European Securities and Markets Authority

Report and Consultation paper

Guidelines on ETFs and other UCITS issues
Consultation on recallability of repo and reverse repo arrangements

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European Securities and Markets Authority

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Contents

Acronyms

ESMA	European Securities and Markets Authority
OTC	Over-the-counter
UCITS	Undertaking for Collective Investment in Transferable Securities
UCITS Directive	Directive 2009/65/EC

Executive Summary

Reasons for publication

ESMA has reviewed the current regulatory regime applicable to certain types of UCITS, including UCITS ETFs, and particular activities such as efficient portfolio management techniques. This assessment showed that existing requirements are not sufficient to take account of the specific features and risks associated with these types of fund and practice.

It is against this background that ESMA has developed guidelines aimed at strengthening investor protection and ensuring greater harmonisation in regulatory practices. A number of different means are used to achieve this, including improving the content of the information communicated to investors and setting out quantitative and qualitative criteria for collateralised transactions such as securities lending arrangements, repo and reverse repo transactions and over-the-counter (OTC) financial derivative transactions.

Contents

- Guidelines on ETFs and other UCITS issues

This paper sets out ESMA's guidelines on ETFs and other UCITS issues. The guidelines are adapted to the type of UCITS, management technique or financial instrument in question and are detailed in Annex III of the document.

In particular, for index-tracking UCITS and index-tracking leveraged UCITS, ESMA details the information that should be communicated to investors in relation to the index tracked, such as the replicating model and the associated risks or the anticipated tracking-error.

With regard to UCITS ETFs, ESMA's guidelines provide a clear definition of these products together with a recommendation on the use of the specific identifier "UCITS ETF" in the name of the UCITS to enable investors to differentiate these funds from other UCITS. The guidelines also detail the circumstances under which UCITS ETFs should be open for direct redemptions at the level of the UCITS for investors that have acquired units or shares in the secondary market.

In the context of efficient portfolio management techniques (securities lending, repo and reverse repo activities), ESMA's guidelines provide clarification on the information that should be communicated to investors when UCITS enter into such arrangements. Also, with respect to securities lending arrangements, the ESMA guidelines set out clear rules on the necessity for UCITS entering into such arrangements to be able at any time to recall the assets or to terminate these operations.

Concerning the use by UCITS of financial derivatives instruments such as total return swaps, the guidelines clarify how the risk diversification limits of the UCITS Directive should be calculated and applied.

Beyond this, ESMA's guidelines set out qualitative and quantitative criteria to be respected by collateral received by UCITS in the context of OTC financial derivative transactions and efficient portfolio management techniques. In that respect, ESMA's guidelines amend certain aspects of the existing Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788). ESMA's guidelines provide rules to be respected by financial indices in which UCITS may invest. These rules cover, inter alia, information to be disclosed on the calculation methodology of the index, restrictions on the rebalancing frequency and how diversification rules should be assessed in the context of commodity indices.

- Consultation paper on repo and reverse repo arrangements

Finally, this document sets out in Annex IV a public consultation on the treatment of repo and reverse repo arrangements on which ESMA is seeking feedback from stakeholders. The feedback to this further consultation will be used by ESMA to finalise its position on this specific issue, which will be incorporated into the rest of the guidelines already adopted by the Authority (cf. Annex III of this document).

Feedback Statement

1. Index-tracking UCITS

Q1: Do you agree with the proposed guidelines?

1. Most respondents to the consultation strongly supported the widening of the scope of the guidelines to all index-tracking UCITS. However, respondents suggested that ESMA should develop a definition of such UCITS.

2. Some comments were also made about the disclosure of the target tracking error of the UCITS which, according to some respondents, would be very difficult to estimate (in particular for newly created UCITS or indices).

3. In light of the feedback received, ESMA decided to provide a definition of 'index-tracking UCITS'. ESMA also took on board the comments regarding the target tracking error and recommends that index-tracking UCITS should indicate the anticipated level of tracking error of the UCITS in normal market conditions. This anticipated tracking error should not be seen as being a hard limit that UCITS may not breach but rather an objective for the tracking error in normal market conditions.

Q2: Do you see merit in ESMA developing further guidelines on the way that tracking error should be calculated? If yes, please provide your views on the criteria which should be used, indicating whether different criteria should apply to physical and synthetic UCITS ETFs.

4. Most respondents to the consultation expressed some support for ESMA developing further guidelines on the way the tracking error should be calculated. The same respondents did not consider it appropriate to differentiate between synthetic and physical UCITS ETFs tracking an index.

5. After further analysis and despite the support from most stakeholders, ESMA did not feel necessary to develop precise guidelines for the computation of the tracking-error.

Q3: Do you consider that the disclosures on tracking error should be complemented by information on the actual evolution of the fund compared to its benchmark index over a given time period?

6. The vast majority of respondents agreed with this proposal but pointed out that a similar requirement was already required in the KIID Regulation for the presentation of past performance.

7. ESMA acknowledges that such information is already required in the Key Investor Information Document under the section of past performance but the Authority is of the view that it should be provided in the annual report of UCITS as well.

2. Index-tracking leveraged UCITS

Q4: Do you agree with the proposed guidelines for index-tracking leveraged UCITS?

8. The majority of respondents strongly welcomed the widening of the scope of the guidelines to all index-tracking leveraged UCITS. Like for index-tracking UCITS, ESMA was asked by some contributors to provide a definition of index-tracking leveraged UCITS.

9. In light of the feedback received and the strong support from stakeholders, ESMA did not substantially modify the guidelines in the context of index-tracking leveraged UCITS. ESMA agreed with the suggestion made by some respondents to define more precisely Index-tracking leveraged UCITS and therefore included a definition in the final guidelines.

Q5: Do you believe that additional guidelines should be introduced requiring index-tracking leveraged UCITS to disclose the way the fund achieves leverage?

10. The majority of stakeholders did not foresee the need for ESMA to introduce additional guidelines to disclose the way UCITS achieve leverage.

11. However, it was suggested that leverage and/or inverse ETF should use the word "daily" or "monthly" in their identifier, as well as the level of leverage (e.g. "2X"), in order to make it clear to investors which return is being tracked.

12. Based on the comments received, ESMA decided not to recommend additional guidelines on the way UCITS achieve leverage. However, ESMA felt appropriate to clarify that index-tracking leveraged UCITS should comply with the guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty for UCITS with regards to the limits applicable to global exposure.

3. UCITS Exchange Traded Funds

Definition of UCITS ETFs and Title

Q6: Do you agree with the proposed definition of UCITS ETFs? In particular, do you consider that the proposed definition allows the proper distinction between Exchange-Traded UCITS versus other listed UCITS that exist in some EU jurisdictions and that may be subject to additional requirements (e.g. restrictions on the role of the market maker)?

13. Respondents to the consultation welcomed the initiative from ESMA to provide a harmonised definition of UCITS ETFs. However, according to certain respondents, the definition was not totally accurate as it did not sufficiently distinguish between UCITS ETFs and other UCITS that are admitted to trading on a regulated market. Therefore, the following definition was proposed:

"*A UCITS exchange traded fund (UCITS ETF) is a UCITS at least one unit or share class of which is continuously tradable on at least one regulated market or multilateral trading facility (MTF)* ***at the initiative or with the consent of the UCITS or its management company*** *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* ***indicative*** *net asset value* ***without being restricted by the UCITS in this action*****".**

14. For other respondents, the definition should include an explicit reference to index-tracking UCITS in order to take out actively managed UCITS from the scope of UCITS ETFs.

15. ESMA did not support the suggestions made by respondents to the consultation about the modification of the definition. Indeed, ESMA did not believe that it was appropriate to limit the definition of UCITS ETFs to UCITS ETFs tracking an index. Also, the Authority did not feel necessary to include a reference to the initiative or the consent of the UCITS for the admission to trading. However, after further consideration, ESMA decide to replace "*continuously tradable*" by "*traded*" and also added a reference to the indicative net asset value in the definition.

Q7: Do you agree with the proposed guidelines in relation to the identifier?

16. The majority of respondents agreed with the policy approach to request UCITS ETFs to include an identifier like "ETF" or "UCITS Exchange-Traded Funds" in their name. However, a slight preference was expressed for the use of "ETFs" mainly for translation issues. As highlighted in question 5 above, it was also suggested that ESMA should ask for the level of leverage to be included in the identifier.

17. ESMA recommends that UCITS should use the identifier "UCITS ETF" to be more easily identifiable by investors and that this identifier should not be translated into national languages. Also, ESMA recommends that neither the words "UCITS Exchange-Traded Funds" nor ETF should be used by UCITS that do not comply with the definition of UCITS ETFs.

18. ESMA remains concerned by other exchange-traded products which are not UCITS and that may use the word "ETF" in their name. Such practice may create confusion for investors and ESMA believes that appropriate actions should be taken to address this issue.

Q8: Do you think that the identifier should further distinguish between synthetic and physical ETFs?

19. The majority of respondents to the consultation disagreed with this approach for both practical and policy reasons. According to the majority of stakeholders, such requirement would be difficult to put in place in practice as it would require long fund names and would not capture mixed situations with synthetic and physical replications. From a policy perspective, a strong preference was expressed for this information to be disclosed either in the prospectus or the KIID of the UCITS because this information concerns the investment strategy of the fund.

20. ESMA recommends that the identifier should not distinguish between physical and synthetic ETFs. According to ESMA, such requirement would be difficult to put in place in practice and would not address mixed situations where the replication is partially physical and synthetic. However, ESMA is of the view such information should be communicated to investors in both the prospectus and the Key Investor Information Document.

Q9: Do you think that the use of the words 'Exchange-Traded Fund' should be allowed as an alternative identifier for UCITS ETFs?

21. Respondents did not express strong views on this point.

22. ESMA recommends that the identifier "Exchange-Traded Fund" should not be used to avoid problems linked to the translation into national languages. The identifier should therefore be limited to " UCITS ETF"

Q10: Do you think that there should be stricter requirements on the minimum number of market makers, particularly when one of them is an affiliated entity of the ETF promoter?

23. Respondents to the consultation did not express strong views on this issue. Some of the respondents expressed their disagreement with stricter requirements on the minimum number of market makers while others acknowledged that end-investors would benefit from multiple market makers in a fund and that it could be one element of good practice in the ETF industry.

24. Based on the feedback received, ESMA decided not to recommend a minimum number of market makers for ETFs.

Actively-managed UCITS ETFs

Q11: Do you agree with the proposed guidelines in relation to actively-managed UCITS ETFs? Are there any other matters that should be disclosed in the prospectus, the KIID or any marketing communications of the UCITS ETF?

25. Stakeholders overwhelmingly welcomed the proposed guidelines on actively-managed UCITS ETFs. However, some respondents questioned the merit and appropriateness of disclosing to investors how the indicative net asset value is calculated as they will buy and sell units or shares at the offer price on the exchange.

26. Based on the feedback received and the broad agreement from stakeholders, ESMA decided to keep the guidelines on actively-managed UCITS ETFs unchanged.

Secondary market investors

Q12: Which is your preferred option for the proposed guidelines for secondary market investors? Do you have any alternative proposals?

27. Respondents to the consultation expressed mixed views on this issue and some of them suggested that both options should be available to UCITS ETFs.

28. With respect to option 2, it was generally pointed out by respondents that direct redemptions at the level of the UCITS ETF or its management company would be difficult to manage in practice.

Q13: With respect to paragraph 2 of option 1 in Box 5, do you think there should be further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption? If yes, please elaborate.

29. With respect to option 1, respondents to the consultation generally did not express the need for further specific investor protection measures to ensure the possibility of direct redemption during the period of disruption.

30. Regarding the treatment of secondary market investors, after further consideration, ESMA took the decision that the best solution was to request UCITS ETFs that generally do not accept direct redemptions at the level of the UCITS ETFs to disclose this information to investors in the prospectus. However, ESMA recommends that for such UCITS ETFs, if the conditions referred in to Article 1 paragraph 2 of the UCITS Directive are no longer fulfilled, the UCITS ETF or its management company should

accept direct redemptions from secondary market investors. The Authority is also of the view that if such situation arises, a market warning should be published indicating that the UCITS ETF is opene for direct redemptions.

Q14: Do you believe that additional guidelines should be provided as regards the situation existing in certain jurisdictions where certificates representing the UCITS ETF units are traded in the secondary markets? If yes, please provide details on the main issues related to such certificates.

31. No specific comments were made on this question by respondents to the consultation.

Q15: Can you provide further details on the relationship between the ETF's register of unitholders, the sub-register held by the central securities depositaries and any other sub-registers held, for example by a broker or an intermediary?

32. Respondents to the consultation informed ESMA that usually, UCITS ETFs only know who is registered as its own shareholder and may not have access to the central securities depositary (CSD) registers.

4. Efficient portfolio management techniques

Q16: Do you agree with the proposed guidelines in Box 6? In particular, are you in favour of requiring collateral received in the context of EPM techniques to comply with CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS?

33. Respondents to the consultation generally expressed their support to the policy approach taken by ESMA to apply to collateral received in the context of efficient portfolio management arrangements the same treatment as for collateral posted for OTC financial derivative transactions. However, some respondents expressed their concerns about the application of this approach to assets received in the context of reverse repo transactions as the guidelines would not allow the reinvestment of assets received by UCITS.

34. With respect to the other provisions on efficient portfolio management techniques, the following comments were made:

- Many respondents disagreed with the requirement that a UCITS should be able to recall at any time any asset subject to efficient portfolio management transactions or to terminate the transactions into which it has entered. According to them, this provision was against market practices and would prevent UCITS from entering into fixed-term securities lending or repo transactions.

- With regards to the reinvestment of cash collateral, many respondents disagreed with the approach taken by ESMA to limit it to risk-free assets.

- Respondents requested clarification on fee-sharing arrangements and to what extent UCITS management companies should be permitted to carry-out these activities and be compensated for.

35. With respect to the issue of collateral, ESMA decided to stick to the policy approach to have the same treatment for collateral received in the context of efficient portfolio management transactions and in over-the counter operations. For sake of clarity, ESMA felt it appropriate to address this issue in a separate part of the guidelines rather than in the sections on EPM techniques or total return swaps.

36. The Authority also decided to clarify in the final guidelines all the criteria that collateral should respect and which are in Box 26 of the guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. In particular, the provisions of Box 26 of the CESR guidelines are replaced by the present ESMA guidelines. Furthermore, the present guidelines also amend Boxes 26 and 9 of the existing CESR guidelines by providing clarification on the types of assets in which cash collateral arising from OTC financial derivative transactions and efficient portfolio management techniques can be reinvested.

37. With respect to the recallability of assets, ESMA recommended that UCITS should have the ability to recall at any time securities lent out. Concerning repo and reverse repo arrangements, ESMA took the decision to further consult on this issue and has set out in Annex IV of the present document a new proposal.

38. Concerning the reinvestment of cash collateral, ESMA took on board the comments made by some respondents and removed the limitation of reinvestment of cash collateral in risk-free assets. The final guidelines contain an exhaustive list of assets in which UCITS may decide to reinvest the cash collateral received in the context of efficient portfolio management arrangements and over-the-counter transactions.

39. 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.

Q17: Do you think that the proposed guidelines set standards that will ensure that the collateral received in the context of EPM techniques is of good quality? If no, please justify.

40. For this question, please refer to question 16 above.

Q18: Do you see merit in the development of further guidelines in respect of the reinvestment of cash collateral received in the context of EPM techniques (the same question is relevant to Box 7 below)?

41. For this question please refer to question 16 above

Q19: Would you be in favour of requiring a high correlation between the collateral provided and the assets subject to efficient portfolio management transactions? Please explain your view.

42. Respondents strongly disagreed with this approach that according to them would be detrimental to investors as it would go against the functioning of efficient portfolio management techniques.

43. Based on the feedback received and after further consideration, ESMA decided that it would not be appropriate to require a high level of correlation between the collateral provided and assets subject to efficient portfolio management arrangements.

Q20: Do you agree that the combination of the collateral received by the UCITS and the assets of the UCITS not on loan should comply with the UCITS diversification rules?

44. The feedback from the consultation showed a strong opposition from stakeholders with regards to the proposed guidelines for the diversification of collateral. According to them, ESMA should not require the collateral to respect UCITS diversification limits that were designed for risk-spreading purposes. Moreover, many respondents expressed their preference for qualitative criteria like the liquidity and appropriate levels of haircuts.

45. Furthermore, according to several respondents, the proposed guidelines would be very difficult to manage in practice and would raise major practical difficulties for UCITS asset management companies. Indeed, any investment decision at the level of the UCITS portfolio may have an impact on the portfolio of collateral and therefore would need very frequent adjustments of the collateral portfolio.

46. Finally, ESMA took the decision not to retain in the final guidelines the approach it had consulted upon and recommended that the collateral received by UCITS under both efficient portfolio management arrangements and over-the-counter operations should be sufficiently diversified. However, in order to provide certainty about the acceptable level of diversification, ESMA developed quantitative criteria that the UCITS should respect.

Q21: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

47. Respondents to the consultation generally felt that the best approach was to rely on a list of qualitative criteria but some of them acknowledged that it may be useful to supplement these criteria with an indicative list of assets eligible as collateral.

48. In the final guidelines, ESMA decided not to develop an indicative list of eligible assets of collateral and preferred to rely on a qualitative-based approach.

Q22: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 52 is appropriate.

49. For this question, please refer to question 21 above.

Q23: Do you believe that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive?

50. Only a minority of respondents to the consultation expressed their support for this proposal.

51. Taking into account the support from some respondents and after further reflection SMA took the decision that the right approach was to recommend that the counterparty risk created by EPM techniques should be added to the counterparty risk linked to OTC derivative transaction when calculating the maximum exposure under Article 52.1 of the UCITS Directive. Such recommendation constitutes a modification of Box 27 of the existing CESR guidelines on Risk Measurement and Calculation of Counterparty Risk for UCITS that limit the counterparty risk arising from EPM techniques to 20% of the net asset value of the UCITS per counterparty.

Q24: Do you agree that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive?

52. Respondents to the consultation generally supported this proposal.

53. Based on the feedback received, ESMA recommends in the final guidelines that entities to which cash collateral is deposited should comply with Article 50(f) of the UCITS Directive.

Q25: Do you believe that the proportion of the UCITS' portfolio that can be subject to securities lending activity should be limited? If so, what would be an appropriate percentage threshold?

54. According to respondents to the consultation, there should not be any limitation to the proportion of the UCITS portfolio that could be subject to securities lending activities. For them, if a maximum proportion was introduced this would be detrimental to investors because UCITS would be limited in such activities.

55. Based on the comments from stakeholders ESMA does not recommend, in the final guidelines, any limits for the proportion of assets that may be subject to securities lending.

Q26: What is the current market practice regarding the proportion of assets that are typically lent?

56. With respect to market practices regarding the proportion of assets that are lent out, respondents indicated that this proportion may vary a lot according to market circumstances but that it could represent a significant proportion of the portfolio.

Q27: For the purposes of Q25 above, should specific elements be taken into account in determining the proportion of assets (e.g. the use made by the counterparty of the lent securities)?

57. Respondents to the consultation did not provide ESMA with specific elements in relation to this question for the reason that most of them did not support the approach to limit the proportion of assets of UCITS that can be subject to efficient portfolio management transactions.

Q28: Do you consider that the information to be disclosed in the prospectus in line with paragraphs 1 and 2 of Box 6 should be included in the fund rules?

58. The majority of respondents to the consultation did not feel appropriate to disclose this information in the fund rules.

59. In light of the feedback received, ESMA decided not to request this information to be included in the fund rules of UCITS.

Q29: Do you see the merit in prescribing the identification of EPM counterparties more frequently than on a yearly basis? If yes, what would be the appropriate frequency and medium?

60. Respondents to the consultation generally did not see the added value of a more frequent disclosure of the identity of the counterparties of efficient portfolio management transactions.

61. ESMA decided to take on board the feedback from respondents to the consultation and did not recommend more frequent disclosure of the identity of the counterparties of efficient portfolio management transactions in the final guidelines.

Q30: In relation to the valuation of the collateral by the depositary of the UCITS, are there situations (such as when the depositary is an affiliated entity of the bank that provides the collateral to the UCITS) which may raise risks of conflict of interests? If yes, please explain how these risks could be mitigated? The question is also valid for collateral received by the UCITS in the context of total return swaps.

62. Some respondents to the consultation acknowledged that potentially conflicts of interest may arise in this type of structure but that the existing provisions in the legislation were sufficient to address this issue. It was also pointed out that as collateral should be composed of liquid assets, the risks of non-accurate valuation were limited.

Q31: Do you think that the automation of portfolio management can conflict with the duties of the UCITS management company to provide effective safeguards against potential conflicts of interest and ensure the existence of collateral of appropriate quality and quantity? This question is also relevant to Box 7 below.

63. Respondents to the consultation did not believe that the automation of portfolio management could conflict with the duties of the UCITS management companies. According to them automation of portfolio management techniques does not relieve UCITS management companies of their usual duties of risk measurement, including monitoring of the collateral (both in terms of quality and quantity). Provided the automation of the portfolio management operates under the guidelines, supervision and control of the risk management department of the UCITS management company, respondents did not believe that it raised specific issues.

5. Total return swaps

Q32: Do you agree with the proposed guidelines?

64. Many respondents to the consultation disagreed with ESMA's proposal according to which the UCITS investment portfolio should comply with the UCITS diversification rules. According to them, the assessment of the UCITS diversification rules should be carried out taking into account the derivatives transaction and not before.

65. Furthermore, the proposed approach for the diversification of collateral was not welcomed by stakeholders for the same reasons as for the one for efficient portfolio management transactions.

66. Besides, stakeholders expressed some concerns about the treatment of counterparties of total return swaps as investment managers and sought clarification from ESMA on the circumstances inwhich this treatment would be applicable.

67. ESMA did not share the view of the majority of respondents according to which the assessment of the UCITS diversification limits should be done only after taking into account the financial derivative transactions and therefore did not take on board this comment in the final guidelines. However, ESMA took on board the comment made that the guidelines should apply to total return swaps and to all financial derivative instruments with similar characteristics and should not be limited to situations

where 100% of the UCITS' investment portfolio is swapped out. Therefore, the final guidelines have been redrafted to provide such clarification.

Q33: Do you think that the proposed guidelines set standards that ensure that the collateral received in the context of total return is of good quality? If not, please justify.

68. For this question, please refer to question 32 above.

Q34: Do you consider that the information to be disclosed in the prospectus in line with paragraph 5 of Box 7 should be included in the fund rules?

69. The majority of respondents to the consultation did feel appropriate to disclose this information in the fund rules.

70. In light with the feedback received, ESMA decided not to request this information to be included in the fund rules of UCITS.

Q35: With regards to eligibility of assets to be used as collateral, do you have a preference for a list of qualitative criteria (as set out in CESR's guidelines on risk measurement) only or should this be complemented by an indicative list of eligible assets?

71. For this question, please refer to question 21 above.

Q36: Alternatively, do you see merit in prescribing an exhaustive list of assets eligible for use as collateral? If so, please provide comments on whether the list of assets in paragraph 73 is appropriate.

72. For this question, please refer to question 21 above.

Q37: Do you agree that the combination of the collateral received by the UCITS and the other investment made by the UCITS should comply with the UCITS diversification rules?

73. Like in the context of efficient portfolio management transactions and the diversification of collateral, respondents to the consultation expressed strong opposition to this requirement.

74. As explained above in question 20, ESMA decided to treat the issue of collateral management in isolation. Therefore, collateral received in the context of over-the-counter transactions has to comply with the same diversification requirements as collateral received for efficient portfolio management arrangements. For further details on the diversification requirements, please refer to question 21 above.

Q38: Do you consider that the guidelines in Box 7 and in particular provisions on the diversification of the collateral and the haircut policies should apply to all OTC derivative transactions and not be limited to TRS?

75. Respondents to the consultation generally encouraged ESMA to take a horizontal approach across all over-the-counter transactions and not to limit it to total return swaps.

76. Based on the feedback received from the consultation, ESMA recommends that the guidelines should apply for total return swaps and all financial derivatives instruments with similar characteristics.

6. Strategy indices

Q39: Do you consider the proposed guidelines on strategy indices appropriate? Please explain your view.

77. For many respondents, the guidelines should apply to all financial indices and not only to strategy indices. One trade association also asked ESMA to provide clarification on the conditions to be fulfilled by an index to represent a benchmark for the market it represents.

78. Furthermore, many respondents disagreed with ESMA's proposal to require the full disclosure of the calculation methodologies of financial indices to allow investors to replicate the performance of the index. According to these stakeholders, this requirement was against the rules on protection of proprietary information.

79. It was also pointed out that UCITS should be allowed to invest in financial indices with intra-day or daily rebalancing.

80. Moreover, several stakeholders sought clarification from ESMA on the treatment of commodity indices and asked for clearer guidelines on the assessment of the diversification limit for such indices.

81. The publication of the constituents of the index together with the respective weightings raised some concerns for many respondents that believed that this would go against the principles of protection of proprietary information.

82. In light of the feedback received, ESMA extended the scope of the guidelines to all financial indices. Despite the strong pushback from stakeholders on the disclosure of the calculation methodologies of financial indices, the Authority decided to confirm the proposal that was set out for consultation. Indeed, ESMA is of the view that these elements are of utmost importance for investors and takes note that some market participants already disclose the full calculation methodology in the format of index rule books which are publicly available on the internet. In this context, ESMA will consider the possibility of developing further guidance (e.g. in the form of guidelines or a Q&A) should further clarity be needed on the precise information to be disclosed.

83. With respect to the rebalancing frequency of financial indices, ESMA remains convinced that the composition of financial indices should not change on a daily basis. However, ESMA deemed necessary to clarify that technical adjustments to financial indices that can occur on a daily basis or intra-day basis should not be considered as rebalancing.

84. Regarding the publication of index constituents and their respective weightings, ESMA strongly believed that this information should be provided to investors but recommends that it could be done with a certain delay.

Q40: Do you think that further consideration should be given to potential risks of conflict of interests when the index provider is an affiliated firm of the management company?

85. Respondents to the consultation pointed out that risks of conflicts of interest were already covered by specific provisions in the UCITS Directive and that therefore no further consideration was needed.

7. Transitional provisions

Q41: Do you consider the proposed transitional provisions appropriate? Please explain your view.

86. The majority of respondents believed that the transitional provisions should be further clarified in the final guidelines. In particular, stakeholders asked for clarity on the treatment of new investments made by existing UCITS and whether investments made to manage, for example, swaps contracts should be considered as new investment.

87. Also, many respondents asked ESMA to grandfather UCITS that existed before the entry into force of the guidelines and that may not comply with the guidelines.

88. In the final guidelines, ESMA clarified the transitional provisions with respect to the different requirements (disclosure, collateral, exposure to indices etc.) and, in some cases, introduced a 12-month transitional period after the guidelines enter into force to allow UCITS to adapt to the guidelines.

89. With respect to existing UCITS, ESMA deemed it appropriate not to request UCITS with fixed maturities to comply with the guidelines, provided that they do not receive any new subscriptions after the guidelines enter into force. However, existing UCITS that may not comply with the guidelines and that do not have a fixed maturity and that accept new subscriptions will not be able to benefit from the grandfathering rules and will have 12 months after the guidelines enter into force to align their portfolio with the guidelines.

Annex I - Cost-benefit analysis

1. Index-tracking UCITS

Risk addressed / Policy objective

With these guidelines, ESMA wants to foster investors' protection by improving the level of information provided to investors by UCITS tracking an index.

Scope issues

These guidelines will apply to all UCITS complying with the definition of index-tracking UCITS.

Options

When developing the guidelines, ESMA considered the following options.

Options	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines	The guidelines apply to all UCITS tracking an index and not only to index-tracking UCITS. Transparency in terms of index composition would be improved. Investors would be better informed about the exposition of UCITS. UCITS management companies would not need to keep the prospectus updated with the exact composition of the index tracked by the ETFs as long as investors have access to this information via a link to a web site where the exact composition of the index should be disclosed	Prospectus and key investor information document of existing UCITS ETFs may have to be modified to reflect these new guidelines.	N/A
Option 2 As proposed in the discussion paper on policy orientations.	Existing index-tracking UCITS that are not UCITS ETFs do not need to amend their prospectus and key investor information documents	Low level of harmonisation across UCITS.	Feedback from the consultation

The difference between option 1 and option 2 is that option 2 concerns only UCITS ETFs tracking and index whereas option 1 covers all UCITS tracking an index, being UCITS ETFs or not.

ESMA preferred to opt for option 1 for the reason that it would have been detrimental for investor protection to focus only on UCITS ETFs tracking an index. Indeed, option 1 ensures a level-playing field in terms of information delivered to investors investing in UCITS tracking an index.

2. Index-tracking leveraged UCITS

Risk addressed / Policy objective

With these guidelines, ESMA wants to foster investors' protection by improving the level of information provided to investors by index-tracking UCITS tracking an index. In particular, ESMA is of the view that more information on the mechanics of these UCITS should be communicated to investors. For example, the calculation of the leverage is not always been explained to investors who therefore may not always understand why the performance of the UCITS differs from the multiple of the performance of the index over the medium to long term.

Scope issues

These guidelines apply to all UCITS complying with the definition of Index-tracking leveraged UCITS

Options

When developing the guidelines, ESMA considered the following options

Options	Benefits	Costs	Evidence
Option 1 As proposed in the final guidelines.	The guidelines apply to all index-tracking leveraged UCITS, not just leveraged ETFs. Investors are informed about the leverage policy, whether the leverage is at the level of the fund or at the level of index tracked.	Prospectus of the existing index-tracking leveraged UCITS may have to be modified to reflect these new guidelines.	N/A
Option 2 As proposed in the discussion paper on policy orientations.	Existing Index-tracking leveraged UCITS that are not UCITS ETFs do not need to amend their prospectus and key investor information document.		Feedback from the consultation.

The difference between option 1 and option 2 is that option 2 concerns only index-tracking leveraged UCITS ETFs whereas option 1 covers all index-tracking leveraged UCITS.

ESMA preferred to opt for option 1 for the reason that it would have been detrimental for investor protection to focus only on index-tracking leveraged UCITS ETFs. Indeed, option 1 ensures a level-playing field in terms of information delivered to investors investing in all Index-tracking leveraged UCITS being ETF or not.

3. UCITS ETFs

3.1. Definition of UCITS ETFs

Risk addressed / Policy objective

The purpose of these guidelines on UCITS ETFs is first to develop a uniformed and detailed definition of UCITS ETFs. Such definition will ensure that all UCITS complying with this definition will be covered by the requirements of the guidelines. This will ensure a level-playing field across UCITS in Europe and reinforce investors' protection.

Scope issues

These guidelines apply to all UCITS complying with the definition of UCITS ETFs.

Options

When developing the guidelines, ESMA considered the following options

Options	Benefits	Costs	Evidence
Option 1 As proposed in the final guidelines	Clear definition of UCITS ETFs	UCITS which do not comply with the definition cannot be marketed as UCITS ETFs. Modification of the prospectus, marketing materials and KIID necessary.	N/A
Option2 As proposed in Box 3 of the consultation paper.	Clear definition of UCITS ETFs. Not all listed UCITS ETFs are categorised as ETFs.	UCITS which do not comply with the definition cannot be marketed as UCITS ETFs. Modification of the prospectus, marketing materials and KIID necessary.	Feedback from the consultation.
Option 2 No definition of UCITS ETFs	No need to modify the prospectus, marketing materials and KIID.	Low level of harmonisation. Definition of UCITS ETFs left to national legislation or market practices.	Feedback from the consultation.

ESMA decided to not adopt as a final definition of UCITS ETFs the definition displayed in the consultation paper. Indeed, ESMA felt more appropriate to refer to shares which are "traded throughout" than "continuously tradeable". Furthermore, ESMA believed that definition of UCITS ETFs should mention the Indicative net asset value.

3.2. Identifier for UCITS ETFs

Risk addressed / Policy objective

With these guidelines, ESMA wants to facilitate the awareness of investors investing in UCITS ETFs by requiring a specific identifier in the name of the fund. With a specific identifier, investor will be directly informed about the nature of the UCITS they subscribe in.

Scope issues

These guidelines apply to all UCITS complying with the definition of UCITS ETFs.

Options

When developing the guidelines, ESMA considered the following options.

Options	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines.	Investors would be immediately informed by reading the name of the UCITS that the UCITS is an ETF.	Management companies, promoters and entities in charge of the commercialisation would have to adapt their documentation to reflect these new guidelines when applicable.	N/A
Option 2 Identical to Option 1 with further distinction between the structure of the UCITS ETFs and the level of leverage.	Investors would be immediately informed about the type of ETFs and the level of leverage by reading the name of the UCITS.	Management companies, promoters and entities in charge of the commercialisation would have to adapt their documentation to reflect these new guidelines when applicable. The name of the ETFs may be long in order to reflect the different features of the fund.	Feedback from the consultation on the costs for modifying prospectus and marketing materials of existing materials.

Under option 1, UCITS complying with the definition of UCITS ETFs have to use an identifier "UCITS ETFs". Under option 2, the identifier has to further distinguish between physical and synthetic UCITS ETFs and the level of leverage.

ESMA decided to favour option 1 and not to require distinction between physical and synthetic UCITS ETFs. Indeed, ESMA felt that this requirement would have been difficult to put in place in practice and would not address mixed situations where the replication is partially physical and synthetic. However, ESMA is of the view such information should be communicated to investors in both the prospectus and the key investor information document of the UCITS ETFs.

3.3. Actively-managed UCITS ETFs

Risk addressed / Policy objective

With these guidelines, ESMA wants to foster investors' protection by improving the level of information provided to investors by actively-managed UCITS ETFs. Indeed, the vast majority of UCITS ETFs are tracking an index and usually investors assimilate UCITS ETFs as *index trackers*. However, some UCITS ETFs are actively managed with usually the objective to out-perform a benchmark. In this type of UCITS ETFs, the manager has discretion over the composition of the portfolio subject to the stated investment objectives and policies.

Therefore, in order to avoid any confusion from investors, ESMA believed that this type of UCITS ETFs should be required to provide specific information.

Scope issues

These guidelines apply to all UCITS complying with the definition of actively-managed UCITS ETFs.

Options

When developing the guidelines, ESMA considered the following options.

Options	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines	Improvement of the quality of the information delivered to investors. Avoid investors investing in an actively-managed UCITS ETFS to think that they invest in an ETF that tracks an index.	Prospectus of existing ETFs may have to be modified in order to reflect the guidelines.	N/A
Option 2 No specific guidelines	Prospectus of existing ETFs would not have to be modified.	No harmonisation of the minimum set of information to be provided to investors. No guarantee that investors would be provided with the necessary information to allow them to identify actively-managed ETFs	Feedback from the consultation

The feedback from the consultation was overwhelmingly supportive and therefore ESMA decided to keep as final guidelines the proposal on which it had consulted.

3.4. Secondary market investors

Risk addressed / Policy objective

With these guidelines ESMA wants to ensure uniform conditions for secondary market investors of UCITS ETFs that want to redeem their shares.

Indeed, secondary market investors of UCITS ETFs generally redeem only on the stock exchange and notat the level of the fund. This practice is allowed by the UCITS Directive as long as the stock exchange value of the units of the UCITS does not significantly vary from the net asset value of the UCITS.

However, the treatment of secondary market investors is not harmonised, nor is there consistency in the approaches taken to situations where the conditions imposed by the UCITS Directive are not satisfied. Therefore, in order to strengthen investor protection, ESMA is convinced that guidelines should be developed in this context.

Scope issues

These guidelines apply to all UCITS complying with the definition of UCITS ETFs.

Options

When developing the guidelines, ESMA considered the following options.

Options	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines	If liquidity conditions are no longer satisfactory in the secondary market, secondary market investors should be able to redeem directly at the level of the UCITS ETFs	Management companies may have to adapt their redemption policies that ensure that secondary market investors can redeem directly at the level of the UCITS ETFs if needed. Practical problems may arise for execution of direct redemptions.	N/A
Option 2 As proposed under option 1 in Box 5 of the consultation paper	Investors can redeem their shares at any time either on the secondary market or directly from the ETF if needed.	Management companies should take the necessary measures to ensure that secondary market investors can redeem their shares at any time either on the secondary market or directly from the ETF if needed.	Feedback from the consultation.
Option 3 As proposed under option 2 in Box 5 of the consultation paper.	Secondary market investors would be able to redeem their shares or unit directly from the ETF at any time.	UCITS ETFs would be obliged to accept direct redemptions at the level of the UCITS. Practical problems may arise for the execution of direct redemptions	Feedback from the consultation.

Regarding the treatment of secondary market investors, after further consideration, ESMA took the decision that the best solution was to request UCITS ETFs that generally do not accept direct redemptions at the level of the UCITS ETFs to disclose this information to investors in the prospectus. However, ESMA recommends that for such UCITS ETFs, if the conditions refer in to Article 1 paragraph 2 of the UCITS Directive are no longer fulfilled, UCITS ETFs or its management companies should accept direct redemptions from secondary market investors. The Authority is also of the view that if such situation arises, a market warning should be published indicating that the UCITS ETF is opened for direct redemptions.

4. Efficient portfolio management techniques

Risk addressed / Policy objective

With these guidelines, ESMA wants to improve the quality of the information communicated to investors by UCITS entering into efficient portfolio management techniques. Indeed, investors are not always aware of the use of such techniques by UCITS that can represent an important amount of the assets of the UCITS.

In addition to the disclosure of the information, ESMA believes that the conditions of these arrangements and in particular the possibility for the UCITS to recall the assets subject to the arrangement should be further strengthened and harmonised.

Scope issues

These guidelines apply to all UCITS entering into efficient portfolio management techniques.

Options

When developing the guidelines, ESMA considered the following options.

Efficient portfolio management techniques	**Benefits**	**Costs**	**Evidence**
Option 1 As recommended in the final guidelines	Option 1 applies to UCITS using efficient portfolio management techniques and is not limited to securities lending activities performed by UCITS ETFs. Investor protection reinforced with strong requirements with respect to the ability of the UCITS to recall assets subject to securities lending arrangements.	UCITS management companies may have to adapt the information provided to investors as well as their existing arrangements in relation to revenue-sharing arrangements.	N/A
Option 2 As proposed under Box 6 of the consultation paper.	Option 2 applies to all UCITS using efficient portfolio management techniques and is not limited to securities lending activities performed by UCITS ETFs.	UCITS management may have to adapt the composition of the collateral in order to comply with the guidelines with regards the diversification and the haircuts.	Feedback from the consultation.
Option 3 As proposed in the discussion paper on policy orientations.	More flexibility for UCITS management companies in terms of diversification and haircut policies with regards collateral.	No horizontal approach: guidelines limited to securities lending activities in the context of UCITS ETFs. Less convergence with more room for interpretation and national or market practices.	Feedback from the consultation.

ESMA decided to favour option 1 in order to have a uniformed treatment of efficient portfolio management techniques across all UCITS. Therefore, the guidelines will apply to all UCITS and are not limited to UCITS ETFs. In particular, ESMA decided to recommend that all the revenues arising from efficient portfolio management techniques, net of direct and indirect costs and fees should be returned to the UCITS.

With respect to the management of collateral received in the context of efficient portfolio management techniques, ESMA took the decision to treat together with collateral received in the context of OTC transactions and to apply the same regime.

5. Financial derivative instruments

Risk addressed / Policy objective

The purpose of these guidelines is to improve investors' protection by improving the quality of the information delivered to investors and by introducing requirements on the level of diversification of UCITS' investment portfolio and on the treatment of the counterparties of OTC financial derivative transactions.

Some UCITS use financial derivatives, usually a total return swap (TRS), to provide investors with a predefined return at the end of a specific period based on the return on underlying assets. The underlying assets to the TRS can consist of a variety of asset classes, strategies and indices. These UCITS are usually passively managed and can incorporate features such as capital protection or a payoff guarantee. This investment can represent up to 100% of the assets.

Questions have arisen on the extent to which the investments of UCITS might not be required to comply with the diversification requirements of the UCITS Directive where the UCITS has invested in a TRS giving exposure to an underlying UCITS compliant index or diversified basket of UCITS compliant instruments.

Some UCITS enter into swaps which are not passively managed by the counterparty and the contract incorporates some discretionary elements. For example, the UCITS sets the investment policy but, rather than selecting the individual assets and their weighting in the strategy, the UCITS defines a pool of eligible assets and sets minimum and maximum exposure limits which the counterparty can work within. In some cases the underlying strategy to the swap is managed completely within the discretion of the swap counterparty without a clear objective methodology.

UCITS which enter into an actively managed swap must also consider other issues in relation to the management of the UCITS and the role of the counterparty, including conflict of interest or management delegation issues.

Scope issues

These guidelines apply to all UCITS investing in total return swaps and other financial derivative with similar characteristics.

Options

When developing the guidelines, ESMA considered the following options.

Total return swaps	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines. The guidelines apply to all UCITS investing in total return swaps and	Better investor protection. Harmonised treatment of total return swaps and other financial derivative instruments with similar characteristics.	UCITS management companies may have to adapt the composition their investment portfolio to respect the guidelines with respect to the diversification.	N/A

financial derivatives with similar characteristics.	Rules on delegation of portfolio management cannot be circumvented by the use of total return swaps or other financial derivative instruments with similar characteristics.	UCITS may have to treat counterparties of total return swaps and financial derivatives instruments with similar characteristics as investment managers and under delegation arrangements.	
Option 2 As proposed under Box 7 of the consultation paper. The guidelines apply to all UCITS investing in total return swaps and not only to sol called Structured UCITS.	Full consistency between rules applicable to collateral received in the context of securities lending activities and total return swaps.	UCITS management companies may have to adapt the composition of the collateral in order to comply with the guidelines with regards the diversification and the haircuts. UCITS may have to treat counterparties of total return swaps and financial derivatives instruments with similar characteristics as investment managers and under delegation arrangements.	Feedback from the consultation.
Option 3 As proposed in the discussion paper on policy orientations	More flexibility for UCITS management companies in terms of diversification and haircut policies with regards collateral.	No horizontal approach: guidelines limited to structured UCITS investing in total return swaps Less convergence with more room for interpretation and national or market practices.	Feedback from the consultation.

ESMA decided to opt for option 1 and treat equally all UCITS investing in total return swaps or other OTC financial derivative instruments. Indeed, ESMA believed that the guidelines should not be limited to first, total return swaps and secondly, to UCITS investing 100% of their assets as originally contemplated in the discussion paper setting out policy orientations.

With respect to the diversification of the investment portfolio of the UCITS that is subject to performance swap, ESMA clarified that this portfolio should respect the relevant UCITS diversification limits.

6. Management of collateral

Risk addressed / Policy objective

With these guidelines, ESMA wants to foster investors' protection by introducing clear qualitative and quantitative criteria for the collateral to be received by UCITS in the context of efficient portfolio management techniques and OTC financial derivative transactions.

Scope issues

These guidelines apply to all UCITS investing entering into efficient portfolio management techniques or in over-the-counter financial derivative transactions.

Options

When developing the guidelines, ESMA considered the following guidelines.

Total return swaps	**Benefits**	**Costs**	**Evidence**
Option 1 As proposed in the final guidelines	Better investor protection via: - Horizontal treatment of management collateral across over-the-counter transactions and efficient portfolio management transactions. - Clear criteria to be respected by collateral in terms of diversification, quality of the assets, and limitation of the re-use of the assets received. Clear list of assets in which cash collateral can be reinvested.	UCITS management companies may have to adapt their portfolio of collateral to respect the guidelines and their policy in terms of reinvestment of cash collateral.	N/A
Option 2 As proposed in the consultation paper under the boxes on efficient portfolio management techniques and total return swaps	Better investor protection. Full consistency between rules applicable to collateral received in the context of securities lending activities and total return swaps (funded swaps). Requirements on the diversification of collateral, haircuts are further specified compared to the CESR's guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS.	UCITS management companies may have to adapt their portfolio of collateral to respect the guidelines. With respect to the diversification of collateral, option 2 may have required important adjustments in terms of collateral management and procedures. Restriction of the reinvestment of cash collateral in risk-free assets	Evidence from the consultation

Based on the feedback received from respondents to the consultation, ESMA decided to opt for option 1 and to modify its approach with respect to the diversification of collateral. Indeed, in the consultation paper, ESMA had proposed to require the combination of collateral and assets not subject to EPM techniques (or not subject to TRS) to respect the UCITS diversification. Respondents to the consultation expressed their opposition for such approach which would have been very difficult to put in place. Therefore, in the final guidelines, ESMA recommends quantitative criteria that apply only to each basket of collateral received from each counterparty of OTC financial derivative transactions or EPM techniques.

7. Strategy indices

Risk addressed / Policy objective

With these guidelines, ESMA wants to strenghten the legal framework applicable to financial indices with a view to ensuring a better protection of investor. In particular, ESMA wants improve the transparence of the information provided to investors and impose additional safeguards to limit the complexity of financial indices to which an increasing UCITS are exposed via financial derivative instruments.

Scope issues

These guidelines apply to all UCITS investing in financial indices.

Options

When developing the guidelines, ESMA considered the following guidelines.

Strategy indices	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines	Horizontal treatment across all financial indices. These guidelines would ensure that the performance delivered to investors in case of strategy indices is not driven by a too limited number of components and comply with UCITS diversification rules. Clarification of the treatment of commodity indices. Investors would be able to better understand the exact strategy of the underlying index and how this index is constituted. Investors would be able to better replicate	UCITS investing in strategy indices that do not comply with the UCITS diversification rules would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to comply with ESMA guidelines or to modify their portfolio in the case of existing UCITS.	N/A

	the performance of the underlying index what would enhance the understanding of the fund by investors. A minimum level of due diligence by UCITS management companies when selecting hedge funds indices as underlying of the strategies would be ensured. Potential conflicts of interest between the index provider and index components which otherwise could undermine the adequate benchmark requirement of the index would be prevented.		
Option 2 As proposed in the consultation paper.	These guidelines would ensure that the performance delivered to investors in case of strategy indices is not driven by a too limited number of components and comply with UCITS diversification rules. Clarification of the treatment of commodity indices. Investors would be able to better understand the exact strategy of the underlying index and how this index is constituted. Investors would be able to better replicate the performance of the underlying index what would enhance the understanding of the fund by investors. A minimum level of	UCITS investing in strategy indices that do not comply with the UCITS diversification rules would not comply with ESMA guidelines. Therefore, UCITS management companies may stop investing in some strategy indices if they want to comply with ESMA guidelines.	Evidence from the consultation.

	due diligence by UCITS management companies when selecting hedge funds indices as underlying of the strategies would be ensured. Potential conflicts of interest between the index provider and index components which otherwise could undermine the adequate benchmark requirement of the index would be prevented.		
Option 3 No guidelines.	Market participants would not be required to modify their practices.	Investor protection is not reinforced. Possibility of diverging interpretations/practices across market participants and national competent authorities.	N/A

In the final guidelines, ESMA decided to opt for option 1. In particular, ESMA felt appropriate the guidelines to financial indices and to limit it to so-called strategy indices. Moreover, the final guidelines further clarify the applicable regime for commodity indices by introducing detailed quantitative criteria to calculate their diversification.

8. Transitional provisions

Risk addressed / Policy objective

The purpose of the transitional provisions is to ensure that UCITS management companies will have sufficient time to adapt to the guidelines.

Scope issues

These provisions apply to all UCITS covered by the guidelines.

Options

When developing the guidelines, ESMA considered the following guidelines.

Transitional provisions	Benefits	Costs	Evidence
Option 1 As recommended in the final guidelines	UCITS would be granted with sufficient time to ensure a smooth entry into force of the guidelines.	No immediate entry into force of the guidelines.	N/A

	Existing UCITS with fixed maturity and that do not accept new sub-scriptions after the entry into force of the guide-lines are grandfathered.		
Option 2 No transitional provi-sions	Immediate entry into force of the guidelines	UCITS management companies may have some difficulties to make the necessary adjustments to comply immediately with the guidelines once they enter into force.	Feedback from the consultation.

Annex II - Advice of the Securities and Markets Stakeholder Group[1] on the discussion paper

I Executive Summary

The Group generally agrees with the concerns raised by ESMA in its Consultation Paper, which relate mainly to the fact that ETFs have become increasingly complex, and may raise significant issues both in respect to investor protection and to systemic risk. However, ETFs are a low cost and straightforward investment proposition for investors, and as such, ESMA should investigate how to make indexed ETFs more offered to retail investors, In respect to the prevention and mitigation of the risks that may arise from ETFs, while the whole Group agrees that greater disclosures are required, the majority of the Group members believes that, in addition to these disclosure requirements, regulators should adopt a more interventionist approach. The Group also believes it necessary to avoid any type of regulatory arbitrage, by subjecting all UCITS products and exchange-traded products to similar rules.

The Group generally supports the recommendations made by ESMA, and agrees that:

- UCITS ETFs should use an identifier in their titles, fund rules, Key Investor Document, prospectus and marketing material;
- investors should be provided with sufficient details to understand the index tracking policy used;
- there is a need for greater disclosures in respect to synthetic ETFs, notably in relation to underlying exposure, counterparty(ies) and the portfolio fund, as well as for stricter requirements in respect to the quality of the collateral, in the form of quantitative requirements on the quality (notably the liquidity) of the collateral, over-collateralisation requirements in specific circumstances, the regulators (and potentially ESMA) being responsible for regularly controlling the quality of the collateral. In addition, risks of conflicts of interests should be limited by prohibiting entities from the same group from acting at the same time as the ETF provider and the derivative counterparty;
- securities lending should be made more transparent to investors, should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, and the lending agent must be required to indemnify the UCITS when a counterparty defaults for all types of ETFs (synthetic and physical);
- actively-managed UCITS ETFs should be subject to greater disclosure requirements;
- it is necessary to specify, in the product title of leveraged UCITS ETFs, that they constitute leveraged ETFs, as well as the level of leverage;
- greater protection of secondary investors would be achieved by informing investors of their redemption rights, the ETF manager being made responsible for paying the difference between the collateral and the index underlying the swap if a counterparty defaults;
- total return swaps and strategy indices need to be better regulated.

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[1] This SMSG advice is available to view on ESMA's website at: http://www.esma.europa.eu/node/57198

II Explanatory remarks

1. The members of the Group welcome the opportunity to comment on the public consultation on UCITS Exchange-traded funds in the European Union (hereafter the “Discussion Paper”). However, before commenting ESMA’s Discussion Paper, the Group believes it necessary to place the key issues around UCITS Exchange-traded funds (hereafter “ETFs”) in the wider context. ETFs are one of the fastest growing investment products in the world, combining the trading characteristics of stocks with the diversified risk of investment funds. However, ETFs are still very small in comparison to the overall size of the fund market and their impact on secondary markets and their stability should be put into perspective: only 2.6% of all European funds are ETFs (3.5% of UCITS funds), and high growth rates are due to a low starting base. A large majority of ETFs in the European Union are already subject to one of the most respected and widely recognized fund regulatory frameworks: the UCITS Directive. Nonetheless, the Group believes that adapted regulation and its efficient enforcement can address some of the characteristics of ETFs, in order to ensure better protection of investors and a level playing field across Europe. The Group would therefore like to subscribe to the efforts of ESMA to provide guidelines on safeguards and controls in a proactive manner.

2. It is important to point out some key points for retail investors when discussing index-tracking ETF regulation: ETFs are a very low cost alternative to other UCITS funds for private investors but unfortunately most of them are very rarely, if at all, marketed for European individual investors. The main cause is due to differences in remuneration of the distribution channels and seems unrelated to the relative performance of index-tracking ETFs vis-à-vis other UCITS funds. This points to potential problems regarding ETF distribution.

3. In addition, the Group believes it important to distinguish between “index-tracking” ETFs (the bigger share of the ETFs market, simple and easy to understand investment objective, providing the performance of the market) and other ETFs (much less important in market share: leveraged ETFs and “active” ETFs, with less clear and more complex investment objectives).

4. The Group believes that issues around UCITS ETF should not be treated differently from other UCITS, and more importantly, from other exchange-traded products (“ETPs”) such as notes and certificates that are distributed to retail investors, in order to avoid the creation of regulatory loopholes, and to establish a level playing field between similar products.

5. Two options are possible in order to address the issues raised by ESMA in its Consultation paper. First, some argue that only transparency needs to be addressed by regulation creating more disclosure and information given to investors. Second, others argue that this regulation needs to go further by addressing not only transparency measures but also control and/or intervention on the products design, sale and governance.

6. This report will therefore present general observations of the Group and more specific comments relating to the different sections of the Consultation paper. In the General observations section, we will analyse the risks and benefits related to UCITS ETFs. In section two, we will broadly address the questions presented in the Consultation paper and analyse the different options for regulating UCITS ETFs in light of these different elements and ESMA’s propositions.

III GENERAL COMMENTS OF THE GROUP ON UCITS EXCHANGE-TRADED FUNDS IN THE EUROPEAN UNION

III.I Complexity

7. Some financial instruments are currently defined as automatically non-complex in Art. 19 of the MiFID Directive. For other instruments, criteria to identify non-complex financial instruments (set out in Article 38 of the MiFID implementing Directive2) focus on the ease with which the product can be understood by an investor, and not to the potential risk(s) it gives rise to[3]. All UCITS are currently classified as automatically non-complex.

8. ESMA's consultation raises the question as to how ETFs have evolved and whether some forms of ETFs should be considered "complex". If an ETF is created under the UCITS regime, there are already certain restrictions on the investment policy of the fund[4]. A number of regulators and policy-makers, along ESMA's line, are concerned by the potential complexity of ETFs, and the fact that, given the high level of innovation that has been observed lately, retail investors may not understand the products at stake, as illustrated by the FSA's 2011 Retail Conduct Risk Outlook.

9. In its proposal regarding the review of MiFID, released in October 2011, the European Commission suggests introducing some important changes in respect to UCITS products. It suggests excluding from the scope of "execution only" services (that is to say the services that an investment firm can provide without the need to obtain information regarding the knowledge and experience of the clients) the financial instruments including collective investment in transferable securities (UCITS), which embed a derivative or incorporate a structure for which it may make it difficult for the client to understand the risk involved. The proposal excludes explicitly structured UCITs (as defined in Commission Regulation 583/1020 at Level 2 of the UCITS Directive[5]) from the scope of the instruments that can be provided on an "execution only" basis. However, some the Group members believe there is still a scope for interpretation over whether swap-based ETFs (which embed a derivative) would also be excluded from the scope of the instruments that can be provided on an "execution-only" basis.[6]

III.II Main risks and benefits

10. UCITS ETFs' intrinsic advantage relates to the fact that these products combine the benefits of exchange-traded products (namely trading flexibility and cost-efficiency) with those of mutual funds (namely diversification). In addition, ETFs offer tax advantages in certain member states and cover different types of asset classes such as equities, commodities and fixed income.

11. Despite these benefits, UCITS ETFs also present significant risks:

    A. Increased complexity and opacity

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[3] The central aim of the MiFID appropriateness test is to prevent complex products from being sold on an "execution-only" basis to retail clients who do not have the experience and/or knowledge to understand the risks of such products. The MiFID Level 2 Directive allows a firm to assume that a professional client has the necessary experience and knowledge in order to understand the risks involved in relation to those investment services or types of transactions or products for which the client is classified as a professional client.

[4] Risk diversification is the strength of UCITS, with a ceiling of 10 percent of the overall assets for any individual investment, with any holdings representing more than 5 percent of the overall assets capped collectively at 40% of the fund. The UCITS directive does, however, contain a special allowance for trackers, whereby the ceiling for an individual holding can reach 20 percent, and in exceptional circumstances 35 percent, provided the index is sufficiently diversified, is an adequate benchmark for the market it replicates, and is published in an "appropriate" manner (Art 53).

[5] See article 19 (6) of MiFID1 and new proposed art 25(3)a)iv) of October 2011 MiFID proposal.

[6] See article 19 (6) of MiFID1 and new proposed art 25(3)a)iv) of October 2011 MiFID proposal.

- Complexity as a result of synthetic ETFs and a wide range of asset classes covered
- Transparency issues related to the composition of the underlying assets, replication mechanism used (physical, synthetic, sampling), composition of the collateral and on the lending and borrowing arrangements

B. Counterparty risk and collateral

- Composition of the collateral is not yet sufficiently regulated
- The level of haircut on collateral is not yet regulated
- Limit on swap counterparty risk (10% swap counterparty risk maximum)
- Low liquidity of the assets held as collateral (risk to investors, bank and systemic risk)
- Risk of default of the swap counterparty (borne by investors and/or bank)
- Weaknesses of the enforcement procedure on swap counterparty risk

C. Securities lending and liquidity risks

- Counterparty risk borne by fund investors
- Many fund managers keep part of the benefits of security lending; there is no clear rule about passing on these benefits to the investors of the UCITS ETF
- Collateral rules
- Risk of market squeeze in the underlying securities
- But securities lending is not specific to ETF UCITS funds

D. Risk implications for authorities and ETF investors

- Regulatory arbitrage and unlevel playing field

IV SPECIFIC COMMENTS RELATED TO THE CONSULTATION

IV.I Scope

12. Regulation should be harmonised at European level. In this respect, ESMA should have a particular role, through, notably, the adoption of legally binding standards, and, potentially, a greater direct supervision role. The majority of the Group members therefore support the introduction of guidelines on UCITS ETFs. Some members insist on the need to extend the scope of these guidelines to all ETFs and - depending on the concern to be addressed - also other ETPs. The MiFID review and the Package Retail Investment Products legislation ("PRIPs") appear to them as more appropriate as policy instruments than guidelines only for UCITS ETFs and/or modifications to the UCITS Directive, in order to reduce regulatory arbitrage, and to provide comprehensive investor protection.

13. Regulators should be adopting an evidence-based approach to regulation and should seek to apply equal treatment for similar financial instruments. They must be wary of the unintended consequences of developing regulation that would have the effect of creating potential incentives for investors and issuers to move similar products off-exchange, where they are not subject to the same transparency and regulatory requirements as exchange-traded products.

IV.II Potential requirements

14. Greater transparency relating to UCITS ETFs is beneficial to foster investor protection and confidence.

15. However, the Group believes that transparency is not enough to truly protect retail investors. Considering the difficulty that the average investor may have in respect to understanding disclosed information related to characteristics and the significant systemic risks that may derive from some UCITS ETFs, the Group believes that disclosure requirements are not sufficient. Whilst disclosure about ETFs is important, it does not provide an appropriate substitute for action to eliminate conflicts of interest and set clear product-standards. Therefore, on top of greater transparency rules, according to the majority of the Group members, UCITS ETFs should also be subject to stricter regulation related to product control. Such more "interventionists" regulatory policies are currently contemplated in some of the European Union member state, as illustrated by the FSA's new product intervention policy reflecting its willingness to intervene during the product development cycle.

16. A minority of the Group members considers that the existing UCITS Directive already provides a very robust framework to mitigate the potential risks and manage conflicts of interest raised by some ETFs. They consider that existing rules are sufficient, notably in respect to the prevention and management of conflicts of interests that may arise when entities from the same group are at the same time the provider of a synthetic ETF and acts as the derivative counterparty. In addition, they believe that the potential risks related to collateral and securities lending are already well regulated – although some improvements may be appropriate – and ESMA's focus should be on establishing a level playing field with ETPs.

IV.III Retailisation of complex products (Questions 1 to 7)

17. The Group believes that the issue of marketing and sale of UCITS ETFs and structured UCITS to retail investors, including potential limitations on the distribution of certain complex products to retail investors could be solved by a common approach to these issues.

18. In general, the Group members believe that the UCITS disclosure rules and exchange listing requirements promote transparency in UCITS ETFs, but that additional disclosure is positive. However, the majority of the Group members is in favour of restrictions on the distribution even if investors understand the inherent risks by reading standardized disclosure and annual reporting of the fund.

19. Given the increasing familiarity and use of a range of investment products from structured UCITS, ETFs, CFDs, Warrants and Certificates – all of which have investment profiles which can be similar on certain dimensions, the Group suggests that any approach to marketing and solicitation rules must consider the unintended consequences of creating an unlevel playing field among all ETPs and similar financial instruments. This can be avoided if similar approaches including transparency requirements are proposed in the guidelines agreed for UCITS and those applied to regulated non-UCITS funds established or sold within the EU. However, the Group considers that such requirements should be extended to all ETPs in order to provide an appropriate level of investor protection.

20. In addition to these requirements in terms of transparency, some Group members believe it necessary to give regulators, and potentially to ESMA, increased powers in respect to the authorisation, banning[7] and regular controls of ETFs. Throughout the life of a product, regulators should continue

[7] In the regulation setting up ESMA (regulation n°1095/2010), ESMA is entitled to ban financial activities, under certain conditions, and for a 3-month period, but with an unlimited renewal possibility (article 9). ESMA is generally required to consult the recipients of its intended decisions, but only in the case where ESMA's decisions explicitly mention a recipient (article 39), which would not apply to any generic ban or restriction of financial activities.

monitoring the information that had been announced in the product's prospectus. Regulators could also, based on the assessment of the risks presented by certain ETFs, decide to ban their distribution to retail clients.

21. In order to guarantee consistency throughout the European Union, the actions taken by national regulators should be coordinated, notably through the powers of ESMA in respect to the harmonised application of the European regulations[8], and, ESMA, in addition to its own powers of intervention for banning or restricting certain financial activities[9], should also ensure a greater consistency of the bans / restrictions adopted by national regulators through the adoption of standards.

22. Other Group members support stronger powers for ESMA in relation to bans or restrictions on the distribution of products, in order to harmonise intervention in the European Union and preserve benefits of the Single Market for financial products. Consistency with other regulation (UCITS, Prospectus Directive) should also be closely considered. Above all, however, any restrictions or bans to distribution should not apply only to narrow categories of financial instruments (ETFs or subcategories of ETFs, UCITS), but be principle-based and apply to all instruments under MiFID.

23. In addition, the Group also discussed the appropriateness for regulators to forbid the distribution of synthetic ETFs to retail investors, but no definitive recommendation was reached.

IV.IV Title (Questions 8 to 10)

24. The Group agrees that UCITS ETFs should use an identifier in their names, fund rules, prospectus and marketing material as it will help investors' investment decisions. The Group also agrees that the identifier be used in the Key Investor Document as it will be a core support in the investment decision process. Some Group members support the suggestion according to which the identifier should further distinguish between synthetic and physical ETFs and actively-managed ETFs.

25. In addition, the Group believes that with respect to ETFs there should be clearer labelling in the prospectus that in the event of default, consumers do not have recourse to a guarantee scheme. Similar warnings are considered important by other Group members for other ETPs and UCITS products.

IV.V Index tracking issues (Questions 11 to 15)

26. The Group agrees with ESMA's analysis of index-tracking issues, as it contributes to better transparency. A summary of the « index tracking issues » being present in the Key Investor Document (KID); or in the prospectus together with a clear reference in the KID that information on index tracking issues can be found in the prospectus can also be a beneficial disclosure transparency measure.

27. Full replication of an index can be difficult to achieve and issues relating to tracking error can be present. Synthetic or swap-based index-tracking ETFs can avoid the rebalancing costs and tracking error associated with physical replication but introduce other risks including counterparty risk. Tracking error is higher for physical replicating ETFs due to transaction costs and difficulties in buying and selling small illiquid components of the index. But although synthetic replication reduc-

[8] Articles 8.1.b and 9.5of Regulation 1095/2010
[9] Article 9 Regulation 1095/2010

es tracking error, it does not eliminate this problem entirely. Index return swaps may not always be based on the same assumptions and calculations as the main version of an index.

28. The Group believes that it is important that investors be provided with sufficient detail to understand the index tracking policy used and the types of underlying assets and strategies they are gaining exposure to. The Group fully supports ESMA's policy recommendation as to ensure that the prospectus for index-tracking UCITS ETFs contain a clear, comprehensive description of the index to be tracked and the mechanism used to gain exposure to the index, as well as the mechanism and frequency for posting over-collateralisation.

29. Some Group members, however, would like to draw ESMA's attention on the necessity to adopt similar rules for all UCITS products, so as to avoid any kind of regulatory arbitrage.

30. Furthermore, the definition of tracking error in the 21st paragraph (page 10) of ESMA's discussion paper needs to be refined, since, according to some Group members, the tracking error is, in fact, the volatility of the difference of the returns of the fund and of the returns of the index.

31. In addition, while some Group members believe that greater disclosure requirements are sufficient to ensure a high level of investor protection, others believe the contrary. These members believe that a clear distinction should be made between the "theoretical" tracking error (determined at the moment of the creation of the product) and the "real" tracking error (related to the management of the product). The difference between these two types of tracking errors should be regularly compiled, so as to enable investors to have an accurate picture of the actual tracking error risk, throughout the life of the product.

32. In addition, regulators (and potentially ESMA) could be empowered to regularly control that the ETF adequately complies with what has been announced in its prospectus. A minority of the Group members considers that control mechanisms already exist for national regulators for ETFs but should be extended to all ETPs.

IV.VI Synthetic ETFs – counterparty risk (Questions 16 to 18)

33. The Group supports the disclosure proposals in relation to underlying exposure, counterparty(ies) and the portfolio fund.

34. The Group has diverging opinions in respect to the requirements in terms of the composition of the collateral. A minority of the Group members believe that the existing CESR's Guidelines on Risk Measurement for UCITS are sufficient, and that it is important to leave a level of flexibility to the managers of the funds. Also, some members raised the question of the interest and the benefit for the investor in the synthetic approach when the portfolio held by the synthetic ETF (or a part of it) is less liquid than that of the index tracked.

35. The majority of the Group members fully support ESMA's suggestions regarding stricter requirements in respect to the quality of the collateral. The Group agrees that liquidity is an essential factor for the quality of the collateral. The majority of the Group members believes that an appropriate way to ensure that the collateral is sufficiently liquid would be to set qualitative as well as quantitative requirements on the quality of the collateral. The Group suggests that 70% of the collateral should consist in liquid assets, that is to say listed assets such as large caps. In requiring that the majority of the collateral be made out of listed assets, the valuation issues arising in respect to the

collateral will be solved, since the valuation of 70% of the collateral will correspond to stock market prices. Furthermore, an over-collateralisation is necessary when the ETF index type and the collateral posted are not significantly correlated (for instance, are not from the same asset class). The minimum level of over-collateralisation should be explicitly stated in the prospectus. It should not be less than 5x when asset and liability match and not less than 10x when asset and liability do not match. Also collateral should be posted on a daily basis. The level of haircut should also be revised in function of market volatility.

36. In addition, the majority of the Group members believes that regulators (and potentially ESMA) should regularly control the quality of the collateral used throughout the life of the product. A minority of the Group members consider that enforcement powers already exist for national regulators for ETFs but should be extended to other ETPs.

37. Finally, the majority of the Group members believes it necessary to better regulate the risks of conflicts of interest that may arise from the dual role that entities from the same group may have as the synthetic ETF provider and as a derivative counterparty. Such a dual role should be prohibited. A minority of the Group members considers that for UCITS ETFs conflicts of interest involving the management company and other members of the same financial group are already well regulated and appropriately mitigated.

IV.VII Securities lending activities (Questions 19 to 25)

38. The majority of the Group members believe that securities lending activities are among the most critical issues in respect to ETFs (although they are not specific to UCITS ETFs). They exacerbate the risks that may derive from these products, since they add-up to the collateral risk. In fact, the securities and lending risks in respect to ETFs is particularly high because for these products the collateral and the underlying do not necessarily match. Therefore, these members suggest that lending and borrowing should be forbidden in respect to the collateral received in exchange for the swap in the case of synthetic ETFs, because the risks is heightened and the tracking of the underlying is made more difficult.

39. Furthermore, they believe that the lending agent should be required to indemnify the UCITS in the case of a default of a counterparty. This indemnification requirement could also be requested in the case of physical replication ETFs.

40. However, a minority of the Group members believes that securities lending is not risky by itself, but should, nonetheless, be made more transparent to investors, through greater disclosure requirements. Securities lending is a well-established part of the investment management industry. It plays a key role in increasing liquidity in equities markets throughout the EU. That said, the level of stock lending in most markets is relatively low. For example, in the UK in June 2010, less than 5% of stock in the FTSE 100 index was out on loan. If indeed securities lending is an issue to be addressed, it should be done in a broader context and not solely around ETFs.

41. Also, some members raise a fund governance issue regarding the disclosure and the profits allocation of the securities lending activities, as the fund investors provide the funding and bear the risks.

IV.VIII Actively-managed UCITS ETFs (Questions 26 to 28)

42. The Group agrees with ESMA's proposed policy orientations. In particular, the Group believes it is important to inform investors through an explicit statement that actively-managed ETFs are not aiming to track an index, and the investment policy is under the sole discretion of the fund manager.

IV.IX Leveraged UCITS ETFs (Questions 29 to 32)

43. The Group believes that leveraged UCITS ETFs are not as easy to understand for retail investors as other forms of ETFs, and should be subject to additional disclosure requirements. In particular, some Group members consider that their title should specify that they constitute leveraged UCITS ETFs, and the level of leverage should also be disclosed, so as to ensure that investors have a real understanding of the product at stake. The word "daily" or "monthly" should also be included, as appropriate, in the identifier.

IV.X Secondary market investors (Questions 33 to 38)

44. End investors buying individual units of a UCITS ETF from a market participant on the secondary market may not be informed of the possibility to redeem directly the units (not on an individual basis from the fund, but through their regular intermediary, that is to say without having to go through a limited number of market participants selected but the UCITS ETF's issuer). Investors should be better informed of the possibility to redeem any amounts against the fund, although fees would apply.

45. In addition, in order to reinforce investor protection in case of default of the counterparty, some Group members suggests that the UCITS ETF manager should be required to pay for the difference between the collateral and the index underlying the swap. In order to enforce this requirement, it is necessary to apply a haircut on the collateral, and, as previously stated, the swap counterparty should not be from the same group as, the UCITS manager.

46. Furthermore, some Group members consider that the iNAV of an ETF should be made accessible to the retail investors, along with its order book, so that private investors have a sense of the magnitude of the difference between the ETF market bid and offer and its iNAV. Also, investors - especially retail ones who are only trading on the secondary market – should have access to information on the average and maximum bid/offer spreads, as they are an important cost element in buying or selling ETFs.

IV.XI Structured UCITS

a) Total Return Swaps (Questions 39 to 42)

47. The Group believes that policy recommendations as submitted by ESMA are adequate, as long as they respect UCITS diversification rules, and the majority of the Group members consider that the TRSwap should be over-collateralised and the collateral should be posted daily. However, a minority of the Group members has reservations regarding the ESMA's proposal to treat discretionary decisions relating to the underlying swap as delegation of investment management, and regarding the imposition of diversification rules to the swap underlying.

b) Strategy indices (Questions 43 to 46)

48. The Group broadly supports the proposed policy orientations on strategy indices as they reflect most current standards already applied and relating to, amongst others, standards applying to sufficient diversification, adequate benchmarking, transparent methodology, transparent portfolio and the right level of independence between the index provider and the asset manager. Such requirements are particularly important considering the potential complexity and risk of the model or strategy tracking the “index” on which the UCITS ETF has been built on. However, diversification rules might be difficult to implement on some benchmarks (especially bond ones representing a thin bucket of maturity) and a minority of the Group members have concerns on some details of ESMA’s proposals.

Annex III - Guidelines on ETFs and other UCITS issues

I. Scope

1. These guidelines apply to competent authorities designated under Article 97 of the UCITS Directive, UCITS management companies and UCITS taking the form of self-managed investment companies.

2. These guidelines apply from [*date two months after their publication on ESMA's website*]. Transitional provisions are set out in paragraph 59 onwards.

II. Definitions

3. Unless otherwise specified, terms used in the UCITS Directive have the same meaning in these guidelines. In addition, the following definitions apply:

Actively-managed UCITS ETF	An actively-managed UCITS ETF is a UCITS ETF, the manager of which has discretion over the composition of its portfolio, subject to the stated investment objectives and policies (as opposed to a UCITS ETF which tracks an index and does not have such discretion). An actively-managed UCITS ETF generally tries to outperform an index.
Annual Tracking Difference	The difference between the annual return of the *Index-tracking UCITS* and the annual return of the tracked index
Eligible Assets Directive	Directive 2007/16/EC of the European Commission 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[10]
UCITS ETF	A UCITS ETF is 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
Guidelines on a Common Definition of European Money Market Funds	CESR Guidelines on a Common Definition of European Money Market Funds (Ref. CESR/10-049)
Guidelines on Eligible Assets for Investment by UCITS	CESR Guidelines on Eligible Assets for Investment by UCITS (CESR/07-044b)

[10] OJ L 79, 20.3.2007, p 11

Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS	CESR Guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788)
Indicative Net Asset Value	A measure of the intraday value of the net asset value of a UCITS ETF based on the most up-to-date information. The *Indicative Net Asset Value* is not the value at which investors on the secondary market purchase and sell their units or shares
Index-tracking UCITS	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
Index-tracking leveraged UCITS	A UCITS the strategy of which is to have a leveraged exposure to an index or exposure to a leveraged index
Multilateral Trading Facility	A multilateral trading facility as defined in Article 14 of Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments[11]
UCITS Directive	Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast)
Tracking error	The volatility of the difference between the return of the *Index-tracking UCITS* and the return of the index or indices tracked

III. Purpose

4. The purpose of these guidelines is to protect investors by providing guidance on the information that should be communicated with respect to index-Tracking UCITS and UCITS ETFs together with specific rules to be applied by UCITS when entering into over-the-counter financial derivative transactions and efficient portfolio management techniques. Finally, the guidelines set out criteria that should be respected by financial indices in which UCITS invest.

IV. Compliance and reporting obligations

Status of the guidelines

5. This document contains guidelines issued under Article 16 of the ESMA Regulation.[12] In accordance with Article 16(3) of the ESMA Regulation competent authorities and financial market participants must make every effort to comply with guidelines.

6. Competent authorities to whom these guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines are directed primarily at financial market participants.

[11] OJ L 145, 30.4.2004, p 1

[12] 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.

Reporting requirements

7. Competent authorities to which these guidelines apply must notify ESMA whether they comply or intend to comply with the guidelines, with reasons for any non-compliance by [**date two months after publication**] to [**email address**]. A template for notifications is available on the ESMA website.

8. UCITS Management Companies and UCITS taking the form of self-managed investment companies are not required to report to ESMA whether they comply with these guidelines.

V. Index-tracking UCITS

9. The prospectus of an index-tracking UCITS should include:

   a) a clear description of the indices including information on their underlying components. In order to avoid the need to update the document frequently, the prospectus can direct investors to a web site where the exact compositions of the indices are published;

   b) information on how the index will be tracked (for example whether it will follow a full or sample based physical replication model or a synthetic replication) and the implications of the chosen method for investors in terms of their exposure to the underlying index and counterparty risk;

   c) information on the anticipated level of tracking error in normal market conditions;

   d) a description of factors that are likely to affect the ability of index-tracking UCITS to track the performances of the indices, such as transaction costs, small illiquid components, dividend reinvestment etc.

10. Information to be provided under paragraph 9(b) above should also be included in a summary form in the key investor information document.

11. The annual and half-yearly reports of an index-tracking UCITS should state the size of the tracking error at the end of the period under review. The annual report should provide an explanation of any divergence between the anticipated and realised tracking error for the relevant period. The annual report should also disclose and explain the annual tracking difference between the performance of the UCITS and the performance of the index tracked.

VI. Index-tracking leveraged UCITS

12. Index-tracking leveraged UCITS must comply with the limits and rules on global exposure established by Article 51(3) of the UCITS Directive. They should calculate their global exposure using either the commitment approach or the relative Value at Risk approach according to the rules set out in the Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. The global exposure limitation also applies to UCITS replicating leveraged indices.

13. The prospectus for index-tracking leveraged UCITS should include the following information:

a) a description of the leverage policy, how this is achieved (i.e. whether the leverage is at the level of the index or arises from the way in which the UCITS obtains exposure to the index), the cost of the leverage (where relevant) and the risks associated with this policy;

b) a description of the impact of any reverse leverage (i.e. short exposure);

c) a description of how the performance of the UCITS may differ significantly from the multiple of the index performance over the medium to long term.

14. This information should also be included in a summary form in the key investor information document.

VII. UCITS ETFs – Identifier and specific disclosure

15. A UCITS ETF should use the identifier 'UCITS ETF' which identifies it as an exchange-traded fund. This identifier should be used in its name, fund rules or instrument of incorporation, prospectus, key investor information document and marketing communications. The identifier 'UCITS ETF' should be used in all EU languages.

16. A UCITS which is not a UCITS ETF (as defined in these guidelines) should use neither the 'UCITS ETF' identifier nor 'ETF' nor 'exchange-traded fund'.

17. A UCITS ETF should disclose clearly in its prospectus, key investor information document and marketing communications 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.

18. A UCITS ETF should also disclose clearly in its prospectus how the indicative net asset value is calculated, if applicable, and the frequency of calculation.

VIII. Actively-managed UCITS ETFs

19. An actively-managed UCITS ETF should inform investors clearly in its prospectus, key investor information document and marketing communications of that fact.

20. An actively-managed UCITS ETF should disclose clearly in its prospectus, key investor information document and marketing communications how it will meet the stated investment policy including, where applicable, its intention to outperform an index.

IX. Treatment of secondary market investors of UCITS ETFs

21. Where units of a UCITS ETF purchased on a secondary market are generally not redeemable from the fund, the prospectus and marketing communications of the fund should include the following warning:

22. 'UCITS ETF's units / shares purchased on the secondary market cannot usually be sold directly back to UCITS ETF. Investors must buy and sell units / shares on a secondary market with the assistance of an intermediary (e.g. a stockbroker) and may incur fees for doing so. In addition, investors may

pay more than the current net asset value when buying units / shares and may receive less than the current net asset value when selling them.'

23. If the stock exchange value of the units or shares of the UCITS ETF significantly varies from its net asset value, investors who have acquired their units or shares (or, where applicable, any right to acquire a unit or share that was granted by way of distributing a respective unit or share) on the secondary market should be allowed to sell them directly back to the UCITS ETF. For example, this may apply in cases of market disruption such as the absence of a market maker. In such situations, information should be communicated to the regulated market indicating that the UCITS ETF is open for direct redemptions at the level of the UCITS ETF.

24. A UCITS ETF should disclose in its prospectus the process to be followed by investors who purchased their units/shares on the secondary market should the circumstances described in paragraph 23 arise, as well as the potential costs involved. The costs should not be excessive.

X. Efficient portfolio management techniques

25. A UCITS should inform investors clearly in the prospectus of its intention to use the techniques and instruments referred to in Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. The use of these techniques and instruments should be in line with the best interests of the UCITS.

26. In accordance with Article 11 of the Eligible Assets Directive, UCITS employing efficient portfolio management techniques should make sure that the risks arising from these activities are adequately captured by the risk management process of the UCITS.

27. In accordance with paragraph 24 of the Guidelines on Eligible Assets for Investment by UCITS, techniques and instruments relating to transferable securities and money market instruments should not

    a. result in a change of the declared investment objective of the UCITS; or

    b. add substantial supplementary risks in comparison to the original risk policy as described in its sales documents.

28. The UCITS should disclose in the prospectus the policy regarding direct and indirect operational costs/fees arising from efficient portfolio management techniques that may be deducted from the revenue delivered to the UCITS. These costs and fees should not include hidden revenue. The 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.

29. All the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS.

30. A 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 has entered.

31. UCITS entering into efficient portfolio management transactions should take into account these operations when developing their liquidity risk management process in order to ensure they are able to comply at any time with their redemption obligations.

32. The UCITS' annual report should also contain details of the following:

   a) the exposure obtained through efficient portfolio management techniques;

   b) the identity of the counterparty(ies) to these efficient portfolio management techniques;

   c) the type and amount of collateral received by the UCITS to reduce counterparty exposure; and

   d) the revenues arising from efficient portfolio management techniques for the entire reporting period together with the direct and indirect operational costs and fees incurred.

XI. Financial derivative instruments

33. Where a UCITS enters into a total return swap or invests in other financial derivative instruments with similar characteristics, the assets held by the UCITS should comply with the investment limits set out in Articles 52, 53, 54, 55 and 56 of the UCITS Directive. For example, when a UCITS enters into an unfunded swap, the UCITS' investment portfolio that is swapped out should comply with the aforementioned investment limits.

34. In accordance with Article 51(3) of the UCITS Directive and Article 43(5) of Directive 2010/43/EU, where a UCITS enters into a total return swap or invests in other financial derivative instruments with similar characteristics, the underlying exposures of the financial derivative instruments shall be taken into account to calculate the investment limits laid down in Article 52 of the UCITS Directive.

35. The prospectus of a UCITS using total return swaps or other financial derivative instruments with the same characteristics should include the following:

   a) information on the underlying strategy and composition of the investment portfolio or index;

   b) information on the counterparty(ies) of the transactions;

   c) a description of the risk of counterparty default and the effect on investor returns;

   d) the extent to which the counterparty assumes any discretion over the composition or management of the UCITS' investment portfolio or over the underlying of the financial derivative instruments, and whether the approval of the counterparty is required in relation to any UCITS investment portfolio transaction; and

   e) subject to the provisions in paragraph 37, identification of the counterparty as an investment manager.

36. Where the counterparty has discretion over the composition or management of the UCITS' investment portfolio or of the underlying of the financial derivative instrument, the agreement between the UCITS and the counterparty should be considered as an investment management delegation arrangement and should comply with the UCITS requirements on delegation.

37. The UCITS' annual report should contain details of the following:

a) the underlying exposure obtained through financial derivative instruments;

b) the identity of the counterparty(ies) to these financial derivative transactions; and

c) the type and amount of collateral received by the UCITS to reduce counterparty exposure.

XII. Management of collateral for OTC financial derivative transactions and efficient portfolio management techniques[13]

38. The risk exposures to a counterparty arising from OTC financial derivative transactions and efficient portfolio management techniques should be combined when calculating the counterparty risk limits of Article 52 of UCITS Directive[14].

39. All assets received by UCITS in the context of efficient portfolio management techniques should be considered as collateral for the purpose of these guidelines and should comply with the criteria laid down in paragraph 40 below.

40. Where a UCITS enters into OTC financial derivative transactions and efficient portfolio management techniques, all collateral used to reduce counterparty risk exposure should comply with the following criteria at all times:

a) Liquidity – any collateral received other than cash should be highly liquid and traded on a regulated market or multilateral trading facility with transparent pricing in order that it can be sold quickly at a price that is close to pre-sale valuation. Collateral received should also comply with the provisions of Article 56 of the UCITS Directive.

b) Valuation – collateral received should be valued on at least a daily basis and assets that exhibit high price volatility should not be accepted as collateral unless suitably conservative haircuts are in place.

c) Issuer credit quality – collateral received should be of high quality.

d) Correlation – the 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.

e) Collateral diversification (asset concentration) – collateral should be sufficiently diversified in terms of country, markets and issuers. The criterion of sufficient diversification with respect to issuer concentration is considered to be respected if the UCITS receives from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of its net asset value. When UCITS

[13] These guidelines on collateral management modify Box 26 of the existing guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788) with respect to criteria to be respected by collateral received in the context of OTC financial derivative transactions.

[14] This provision modifies Box 27 of the existing guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS with respect to the limit of counterparty risk arising from efficient portfolio management transactions.

are exposed to different counterparties, the different baskets of collateral should be aggregated to calculate the 20% limit of exposure to a single issuer.

f) Risks linked to the management of collateral, such as operational and legal risks, should be identified, managed and mitigated by the risk management process.

g) Where there is a title transfer, the collateral received should be held by the depositary of the UCITS. For other types of collateral arrangement, the collateral can be held by a third party custodian which is subject to prudential supervision, and which is unrelated to the provider of the collateral.

h) Collateral received should be capable of being fully enforced by the UCITS at any time without reference to or approval from the counterparty.

i) Non-cash collateral received should not be sold, re-invested or pledged[15].

j) Cash collateral received should only be:

- placed on deposit with entities prescribed in Article 50(f) of the UCITS Directive;
- invested in high-quality government bonds;
- used for the purpose of reverse repo transactions provided the transactions are with credit institutions subject to prudential supervision and the UCITS is able to recall at any time the full amount of cash on accrued basis;
- invested in short-term money market funds as defined in the Guidelines on a Common Definition of European Money Market Funds.

41. Re-invested cash collateral should be diversified in accordance with the diversification requirements applicable to non-cash collateral.

42. A UCITS receiving collateral for at least 30% of its assets should have an appropriate stress testing policy in place to ensure regular stress tests are carried out under normal and exceptional liquidity conditions to enable the UCITS to assess the liquidity risk attached to the collateral. The liquidity stress testing policy should at least prescribe the following:

a) design of stress test scenario analysis including calibration, certification & sensitivity analysis;

b) empirical approach to impact assessment, including back-testing of liquidity risk estimates;

c) reporting frequency and limit/loss tolerance threshold/s; and

d) mitigation actions to reduce loss including haircut policy and gap risk protection.

[15] These guidelines on collateral management modify Box 9 of the existing guidelines on Risk Measurement and Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788) with respect to the prohibition of reinvestment of non-cash collateral received in the context of efficient portfolio management transactions

43. A UCITS should have in place a clear haircut policy adapted for each class of assets received as collateral. When devising the haircut policy, a UCITS should take into account the characteristics of the assets such as the credit standing or the price volatility, as well as the outcome of the stress tests performed in accordance with paragraph 47. This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut, to a certain class of assets.

44. The prospectus should also clearly inform investors of the collateral policy of the UCITS. This should include permitted types of collateral, level of collateral required and haircut policy and, in the case of cash collateral, re-investment policy (including the risks arising from the re-investment policy).

XIII. Financial indices

45. When a UCITS intends to make use of the increased diversification limits referred to in Article 53 of the UCITS Directive, this should be disclosed clearly in the prospectus together with a description of the exceptional market conditions which justify this investment.

46. A UCITS should not invest in a financial index which has a single component that has an impact on the overall index return which exceeds the relevant diversification requirements i.e. 20%/35%. In the case of a leveraged index, the impact of one component on the overall return of the index, after having taken into account the leverage, should respect the same limits.

47. A UCITS should not invest in commodity indices that do not consist of different commodities. Sub-categories of the same commodity (for instance, from different regions or markets or derived from the same primary products by an industrialised process) should be considered as being the same commodity for the calculation of the diversification limits. For example, WTI Crude Oil, Brent Crude Oil, Gasoline or Heating Oil contracts should be considered as being all sub-categories of the same commodity (i.e. oil). Sub-categories of a commodity should not be considered as being the same commodity if they are not highly correlated. With respect to the correlation factor, two components of a commodity index that are sub-categories of the same commodity should not be considered as highly correlated if 75% of the correlation observations are below 0.8. For that purpose the correlation observations should be calculated (i) on the basis of equally-weighted daily returns of the corresponding commodity prices and (ii) from a 250-day rolling time window over a 5-year period.[16]

48. A UCITS should be able to demonstrate that an index satisfies the index criteria in Article 53 of the UCITS Directive and Article 9 of the Eligible Assets Directive, including that of being a benchmark for the market to which it refers. For that purpose:

   a) an index should have a clear, single objective in order to represent an adequate benchmark for the market;

   b) the universe of the index components and the basis on which these components are selected for the strategy should be clear to investors and competent authorities;

[16] These guidelines modify the existing guidelines on eligible assets for investment by UCITS (Ref. CESR/07-044b) with respect to commodity indices. UCITS should not invest in commodity indices that do not comply with the requirements laid down in paragraph 48.

c) if cash management is included as part of the index strategy, the UCITS should be able to demonstrate that this does not affect the objective nature of the index calculation methodology.

49. An index should not be considered as being an adequate benchmark of a market if it has been created and calculated on the request of one, or a very limited number of, market participants and according to the specifications of those market participants.

50. The UCITS' prospectus should disclose the rebalancing frequency and its effects on the costs within the strategy.

51. A UCITS should not invest in a financial index whose rebalancing frequency prevents investors from being able to replicate the financial index. Indices which rebalance on an intra-day or daily basis do not satisfy this criterion. For the purpose of these guidelines, technical adjustments made to financial indices (such as leveraged indices or volatility target indices according to publicly available criteria should not be considered as rebalancing in the context of this paragraph.

52. UCITS should not invest in financial indices for which the full calculation methodology to, inter alia, enable investors to replicate the financial index is not disclosed by the index provider. This includes providing detailed information on index constituents, index calculation (including effect of leverage within the index), re-balancing methodologies, index changes and information on any operational difficulties in providing timely or accurate information. Calculation methodologies should not omit important parameters or elements to be taken into account by investors to replicate the financial index. This information should be easily accessible, free of charge, by investors and prospective investors, for example, via the internet. Information on the performance of the index should be freely available to investors.

53. A UCITS should not invest in financial indices that do not publish their constituents together with their respective weightings. This information should be easily accessible, free of charge, by investors and prospective investors, for example, via the internet. Weightings may be published after each rebalancing on a retrospective basis. This information should cover the previous period since the last rebalancing and include all levels of the index.

54. A UCITS should not invest in financial indices whose methodology for the selection and the rebalancing of the components is not based on a set of pre-determined rules and objective criteria.

55. A UCITS should not invest in financial indices whose index provider accepts payments from potential index components for inclusion in the index.

56. A UCITS should not invest in financial indices whose methodology permits retrospective changes to previously published index values ('backfilling').

57. The UCITS should carry out appropriate documented due diligence on the quality of the index. This due diligence should take into account whether the index methodology contains an adequate explanation of the weightings and classification of the components on the basis of the investment strategy and whether the index represents an adequate benchmark. The due diligence should also cover matters relating to the index components. The UCITS should also assess the availability of information on the index including:

a. whether there is a clear narrative description of the benchmark;

b. whether there is an independent audit and the scope of such an audit;

c. the frequency of index publication and whether this will affect the ability of the UCITS to calculate its net asset value.

58. The UCITS should ensure that the financial index is subject to independent valuation.

XIV. Transitional provisions

59. Any new UCITS created after the date of application of the guidelines should comply with the guidelines immediately.

60. UCITS that exist before the application date of the guidelines and that invest in financial indices that do not comply with the guidelines should align their investments with the guidelines within 12 months of the application date of the guidelines.

61. Structured UCITS as defined in Article 36 of Regulation 583/2010 that exist before the date of application of the guidelines are not required to comply with the guidelines provided that they do not accept any new subscriptions after the application date of the guidelines. However, in order to be able to continue offering the underlying payoff to existing investors, such existing UCITS can actively manage their financial contracts.

62. UCITS that exist before the application of the guidelines should align their portfolio of collateral with the guidelines within 12 months of the application date of the guidelines. However, any reinvestment of cash collateral after the application date of the guidelines should comply with the guidelines immediately.

63. UCITS that exists before the application date of the guidelines and that have entered into revenue-sharing arrangements should comply with paragraph 28 of the guidelines within 12 months of the application date of the guidelines.

64. A UCITS ETF which exists before the application date of the guidelines is not required to comply with guidelines relating to identifiers until the earlier of:

a) the first occasion after the application date of the guidelines on which the name of the fund is changed for another reason; and

b) twelve months after the application date of the guidelines.

65. UCITS ETFs that exist before the application date of the guidelines should comply with the provisions related to the treatment of secondary market investors from the application date.

66. Requirements relating to the contents of the fund rules or instrument of incorporation of an existing UCITS, its prospectus, its key investor information document, or any marketing communication that it has issued prior to the application date of these guidelines, do not come into effect until the earlier of:

a) the first occasion after the application date of the guidelines on which the document or communication, having been revised or replaced for another purpose, is published; and

b) twelve months after the application date of the guidelines.

67. Requirements to publish information in the report and accounts of an existing UCITS do not apply in respect of any accounting period that has ended before the application date of the guidelines.

Annex IV – Consultation paper on the treatment of repurchase and reverse repurchase agreements.

Responding to this paper

ESMA invites comments on all matters in this paper. Comments are most helpful if they:

- indicate the specific question to which the comment relates and respond to the question stated;
- contain a clear rationale, clearly stating the costs and benefits; and
- describe any alternatives ESMA should consider.

Comments should reach us by **25 September 2012**.

All contributions should be submitted online at www.esma.europa.eu under the heading 'Consultations'.

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Disclaimer'.

Who should read this paper?

This document will be specifically of interest to asset management companies and trade associations of asset management companies managing UCITS, as well as to institutional and retail investors and their associations.

Executive summary

Reasons for publication

ESMA is seeking views on the appropriate treatment of repo and reverse repo arrangements in the context of the guidelines on ETFs and other UCITS issues.

Contents

This consultation paper sets out ESMA's proposal for the treatment of repo and reverse repo arrangements. ESMA proposes a distinct regime for repo and reverse repo arrangements which, unlike for securities lending arrangements, would allow a proportion of the assets of the UCITS to be non-recallable at any time at the initiative of the UCITS. The proposed guidelines include safeguards to ensure that the counterparty risk arising from these arrangements is limited and that UCITS entering into such arrangements can continue to execute redemption requests.

Next steps

ESMA will take into account the responses to this consultation in developing the final policy approach on repo and reverse repo transactions. That policy approach will be integrated into the remainder of the guidelines on ETFs and other UCITS issues, which are set out in Annex III of this paper.

Proposed guidelines

1. When UCITS enter into repo and reverse repo arrangements, they should ensure that:

    a. these arrangements do not compromise their abilities to execute redemption requests in accordance with Article 84(1) of the UCITS Directive; and

    b. the value of the assets that are subject to arrangements on terms that do not allow the assets to be recalled at any time by the UCITS should not exceed in aggregate [X]% of the net asset value of the UCITS at any time.

2. For the purpose of paragraph 1b:

    a. overnight repo and overnight reverse repo arrangements should be considered as arrangements on terms that allow the assets to be recalled at any time by the UCITS.

    b. repo and reverse repo arrangements on terms that allow the assets to be recalled at any time by the UCITS should permit the UCITS to:

        i. recall the full amount of cash on an accrued basis or terminate on an accrued basis the reverse repo transaction into which it has entered; and

        ii. recall any securities subject to the repo transaction or terminate the repo transaction into which it has entered.

3. In addition, UCITS should ensure that the following requirements are respected:

    a. where the UCITS uses fixed term arrangements, there should be an appropriate balance between short-term and medium-term arrangements. ;

    b. there should be an appropriate diversification at the level of the counterparties to any arrangements that do not allow the assets to be recalled at any time; and

    c. the collateral received by the UCITS should comply with the criteria set out in paragraph 40 of the guidelines.[17]

4. Paragraphs 1 to 3 of these guidelines will be reviewed one year after the date of application of the guidelines.

[17] This refers to paragraph 40 in page 49 of the present document under the section "Management of collateral for OTC financial derivative transactions and efficient portfolio management techniques".

Questions to stakeholders

Q1: What is the average percentage of assets of UCITS that are subject to repurchase and reverse repurchase agreements? For the purposes of this question, please have regard to arrangements covered by the provisions of Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive (i.e. those arrangements which do not fall under the definitions of transferable securities and money market instruments, in accordance with recital 13 of the Eligible Assets Directive). In addition, please provide input on the following elements:

i) the extent to which assets under such arrangements are not recallable at any time at the initiative of the UCITS.

ii) the maximum and average maturity of repo and reverse arrangements into which UCITS currently enter. Please provide a breakdown of the maturities with reference to the proportion of the assets of the UCITS.

Q2: Do you agree with the proposed guidelines for the treatment of repo and reverse repo agreements? If not, please justify your position.

Q3: What are your views on the appropriate percentage of assets of the UCITS that could be subject to repurchase and reverse repurchase agreements on terms that do not allow the assets to be recalled by the UCITS at any time and that would not compromise the ability of the UCITS to execute redemption requests?

Q4: Do you consider that UCITS should be prohibited from entering into repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time? If not, please indicate possible mitigating measures that could be envisaged in order to permit UCITS to use repo and reverse repo arrangements on terms that do not allow the assets to be recalled by the UCITS at any time.

Q5: Do you think that there should be a minimum number of counterparties of arrangements under which the assets are not recallable at any time? If yes, what should be the minimum number? To answer this question, you are invited to take into account your response to question 2 above.

Cost Benefit Analysis

Risk addressed / Policy objective

With these guidelines, ESMA wishes to develop an appropriate regime for the treatment of repo and reverse repo with regard to the recallability of assets subject to these arrangements. This regime is designed to ensure that UCITS which enter into repo and reverse repo arrangements can continue to execute redemptions.

Scope issues

These guidelines apply to all UCITS entering into repo and reverse repo arrangements.

Options

When developing the consultation paper ESMA considered the following options.

Efficient portfolio management techniques	Benefits	Costs	Evidence
Option 1 As proposed in the present consultation paper	Option 1 leaves the possibility for UCITS to enter into fixed term repo and reverse repo arrangements under which the assets are not recallable at any time for a certain proportion of their assets (the exact proportion remaining to be determined) provided that the UCITS is able to execute redemption requests.	Option 1 is less restrictive than Option 2	Feedback from the consultation.
Option 2 As proposed under Box 6 of the first consultation paper (ESMA/2012/44).	Option 2 requires that UCITS entering into repo and reverse repo arrangements should have the capacity, at any time, to recall any asset subject to repo or to terminate the contract.	UCITS would no longer be able to enter into fixed term repo and reverse repo arrangements that do not allow them to recall at any time the assets or to terminate the contract.	Feedback to the previous consultation suggested this would be unduly restrictive on UCITS.