

Ms Martina Kelly  
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Central Bank of Ireland,  
Block D, Iveagh Court,  
Dublin 2

21 October 2013

### **Classification of Financial Indices**

Dear Martina,

We are writing to you in relation to the classification of indices as “financial indices” following the coming into force of the ESMA Guidelines “On ETFs and other UCITS Issues” (the “**ESMA Guidelines**”) and have set out below the points of clarification we are seeking on this issue.

Specifically, we request clarification on three key points:

1. The distinction between Part V and Part IX of the ESMA Guidelines
2. Central Bank policy in relation to the approval of financial indices
3. The implications of the ESMA Guidelines on financial indices of Financial Derivative Instruments (“**FDI**”) held by Non-Index Tracking UCITS

### **Central Bank implementation of ESMA Guidelines**

The ESMA Guidelines in “Part V” set out the requirements in relation to index-tracking UCITS and the disclosure that is required to be included in the UCITS prospectus in relation to the index being tracked as set out below:

- (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 website 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 re-investment etc.

Our view of the application of the ESMA Guidelines is that “Part V” applies to all indices (regardless of whether they are approved as financial indices) which a UCITS tracks (i.e. indices which are eligible on a “look-through” basis). This we believe is the reason that this section purposely does not use the term “financial index” as it applies to all indices and is not confined solely to “financial indices”. We understand that the term “index” has been used by ESMA in order to give indices their “common sense” and “plain English” meaning.

“Part IX” of the ESMA Guidelines sets out the requirements which relate to “financial indices” and we believe “Part IX” represents a separate distinct section of the ESMA Guidelines relating solely to “financial indices” as evidenced by the introduction of the term “financial index” in this section to distinguish it from “Part V” which applies to **all** indices (the term “index” being used to give indices their “plain English” and “common sense” meaning). We understand this section of the ESMA Guidelines applies only to UCITS which intend to avail of the increased diversification limits under the European Communities (UCITS) Regulations 2011 (the “**UCITS Regulations**”) or to obtain exposure to indices which contain ineligible assets by way of **investing** in a “financial index”. We further understand the ESMA Guidelines only classify “indices” which it is not possible to invest directly in the underlying assets of, without transgressing the risk-spreading limits of the UCITS Regulations, as “financial indices”. We further believe this interpretation is supported by the consistent use through “Part IX” of the ESMA Guidelines of the term “**investing in**” the “financial index” itself (paragraphs 49,50,54,55 and 56) evidencing the fact that it is not possible for the UCITS to track the performance of the index on a “look through” basis. This contrasts with the language used in “Part V” of the ESMA Guidelines which refers throughout this section to the UCITS “**tracking**” the performance of the “index”.

Our interpretation of the ESMA Guidelines, is that indices which the UCITS is tracking the performance of, are not classified as a “financial index” if on a “look-through” basis, it is possible for the UCITS to invest directly in the constituents of the index in accordance with UCITS Regulations. Our interpretation of the ESMA Guidelines is that these indices are not classified as “financial indices” under Part IX as the UCITS can track the performance of the index through a variety of methodologies (replication, optimisation and stratified sampling strategies) and is not required to invest directly in the “index” (i.e. it is not purchasing all the securities in the S&P 500 by way of example).

On the basis of the above and our understanding of the ESMA Guidelines, we submit:

- (a) Part V of the ESMA Guidelines applies to all indices (regardless of whether they are approved as financial indices) as supported by the use of the term **index**;
- (b) Part IX of the ESMA Guidelines applies only to “financial indices” as supported by the introduction of the term “**financial index**” in this section;
- (c) “Financial indices” constitute indices which are availing of the increased diversification limits under the UCITS Regulations or which contain ineligible assets as supported by the continued

use of the term “investing in”, in reference to the UCITS “investing in” the “financial index”. Traditionally these indices were classified, as “financial indices”, as these were the only indices for which the prior approval of the Central Bank was required and which were required to meet the criteria in Guidance Note 2/07 issued by the Central Bank (“G/N 2/07”). We note that this continues to be the position as currently stated in G/N 2/07;

- (d) Indices which a UCITS intends to track the performance of but which the UCITS could invest in on a “look-through” basis regardless of whether they meet the criteria of G/N 2/07 and Part IX of the ESMA Guidelines are not classified as “financial indices”; and
- (e) We note that in relation to points (c) and (d) this was also the previous position of the Central Bank as outlined in this note and continues to be the current position as stated in G/N 2/07.

We would be grateful if you could confirm that you are in agreement with our interpretation. In particular in relation to the distinction we understand to be drawn in the ESMA Guidelines between UCITS which track the performance of an index where the provisions of “Part V” apply and the separate, distinct and additional requirements applicable to “financial indices” set out in “Part IX”.

### **Central Bank policy in relation to the approval of financial indices**

The previous position adopted by the Central Bank was that for funds that proposed to use an index for replication or tracking purposes, it was not necessary to submit that index to the Central Bank for clearance if, on a “look-through” basis, it is possible for the UCITS to invest directly in the constituents of the index in accordance with the UCITS Regulations, for example the “5/10/40” rule as applied to debt and equity securities. We note that G/N 2/07 maintains this position and states that no index submission is required in such instances. As a result, indices which were investable on a look-through basis were not classified as “financial indices” as they were not approved by the Central Bank as such.

An index submission was, however, required to be made to the Central Bank under the previous policy, if it was not possible for the UCITS to invest directly in such underlying assets, without transgressing the risk-spreading limits of the UCITS Regulations or if the index included ineligible assets. It was only these indices which were specifically approved by the Central Bank which were classified as “financial indices”.

We believe the current position is correct and should not change particularly as the ESMA Guidelines requires the UCITS to satisfy itself as to (and be able to demonstrate) compliance of a financial index with the ESMA Guidelines. We would be grateful if you could confirm this position.

In the event that you consider the ESMA Guidelines to apply in full to all indices, we seek confirmation that this does not preclude a UCITS from buying certain combinations of listed equities, for example, in proportions which comply with the standard UCITS diversification requirements (5/10/40) but which happened to mirror an index which has not been approved by the Central Bank as a “financial index”. Should the Central Bank determine otherwise would be a very significant development in the investment restrictions applicable to UCITS, as it effectively overrules the standard UCITS ability to invest in transferable securities in accordance with the diversification rules set out in the Directive. The UCITS

Directive makes it clear that the ability to increase diversification requirements where a UCITS is taking exposure to an index is intended as an exception to and an expansion on the standard UCITS investment rules and we do not therefore believe that it is legally possible for these provisions (relating to financial indices) to be used to introduce a restriction on such standard UCITS investment rules.

### **Eligible Assets Directive**

The ESMA Guidelines could be interpreted as requiring the underlying financial indices of FDI held by Non-Index Tracking UCITS to always to comply with the 20/35% rule contained in Article 53 of the UCITS Directive. To date, UCITS have been allowed to invest in FDI on an underlying financial index which do not comply with the 20/35% rule provided that the UCITS applies a “look-through” approach and in applying a “look-through” approach does not breach the 5/10/40 rule (i.e. when its indirect exposure (via the index) was aggregated with its directly held portfolio, it complies with the 5/10/40 rule). In our view, this position should not be altered by the ESMA Guidelines.

The Eligible Assets Directive (which is still in effect) suggests that financial indices are a separate category of permitted investment for UCITS when they are using FDI. In this regard, it is worth noting that Article 9(2) of the Eligible Assets Directive which provides,

*“Where the composition of assets which are used as underlyings by financial derivatives in accordance with Article 19(1) of Directive 85/611 does not fulfil the criteria set out in paragraph 1 of this Article, those financial derivatives shall, where the criteria contained set out in Article 8(1) of this Directive, be regarded as financial derivatives on a combination of the assets referred to in points (i), (ii) and (iii) of Article 8(1)(a).”*

The Eligible Asset Directive therefore clearly contemplates that a UCITS may invest in a FDI where an underlying financial index does not comply with the 20/35% rule (i.e. the index tracking rule). It is in our view consistent with the Eligible Assets Directive and should not be amended. Our understanding is that an EU Directive cannot be amended by means of ESMA Guidelines and consequently, the ESMA Guidelines should be interpreted on this basis.

We would be grateful for your thoughts in relation to the points raised in this letter and would welcome the opportunity to discuss further, should you think this necessary.

Yours sincerely



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Kieran Fox (IFIA)