akin to a “passive” fund – has been a key focus for ESMA in recent years.

The aim of the revised ESMA UCITS Q&A is to foster supervisory convergence among national regulators in relation to the practice of closet indexing.

Separately, ESMA has also published a [revised Q&A on AIFMD](#) (the “**ESMA AIFMD Q&A**”) which provides additional clarification on the calculation of leverage under AIFMD.

¹ UCITS funds established as self-managed UCITS will be required to disclosure obligations set down in the KIID Regulation.

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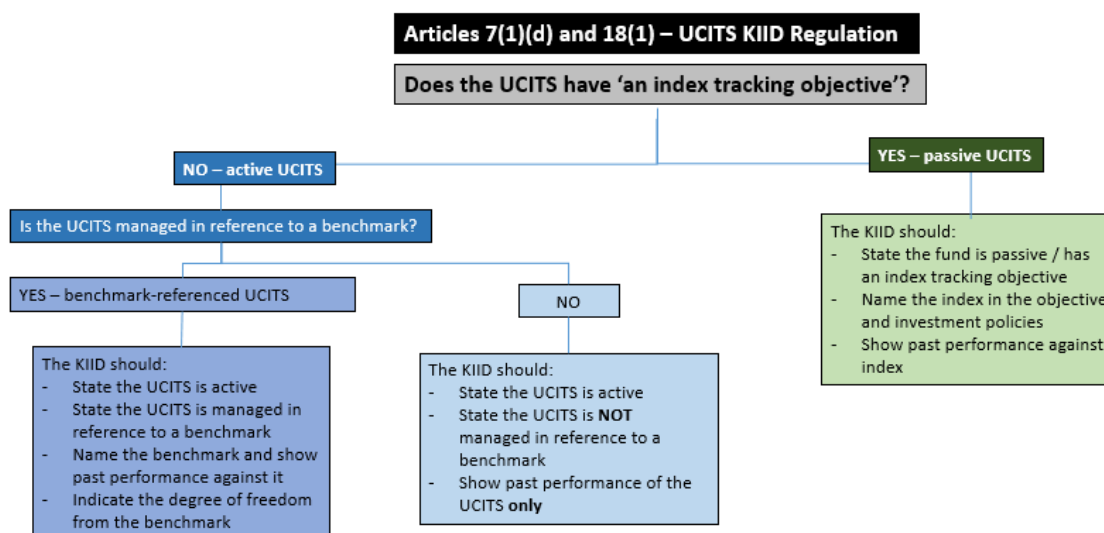
The ESMA UCITS Q&A

ESMA expects UCITS management companies to review existing disclosures relating to past performance and the use of benchmark indices in their KIIDs. Below we outline some of the key changes which may need to be made to a UCITS KIID.

Actively or passively managed UCITS?

Providing clarification on Article 7(1)(d) of the KIID Regulation, ESMA confirms that the KIID should disclose whether the UCITS is actively or passively managed in its “Objectives and Investment Policy”.

ESMA has included the following diagram to assist UCITS management companies determine the disclosure requirements relating to the use of a benchmark index.



We have set out below ESMA’s guidance on what is meant by the various terms used.

What is meant by an “active UCITS” versus a “passive UCITS”?

An active UCITS is where the portfolio manager has discretion over the composition of the UCITS. In contrast, a passive UCITS is one which has an index tracking objective.

What is meant by an active fund which is managed in reference to a benchmark?

ESMA advises that an actively managed UCITS managed in reference to a benchmark is one where the benchmark index plays a role in its portfolio composition and/or performance objectives and measures.

When is a benchmark considered to be used in composing a portfolio?

ESMA provides some examples (which it describes as “non-exhaustive and non-cumulative”) of when a benchmark is considered to be used in composing a portfolio, including:

- (i) any time that a UCITS uses a benchmark as a universe from which to select securities. This applies even if only a small portion of the securities listed in the benchmark are held by the UCITS and where the UCITS does not follow the weightings in the index;
- (ii) where the portfolio holdings of the UCITS are based upon holdings of the benchmark index; and/or
- (iii) the UCITS invests in units of other UCITS or AIFs in order to achieve similar performance to a benchmark index.

It is interesting to note that Steven Maijoor, Chair of ESMA, noted in a recent speech that the “*share of UCITS which would not be defined as managed in reference to a benchmark to be relatively small*”.²

It is also worth noting that the obligations arising under the ESMA UCITS Q&A relating to benchmarks are distinct from, and in addition to, any obligations imposed on UCITS management companies under the Benchmarks Regulation³.

When is a benchmark considered to be used as a performance measure?

ESMA sets down specific circumstances in which a UCITS will be considered to use a benchmark in order to measure its performance, which is wider than may have originally been thought. By way of example only, ESMA has taken the view that the following could amount to the use of a benchmark as a performance measure:

- (i) where the UCITS has an internal or external target to outperform an index; or
- (ii) where the UCITS is constrained by internal or external risk indicators that refer to a benchmark mark index. ESMA provides the example of using a benchmark when calculating global exposure using the relative VaR calculation methodology; or
- (iii) where any marketing material (such as fact sheets, investor presentations etc.) show the performance of the UCITS compared to a benchmark index.

²https://www.esma.europa.eu/sites/default/files/library/esma71-319-93_steven_maijoor_keynote_speech_-_better_finance_10th_anniversary_2019.pdf

³ Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014

What additional disclosures arise if my portfolio is being managed in reference to a benchmark?

In addition to displaying the past performance of the UCITS against the benchmark, the use of the benchmark should be disclosed in the “Objectives and Investment Policy” section of the KIID.

UCITS management companies must also update their KIID to indicate the “degree of freedom from the benchmark”.

What is meant by indicating the “degree of freedom from the benchmark” in the KIID?

ESMA expects that the KIID should provide investors with an indication of how actively managed the UCITS is compared to the benchmark index. ESMA advises that the KIID should strike a balance between providing the level of detail required to sufficiently disclose a UCITS’ degree of freedom from a benchmark index, and the obligation to do so in clear language understandable to a retail investor.

In this regard, ESMA advises that UCITS management companies should at least take into account the following elements:

- (i) The description of the underlying investment universe of the UCITS should indicate to what extent the target investments are part of the benchmark index or not.
- (ii) The KIID should describe the degree or level of deviation of the UCITS in regards to the benchmark index. This should include, where applicable the quantitative and/or qualitative deviation limitations underlying the investment approach (e.g. risk limits defined by reference to the benchmark index such as tracking error) as well as the narrowness of the investment universe.

ESMA has also provided some examples of wording which may be acceptable when indicating the degree of freedom from the benchmark index. These examples, which ESMA describes as for illustrative purposes only and non-exhaustive, are as follows:

1. Regarding point (i) above: *“The majority of the Sub-Fund’s equity securities will be components of and have similar weightings to the Benchmark. The Investment Manager may use its discretion to invest in companies or sectors not included in the Benchmark in order to take advantage of specific investment opportunities.”*
2. Regarding point (ii) above: *“The investment strategy will restrict the extent to which the portfolio holdings may deviate from the ABCD index. This deviation may be [limited]/[material]/[significant]. This is likely to limit the extent to which the Sub-Fund can outperform the ABCD Index. Deviations from the ABCD index are limited by a target tracking error of [X] [accompanied by a clear, concise description of the quantitative indicator’s meaning]”.*

In what circumstances must I disclose the past performance of a benchmark index alongside the past performance of the UCITS?

The previous version of the ESMA UCITS Q&A already confirmed that any UCITS which references an index in its investment objectives as a benchmark and measures its performance against that index must show the performance of that index in the “Past Performance” section of the KIID.

The ESMA UCITS Q&A has been revised to confirm that any UCITS which uses a benchmark as a comparator which it aims to outperform should be included in the past performance section of the KIID, even where that comparator has not been labelled as a “benchmark” in the KIID. ESMA notes as follows:

- (i) if the UCITS’s objectives and investment policy states that it will seek to outperform cash (for example, the 3-month EURIBOR), the performance of the fund against the full target should be shown;
- (ii) where a UCITS measures its performance against an enhanced target (such as the outperformance of a “target plus X%”), it must also show the performance of the UCITS against the enhanced target; and
- (iii) where a UCITS targets outperformance of the benchmark over a period of time, the annualised performance of the benchmark index should be shown alongside that of the UCITS, even if the UCITS’ target is to beat it over a longer timeframe.

So, if my UCITS is actively managed without reference to a benchmark, do I need to do anything?

Yes. The KIID should be revised to state that the UCITS is actively managed and is not managed with reference to a benchmark. In addition, the past performance chart should include the past performance of the UCITS only.

By what date must I update my KIID to address the above disclosure obligations?

KIIDS should be revised “as soon as practicable” or by the next KIID update following the publication of the ESMA UCITS Q&A to address the above disclosure obligations.

This suggests that where a UCITS does not change its KIID in the interim for some other reason, this change can be incorporated into the annual update KIID in February 2020.

All new UCITS (or share classes in respect of which a KIID is prepared) created going forward should comply with these new disclosure obligations immediately.

If I reference a benchmark to measure performance in the prospectus or any other marketing material, must I disclose it in the KIID?

Yes. ESMA has clarified that the KIID must be consistent with all offering documents and other marketing materials so as to avoid confusing an investor who accesses a number of these documents. Therefore, if a UCITS uses a benchmark to measure its performance in its prospectus or in other marketing material, this should be disclosed in the KIID to ensure consistency with other documents. The same benchmark index should be used in all cases.

If I reference a benchmark index in online platforms or financial data providers, should this benchmark be disclosed in the KIID?

Yes. This is in order to ensure consistency across distribution channels.

Can I use a benchmark index in communications to professional investors without disclosing this benchmark in the KIID?

No. ESMA provides that equivalent performance comparisons should be provided to all investors through the KIID.

What are the next steps to take?

ESMA expects UCITS management companies to disclose clearly whether the UCITS is following an active or passive investment strategy in the KIID.

In a recent speech, ESMA chair Steven Maijoor said policy work undertaken by the watchdog aimed to “*raise the bar significantly in respect of enhancing investor protection in UCITS*”. Mr Maijoor added that the guidance would help “*facilitate a consistent interpretation of the provisions on benchmark disclosures across member states*”.

Therefore, while the UCITS ESMA Q&A is not legally binding, UCITS management companies are advised to review existing KIID disclosures in light of the guidance and ensure that the KIID of any new UCITS is drafted in line with this guidance.

ESMA Q&A on AIFMD

Section VII of the ESMA Q&A on AIFMD has been revised to incorporate two new Q&A on the calculation of leverage.

How often must an AIFM calculate leverage?

ESMA expects AIFM to calculate leverage at least as often as the NAV of the Fund is calculated or more frequently if required in order to ensure that the AIF is capable of remaining in compliance with leverage limits at all times. It gives some further clarification of the circumstances in which more frequent clarification is required.

Should the leverage exposure arising from a short-term future be adjusted for the duration of the future?

According to ESMA, the calculation of leverage exposure of an AIF resulting from a short-term interest rate future should not be adjusted for the duration of the future. It does clarify however that this does not preclude the AIFM from applying duration netting rules under the commitment method in accordance with the provisions of the Commission Delegated Regulation 231 of 2013.

Should you have any queries in relation to this article, please contact the author or your usual contact in the Dillon Eustace Asset Management and Investment Funds Team for further information.

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