



FINANCIAL REGULATOR
Rialtóir Airgeadais

Guidance Note 3/07

Undertakings for Collective Investment in
Transferable Securities (UCITS)
Structured Products and Complex Trading Strategies
– Prospectus Disclosure Requirements



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1. Background and Overview

The amendments to the UCITS Directive (Council Directive 85/611/EEC), by Directive 2001/108/EC, (the “Product Directive”), introduced more investment options for UCITS, particularly in allowing financial derivative instruments (“FDI”) to be used to increase investment exposure and risk. An increasing number of UCITS are now availing of these provisions. This has resulted in the use of more innovative and complex products by UCITS, including investment strategies pursuing structured returns¹.

This guidance note applies, inter alia, to the use by UCITS of the following investments / investment techniques:

- financial indices;
- structured notes (e.g. collateralised debt obligations);
- FDI;
- systematic trading models (e.g. algorithmic trading strategies);
- capital protection strategies.

The purpose of the guidance note is to provide clarification with regard to the disclosure of such trading strategies in the prospectus of a UCITS in order to ensure that the important principle of investor-protection continues to be given primacy. It must be stressed that UCITS are retail products and so must ensure that their investment strategies are suitably disclosed to enable retail investors to make an informed decision. Unsophisticated investors may not fully understand the different risk and return characteristics of these products, notwithstanding that some complex strategies may in fact be less risky than some traditional long-only structures.

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

The issues raised here are also being considered by the European Commission and by the Committee of European Securities Regulators in the context of the simplified prospectus / key investor information for UCITS. The outcome of that work is likely to result in amendments to this document and to the Financial Regulators prospectus requirements.

2. Disclosure and Requirements

Notice UCITS 6 of the UCITS Notices sets out the information that the full prospectus of a UCITS must contain with regard to its investment objective and policy (paragraph 12 (xv)). The Notice specifically requires that the descriptions “*must be comprehensive and accurate, readily comprehensible to investors and sufficient to enable investors make an informed judgement on the investment proposed to them*”. In drafting suitable disclosure for retail investors, significant challenges may arise when formulating appropriate wording for innovative and complex products and strategies. In this regard the minimum information that should be included should clearly explain:

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

The description must be carefully drafted and written in a logical and non-confusing manner. The UCITS must make a judgement as to the amount of information that is relevant. In some cases it may be helpful to discuss the proposed strategy with the Financial Regulator prior to submission of an application for authorisation in order to identify drafting issues at an early stage and to ensure that the proposed strategy is fully understood. The Financial Regulator will require that poorly drafted prospectuses are re-submitted, potentially delaying authorisation.

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

The underlying exposure is often unclear due to the complexity of the structure proposed. This is generally due to the number of sophisticated financial instruments and methodologies used in the structure. An example is a UCITS offering a capital protected product with an underlying credit exposure, structured via a total return swap based on the return of a number of credit default swap indices, and where the allocation of exposure to those indices is dictated by a systematic trading model with capital protection provided by notional exposure to a zero-coupon bond. The very important message regarding underlying exposure can get lost amid the technical description of the structure used.

3. Additional Risk Disclosures

It is important that an investor understands, in broad terms, the risks they face in relation to their investment. In particular, an indication of the degree of leverage expected to be generated through the use of FDI should, in all cases, be disclosed, notwithstanding that such use will be within permitted levels. The use of complex trading strategies may also require additional risk disclosures, for example in relation to high levels of expected volatility² or the use of sophisticated risk measurement models such as value at risk. Disclosure is only required when relevant and material, based on risk impact and probability.

4. Description of Payout Profile

Investors are also interested in the question “given the risks, what might I get back?” It is therefore desirable to describe the level of risk exposure and payout profile of the strategy in terms of, say, comparison to a benchmark index, or describing potential levels of volatility, or otherwise informing investors through the use of simple tables, schematics or graphs³.

² Article 24a (3) of the UCITS Directive states that ...
"When the net asset value of a UCITS is likely to have a high volatility due to its portfolio composition or the portfolio management techniques that may be used, its prospectus and where necessary, any other promotional literature must include a prominent statement drawing attention to this characteristic".

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

5. Use of Appendices

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



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