

Guidance Note 2/07

Undertakings for Collective Investment in Transferable Securities (UCITS) Financial Indices

Background and Overview

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

The Financial Regulator recognises that financial markets continually evolve and it is therefore expected that this guidance note will be updated as necessary to reflect such developments. Industry participants are always encouraged to discuss index proposals with the Financial Regulator in advance of an application for authorisation of a UCITS.

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

- European Communities (UCITS) Regulations 2003 (“the Regulations”)
- The UCITS Directive (Council Directive 85/611/EEC), as amended by Council Directive 2001/108/EC
- Commission Directive 2007/16/EC 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
- The Committee of European Securities Regulators (CESR) guidelines concerning eligible assets for investment by UCITS (March 2007) (Ref: CESR/07-044)

1. Regulatory Requirements

1.1 General Considerations

In reading this guidance note, it is important to note the following:

- Based on the criteria outlined in paragraphs 1.2 and 1.3 below, it is the UCITS responsibility to determine whether or not an index should be submitted to the Financial Regulator for review. It is also expected that an index submission will be submitted to, and receive clearance from, the Financial Regulator prior to the application for authorisation.
- The regulatory requirements apply to all financial indices, whether comprised of eligible or ineligible assets, whether used for investment or efficient-portfolio management (“EPM”) purposes, and whether exposure to an index is obtained via FDI or directly through replication.
- The creation of leveraged exposure to an index via FDI, or the inclusion of a leverage feature in an index, must also be taken into account in meeting the quantitative requirements of Guidance Note 3/03, UCITS - Financial Derivative Instruments. This requirement generally applies to index structures incorporating embedded leverage features, such as algorithms and “multipliers”, that give UCITS exposure to leveraged investment returns.
- When a UCITS invests in index-based FDI, the constituents of the index do not have to be combined with the limits laid down in Regulations 49-51 of the Regulations.
- A UCITS proposing to use a financial index comprised of eligible assets with concentration levels in excess of that permitted by the Regulations, may, applying a “look-through” approach, consolidate the constituents of the index with the assets held directly by the UCITS to ensure it meets the risk-spreading requirements of the Regulations. This “look-through” approach may not be used by UCITS using indices comprised of ineligible assets. Indices comprised of ineligible assets must meet the criteria for regulatory approval detailed in paragraph 2 below on a stand-alone basis.
- Non-financial indices are not eligible investments for UCITS.

1.2 Circumstances where an index submission is not required

A UCITS that proposes to use a financial index for replication, investment or EPM is not required to submit that index to the Financial Regulator for approval if, on a “look-through” basis, it would be possible for the UCITS to directly invest in the constituents of the index as allowed by the Regulations (for example the “5/10/40” rule as applied to equity and debt securities¹).

A UCITS that proposes to use a financial index for which there is no requirement to obtain clearance must state, when making the application for authorisation to the Financial Regulator, that such indices meet the regulatory requirements. The absence of such a statement will result in the Financial Regulator querying the use of the index, thus delaying the authorisation process should an index application be required.

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

1.3 Circumstances where an index submission is required

1.3.1 Indices based on Eligible Assets

UCITS proposing to use indices comprised of eligible assets must make an index submission to the Financial Regulator if it would not be possible for the UCITS to invest directly in such underlying assets without transgressing the risk-spreading limits of the Regulations. This does not apply to UCITS applying the “look-through” approach outlined in paragraph 1.1 above.

1.3.2 Indices based on Ineligible Assets

If it is not possible for a UCITS to invest directly in the underlying constituents of a proposed index, the index must be submitted to the Financial Regulator for approval².

¹ The Regulations restrict a UCITS exposure to a single issuer so that a UCITS may invest no more than 10% of its assets in transferable securities or money market instruments issued by the same body, provided that the total value held in the issuing bodies in each of which it invests more than 5% of its net assets must not then exceed 40% of the net asset value (“NAV”) – the “5/10/40” rule.

² Indices based on FDI on commodities or indices on property may be eligible provided they comply with the criteria set down for Financial Indices in Notice UCITS 10 and in this Guidance Note.

1.4 Summary of Index Assessment Criteria

Once it has been determined by the UCITS that an index requires clearance from the Financial Regulator, a submission must be made to the Financial Regulator demonstrating that the index:

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

Where a UCITS uses multiple indices each index must meet these requirements.

The documentary evidence that must be provided with respect to each of these criteria is detailed in Section 2 below. In this regard, the Appendix provides a checklist to assist applicants prepare their submissions.

2. Index Assessment Criteria

A submission will be reviewed under four headings. The Financial Regulator requires sufficient documentary evidence to assess the submission and so it is important that all the relevant data and information is included. Review of an index will be delayed in the event of an incomplete submission³.

2.1 Sufficiently Diversified

An index requiring clearance from the Financial Regulator must be sufficiently diversified. Regulations 49 A (1) and (2) of the Regulations detail the increased limits⁴ allowed for financial indices which are being replicated and are comprised of shares or debt securities. These increased concentration limits are also applicable to indices comprised of other asset classes, subject to the provisions of paragraph 1.2 above. In summary, each individual constituent of an index may not have a weighting greater than 20%. On a case-by-case basis, and where adequate written explanation is

³ The submission should include, *inter alia*, any technical and market documents produced by the index sponsor.

⁴ The limits refer to position (issuer-concentration) exposure limits to the underlying of each constituent of the index.

provided to the Financial Regulator⁵, one constituent of an index may have an individual weighting of up to 35%.

If the composition of the index is not at least as diversified under the ratios of Regulation 49A, its underlying assets have to be combined with the other assets of the UCITS order to avoid undue concentration.

2.2 Adequate Benchmark

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

The methodology used to construct the index should be adequately described, including data on constituent selection criteria, constituent price collection procedures, asset allocation rules and guidelines for altering and re-balancing the index, its constituents and their weights. In this regard, it is expected that the index is revised and rebalanced periodically to ensure that it continues to reflect the performance of the assets to which it refers and to ensure that regulatory requirements with regard to allowed concentration limits are satisfied⁶. Details must also be provided as to how the index calculation methodology is verified. Finally, information should be provided on any fees embedded in the index.

2.3 Publication

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

⁵ For example, on the basis of factors such as exceptional market conditions and market dominance.

⁶ The Financial Regulator accepts that passive breaches may occur periodically due to market movements. However it is expected that indices are re-balanced on a frequent basis to ensure that such breaches are of a limited duration.

to be of a proprietary and commercially sensitive nature is not expected to be published in a detailed manner.

2.4 Independently Managed

The index must be independently managed from the management of the UCITS. The Financial Regulator will take into account the relationship, if any, between the UCITS management and the index sponsor. The performance of the index must be calculated in an independent environment, free from any external influences. This does not preclude index providers and the UCITS forming part of the same economic group, provided that effective arrangements for the management of conflicts of interest are in place.

3. Disclosure Requirements

If an index is used for EPM purposes there is no requirement to disclose details of the index in the prospectus other than the fact that the UCITS will gain exposure to indices for such purposes. Where indices are used for investment purposes, the prospectus must provide sufficient disclosure to allow a prospective investor understand the market the index is representing, why it is being used as part of the UCITS investment strategy, how the investment will be made (i.e. directly through investment in the constituents or indirectly through FDI) and where additional information on the index may be obtained such as that mentioned in paragraphs 2.2 and 2.3 above.

The Financial Regulator recognises that a UCITS investment strategy may not, in all cases, be able to specify the exact indices that the strategy may require exposure to, or that it may be impractical to provide such detail in the prospectus. In such situations it is considered that the UCITS will provide sufficient detail on the types of indices being used in order to satisfy the investment strategy being pursued and where more specific information may be accessed insofar as that is practical and permitted.

4. Hedge Fund Indices

In addition to the requirements of Notice UCITS 10, and the index criteria set out above, hedge fund indices are subject to the following additional criteria:

4.1 A hedge fund index will not fall under the classification of a “financial index”:

- unless the methodology of the index provides for the selection and the re-balancing of components on the basis of pre-determined rules and objective criteria.
- if the index provider accepts payments from potential index components for the purpose of being included in the index.
- if the methodology of the index allows retrospective changes to previously published index values (“backfilling”).

4.2 Where a UCITS will gain exposure to a hedge fund index by means of an OTC derivative, a UCITS must comply with the relevant requirements of the UCITS Regulations including these in relation to:

- eligible counterparty (ref: Regulation 45 (g) and paragraph 4 UCITS 10);
- valuation requirements and ability to close a position (ref: paragraph 4 of UCITS 10);
- risk management requirements (ref: paragraph 11 of UCITS 10 and Guidance Note 3/03); and
- risk spreading rules (ref: Regulations 49 and Notice UCITS 9).

4.3 When gaining exposure to a hedge fund index, a UCITS must carry out appropriate due diligence. This includes consideration by the UCITS of the “quality” of the index. In assessing the quality of the index, the UCITS must take into account at least the following factors. The UCITS must keep a record of its assessment.

(a) the comprehensiveness of the index methodology, including:

- whether the methodology contains an adequate explanation of subjects such as the weighting and classification of components (e.g. on the basis of the investment strategy of the selected hedge funds), and the treatment of defunct components;
- whether the index represents an adequate benchmark for the kind of hedge funds to which it refers.

(b) the availability of information about the index, including:

- whether there is a clear narrative description of what the index is trying to represent;
- whether the index is subject to an independent audit and the scope of the audit (e.g. that the index methodology has been followed, that the index has been calculated correctly);
- how frequently the index is published and whether this will affect the ability of the UCITS to accurately calculate its net asset value (NAV).

(c) matters relating to the treatment of index components, including:

- the procedures by which the index provider carries out any due diligence on the NAV calculation procedures of index components;
- what level of detail about the index components and their NAVs are made available (including whether they are investable or non-investable);
- whether the number of components in the index achieves sufficient diversification.

APPENDIX

Index Review Checklist

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

Supporting documentation must be provided for each criteria below.

A Sufficiently Diversified

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

B Adequate Benchmark

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

C Publication

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

D Independently Managed

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