

UCITS Financial Indices

Background and Overview

1. The purpose of this guidance is to clarify Central Bank requirements where a UCITS intends to use a financial index for investment or efficient portfolio management purposes. It also clarifies other related areas such as the use of indices composed of ineligible assets and prospectus disclosure requirements. Finally, it sets out the certification required from the Responsible Person of a UCITS and the process relating to that certification.

2. The Central Bank recognises that financial markets continually evolve and it is therefore expected that this guidance will be updated as necessary to reflect such developments.

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

- European Communities (UCITS) Regulations 2011 (the "UCITS Regulations")
- Central Bank (Supervision and Enforcement) Act 2013 (Section 48(1))(Undertakings for Collective Investment in Transferable Securities) Regulations 2015 (the "Central Bank UCITS Regulations")
- Council Directive 2009/65/EC (the "UCITS Directive")
- Commission Directive 2007/16/EC implementing Council Directive 2009/65/EC 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
- ESMA guidelines concerning eligible assets for investment by UCITS (March 2007, updated September 2008) (Ref: CESR/07-044b)
- ESMA guidelines concerning eligible assets for investment by UCITS – The classification of hedge fund indices as financial indices (July 2007 – Ref: CESR/07-434)
- ESMA guidelines on ETFs and other UCITS issues (August 2014 – Ref ESMA/2014/937)

General Considerations

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

- The regulatory requirements and the Central Bank's certification process 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 a financial index is obtained via financial derivative instruments ("FDI") or direct investment.
- The creation of leveraged exposure to a financial index via FDI, or the inclusion of a leverage feature in a financial index, should also be taken into account in meeting the quantitative requirements of the UCITS Regulations. This requirement generally applies to index structures incorporating embedded leverage features, such as algorithms and "multipliers" that give UCITS exposure to leveraged investment returns.

- Over time, market movements or other events may cause the weightings of a financial index to change so that it no longer complies with the “5/10/40” rule. Where this happens and on the basis that the UCITS has provided a relevant certification the financial index will be deemed to meet index criteria set out in paragraphs 7 to 9.
- Where a UCITS intends to use an index referred to in Regulation 71(2) of the UCITS Regulations, a Responsible Person should, at the time the UCITS seeks authorisation¹, provide a submission to the Central Bank, setting out that the limit in Regulation 71(1)(a) is to be raised to a maximum of 35% for a single issuer and why this is justified by exceptional market conditions.
- Regulation 9(11)(b) of the Central Bank UCITS Regulations provides:
“sub-categories of a commodity shall be regarded as being the same commodity for the calculation of the diversification limits set out in Regulation 71 of the UCITS Regulations if those sub-categories are highly correlated within the meaning of paragraph (12)”.

This includes, for instance, commodities from different regions or markets or derived from the same primary products by an industrialised process. As an example, WTI Crude Oil, Brent Crude Oil, Gasoline or Heating Oil contracts should be considered as being all sub-categories of the same commodity – oil.

- Where a UCITS uses an index solely as a performance benchmark, no confirmation or certification is required.
- Non-financial indices are not eligible investments for UCITS.

Summary of Financial Index Assessment Criteria

5. The following describes the assessment criteria that should be applied by a Responsible Person when determining if an index meets the criteria for financial indices. The criteria are that the index should be:

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

6. Where a UCITS uses multiple financial indices each financial index should meet these criteria.

Index Assessment Criteria - Adequate Benchmark

7. A financial index should achieve the objective of being a benchmark for the market to which it refers.

Index Assessment Criteria - Publication

8. Regulation 71(1) (iii) of the UCITS Regulations requires that the financial index is published in an appropriate manner. An investor should be able to access relevant

¹ Or: at time of approval in the case of an additional sub-fund to an umbrella UCITS; by way of a post-authorisation submission in the case of previously authorised / approved UCITS/sub-funds.

material information on the financial index with ease, for example, via the internet. Performance of the financial index should be freely and continually available. Information on matters relating to the financial index such as constituents, calculation, re-balancing methodologies, 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 to be of a proprietary and commercially sensitive nature is not expected to be published in a detailed manner.

9. Regulation 9(6)(a) of the Central Bank UCITS Regulations prohibits a Responsible Person from investing in an index, “that rebalances on an intraday or daily basis, or the rebalancing frequency of which prevents investors from being able to replicate the financial index”.

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 Regulation 9(6)(a) of the Central Bank UCITS Regulations.

Index Assessment Criteria - Independently Managed

10. The relationship, if any, between the responsible person and the index sponsor should be taken into account. The performance of the financial index should be calculated in an independent environment, free from any external influences.

Disclosure Requirements

11. The UCITS should comply with the disclosure requirements set out in the UCITS Regulations and the Central Bank UCITS Regulations. If a financial index is used for EPM purposes there is no requirement to disclose details of the financial index in the prospectus other than the fact that the UCITS will gain exposure to financial indices for such purposes.

12. The Central Bank recognises that a UCITS investment strategy may not, in all cases, be able to specify the exact financial 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 financial indices being used in order to satisfy the investment strategy being pursued and where more specific information may be accessed, for example, in the annual reports of the UCITS, insofar as that is practical and permitted.

Certification

13. Based on the criteria outlined above, a Responsible Person should assess each index that the UCITS intends to use in order to determine whether the index meets all of the regulatory requirements. Once determined that this is the case, this must be certified by the Responsible Person when the UCITS seeks authorisation, (or approval of an additional sub-fund in the case of an umbrella UCITS).

Where the Responsible Person has determined that an index is eligible, the following certification must be provided² :

I (being a director of the Responsible Person), on behalf of the [Responsible Person] of {name of UCITS} certify that {name of Index} is a financial index which complies with: the requirements of the UCITS Regulations 2011, the Central Bank UCITS Regulations 2015 and the Central Bank's Guidance on UCITS Financial Indices. [name of Index] is a UCITS eligible financial index.

Where a previously authorised or approved UCITS/sub-fund of an umbrella UCITS proposes to use a financial index, the certification should be provided by the Responsible Person to the Central Bank by way of post authorisation submission.

Quality Assessments

14. The Central Bank will periodically conduct quality assessments of randomly selected financial indices used by UCITS to ensure that they comply with relevant regulatory requirements and guidance.

Where the Central Bank identifies a financial index for assessment, it will request a written submission, with supporting documentation, from the Responsible Person demonstrating that the financial index meets relevant regulatory requirements and guidance. This information must be provided immediately upon request.

Sufficient documentary evidence should be provided to assess the financial index and so it is important that all the relevant data and information is included. The submission should include any technical and marketing documents produced by the index sponsor.

The Central Bank will expect a Responsible Person (at least) to 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 (which should be adequately described and include data on constituent selection criteria, constituent price collection procedures, asset allocation rules and guidelines for altering and re-balancing the index);
- information on index constituents and their current as well as historic weights;
- details as to how the index calculation methodology is verified; and
- information should be provided on any fees embedded in the index.

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² To be amended as appropriate for multiple index submissions.