European Securities and Markets Authority

Final Report

Guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS

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Acronyms used

ESMA	European Securities and Markets Authority
CESR	Committee of European Securities Regulators
UCITS	Undertakings for Collective Investment in Transferable Securities
KII	Key Investor Information
CPPI	Constant Proportion Portfolio Insurance
VaR	Value-at-Risk
SMSG	Securities and Market Stakeholder Group

I. Executive Summary

Reasons for publication

Structured UCITS offer investors a predefined payoff depending on different scenarios based on the value of the underlying assets. ESMA considers that it is appropriate to put in place, for certain types of structured UCITS, an optional regime for the calculation of the global exposure using the commitment approach.

Contents

This paper sets out ESMA's guidelines on risk measurement and the calculation of global exposure for certain types of structured UCITS. These guidelines supplement CESR's guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (Ref. CESR/10-788) published in July 2010 (hereafter 'the General Guidelines').

These guidelines propose, for certain types of structured UCITS, an optional regime for the calculation of the global exposure using the commitment approach.

The specific approach adopted by ESMA consists of the calculation, for each scenario to which investors can be exposed at any one time, of the global exposure using the commitment approach. Under this approach, each scenario must comply at all times with the 100% global exposure limit using the General Guidelines.

ESMA considers that the scope of this alternative approach must be clearly defined. Therefore, a list of all the criteria with which structured UCITS should comply in order to be able to benefit from this specific approach is set out in Guideline 1 in Section II of this paper. A number of examples have also been included to illustrate how the optional regime should be applied in practice. Guideline 2, meanwhile, sets out additional disclosure obligations on UCITS that make use of the optional regime.

ESMA also considers that under certain circumstances structured UCITS that have been authorised before 1 July 2011 should not be required to comply with Boxes 1 to 25 of the General Guidelines, provided they comply with any rules set by their home State competent authority for the calculation of global exposure.

II. Policy approach

1. When developing the guidelines, ESMA took into account the feedback received from stakeholders during the public consultation. ESMA also assessed the costs and benefits of its proposals. The feedback statement and cost-benefit analysis are included in the Annexes I and III of this report respectively.

Guideline 1

1. UCITS which comply in full with the criteria in paragraph 2 may calculate global exposure using the commitment approach in the way described in the paragraph 3.

2. The criteria are:

   a) the UCITS is passively managed and structured to achieve at maturity the pre-defined payoff and holds at all times the assets needed to ensure that this pre-defined payoff will be met;

   b) the UCITS is formula-based and the pre-defined payoff can be divided into a limited number of separate scenarios which are dependent on the value of the underlying assets and which offer investors different payoffs;

   c) the investor can only be exposed to one payoff profile at any time during the life of the UCITS;

   d) the use of the commitment approach as defined in the General Guidelines to calculate global exposure for the individual scenarios is appropriate taking into account the requirements of Box 1 of the General Guidelines;

   e) the UCITS has a final maturity not exceeding 9 years;

   f) the UCITS does not accept new subscriptions from the public after the initial marketing period;

   g) the maximum loss the UCITS can suffer when the portfolio switches from one payoff profile to another must be limited to 100% of the initial offer price; and

   h) the impact of the performance of a single underlying asset on the payoff profile when the UCITS switches from one scenario to another complies with the diversification requirements of the UCITS Directive based on the initial net asset value of the UCITS.

3. The calculation method is the commitment approach as described in the General Guidelines but adjusted in the following way:

   a) The formula-based investment strategy for each pre-defined payoff is broken down into individual payoff scenarios.

   b) The financial derivative instruments implied in each scenario are assessed to establish whether the derivative may be excluded from the calculation of global exposure under the provisions of Box 3 or Box 4 of the General Guidelines.

c) Finally the UCITS calculates the global exposure of the individual scenarios to assess compliance with the global exposure limit of 100% of NAV.

4. UCITS which satisfy the criteria set out in paragraphs 2 (a), 2 (b), 2 (c) and 2 (d) above and which were authorised before 1 July 2011 are not required to comply with Boxes 1 to 25 of the General Guidelines provided they comply with any rules set by their home State competent authority for the calculation of global exposure.

2. In accordance with the requirements of paragraph 3 of Box 1 of the General Guidelines it is the responsibility of the UCITS to select an appropriate methodology to calculate global exposure. Structured UCITS may use the standard commitment or VaR approach to calculate global exposure. The UCITS may also adopt an optional regime using the commitment approach in accordance with the provisions of Guideline 1 above. This permits the UCITS to calculate the global exposure of each individual scenario using the commitment approach. The characteristics of each individual scenario must be compatible with the use of such an approach. This excludes scenarios relying on complex investment strategies or exotic derivatives, as stated in paragraph 4 of Box 1 of the General Guidelines.

3. Structured UCITS for the purposes of the UCITS KII requirements are defined as UCITS which provide investors, at certain predetermined dates, with algorithm-based payoffs that are linked to the performance or the realisation of price changes or other conditions, of financial assets, indices or reference portfolios or UCITS with similar features. The KII provides a broad definition of structured UCITS; however, only those structured UCITS which satisfy the criteria in paragraph 2 of Guideline 1 may calculate the global exposure using the method outlined in Guideline 1.

4. For each structured UCITS portfolio a number of different scenarios may be generated based on the possible payoff outcome at maturity. ESMA expects that UCITS should not include a significant number of different scenarios as this would raise issues regarding proper disclosure and investor comprehension.

5. Actively managed UCITS or UCITS which do not follow a formula-based approach and offer investors a predefined payoff cannot use the approach set out in Guideline 1. However, paragraph 2 (a) of Guideline 1 does not preclude a UCITS from actively managing its counterparty relationship; this includes changing counterparties, managing collateral and restructuring the derivative where necessary to take account of subscriptions and redemptions. A UCITS which follows a CPPI strategy is not considered to be passively managed. Where the structured UCITS gains exposure to an underlying fund or index or other type of managed portfolio, these structures must also be passively managed.

6. UCITS are required to provide redemption facilities to investors in accordance with Article 84 of the UCITS Directive. Investors who redeem units in these structured UCITS prior to maturity do not benefit from the pre-defined payoff and can be subject to the volatility of the underlying assets and fluctuations in the net asset value. It is considered that structured UCITS with longer maturities could increase these volatility risks to redeeming investors and a maximum period is therefore set. The maturity of the structured UCITS shall be measured as of the end of the initial offer period when the derivative is entered into. ESMA expects that the initial offer period for a structured UCITS should generally not exceed 3-6 months.

7. When a UCITS adopts the optional regime, it calculates the global exposure on each individual scenario. This calculation method is appropriate when the subscription is done during the initial offer period. However, a complete closing of the fund may have a negative impact on the pricing of the derivatives, as counterparties would know that trades would be only in one direction. Therefore, the UCITS may not accept new subscriptions from the public after the initial offer period. This can include the provision of limited subscription facilities with a high minimum subscription charge. This does not prevent the UCITS from taking measures to deal with mispricing risk associated with the derivative.

8. Structured UCITS which provide investors with exposure in excess of 200% of the performance of an index or underlying portfolio would not meet the global exposure requirements as set out in Article 51(3) of the UCITS Directive. As such, they are not permitted.

9. When the global exposure is calculated on each individual scenario, the UCITS should be able to measure the loss due to the switch from one scenario to another. This loss/ gap is calculated at the time of the switch, when the underlying hits the barrier, and it depends on the payoff profile at the current market conditions. The loss limit (100% of the initial net asset value) has the objective of limiting the gap due to the barrier event.

<u>Example 1:</u>

Maturity	5 years
Underlying index	Eurostoxx 50 index. Initial net value of €100
Payoff	• If the index decreases by more than 60% then the payoff is equal to the performance of the Eurostoxx 50 index. • Otherwise the payoff is equal to the initial net asset value plus a dividend of €30.

10. When the index crosses the barrier, its performance is equal to -60%. So, the payoff moves from €130 to €40. The loss the UCITS suffers when it switches from scenario 2 to scenario 1 is equal to 90% of the initial net asset value. This complies with the maximum loss limit.

<u>Example 2:</u>

Maturity	5 years
Underlying index	Eurostoxx 50 index. Initial net asset value of €100
Payoff	• If the index decreases by more than 60% then the payoff is equal to the performance of the Eurostoxx 50 index. • Otherwise the payoff is equal to the initial net asset value plus a dividend of €50.

11. In this case, at the time of the switch, the performance of the Eurostoxx 50 index is equal to -60% and the payoff moves from €150 to €40. The loss due to the switch from scenario 2 to scenario 1 is equal to 110% of the initial net asset value. This does not comply with the maximum loss limit required.

12. UCITS must take into account the diversification requirements of the UCITS Directive based on the initial net asset value of the UCITS in considering the impact of one constituent in the underlying basket on the overall payoff profile when the UCITS switches from one scenario to another. This means that the UCITS must identify the asset which leads to this switch and check that its contribution

to the gap between the two scenarios complies with the diversification requirements of the Directive. If the switch depends on several assets, then the contribution of each asset to the gap between the two scenarios should comply with the diversification rules. For a basket of individual securities the 5%/10%/40% rule must be complied with. For other types of underlying asset, e.g. funds of funds or financial indices, the UCITS must respect the relevant investment restrictions contained in Articles 52-55 of the UCITS Directive. The following examples illustrate this issue.

Example 3:

Maturity	5 years
Underlying assets	basket of 20 shares (share 1, share 2... share 20) equally weighted. Initial net asset value of €100
Payoff	• If the performance of all of the shares is positive then the payoff is equal to the initial net asset value plus a dividend of €30. • If the performance of one of the shares is negative then the payoff is equal to the initial net asset value.

13. As the movement on the performance of one share from positive to negative value results in a variation of 30% of the payoff, this does not comply with the diversification rules.

Example 4:

Maturity	5 years
Underlying assets	basket of 20 shares (share 1, share 2... share 20) equally weighted. Initial net asset value €100
Payoff	• If the performance of all of the shares is positive then the payoff is equal to the initial net asset value plus a dividend of €30, • If the performance of one of the shares is negative then the payoff is equal to the initial net asset value plus a dividend of €26.

14. As the movement on the performance of one share from positive to negative value results in a variation of less than 4% of the payoff, this complies with the diversification rules.

Example 5:

Maturity	5 years
Underlying assets	basket of 20 shares (share 1, share 2... share 20) equally weighted. Initial net asset value of €100
Payoff	• If the performance of two or more of the shares is negative then the payoff is equal to the initial net asset value of €100. • Otherwise the payoff is equal to the initial net asset value plus a dividend of €30 i.e. €130.

15. As the movement on the performance of at least two shares from positive to negative results in a variation of 30% of the net asset value, this does not comply with diversification rules.

Example 6:

Maturity	5 years
Underlying assets	basket of 20 shares (share 1, share 2... share 20) equally weighted. Initial net asset value of €100
Payoff	• If the performance of two or more of the shares is negative then the payoff is equal to the initial net asset value plus a dividend of €20 i.e. €120. • Otherwise the payoff is equal to the initial net asset value plus a dividend of €28 i.e. €128.

16. As the move on the performance of two or more shares from positive value to a negative one induces a variation of at most 8% of the net asset value, this complies with diversification rules.

Example 7:

Maturity	5 years
Underlying assets	basket of 20 shares (share 1, share 2... share 20) equally weighted. Initial net asset value of €100
Payoff	• If the performance of all of the shares is positive then the payoff is equal to the initial net asset value plus a dividend of €100 = €200, • Otherwise, if the performance of at least one share is negative the payoff is equal to the initial net asset value plus the performance of the equally weighted basket (minimum redemption = €100)

17. As the movement in the performance of only one share to negative could result in a reduction of 100% in the payoff profile this example does not comply with the diversification rules.

Example 8:

Maturity	5 years
Underlying assets	basket of 20 shares (share 1, share 2... share 20) equally weighted. Initial net asset value of €100
Payoff	• If the performance of the “best performer” share is equal to or greater than 30% then the payoff is equal to the initial net asset value plus a dividend of €20. • Otherwise the payoff is equal to the initial net asset value.

18. As the movement in the performance of one share i.e. the best performer results in a reduction of 20% in the payoff profile this example does not comply with the diversification rules

19. The following examples illustrate how UCITS applying different scenarios can calculate global exposure using the procedure outlined in Guideline 1.

Maturity	5 years
Pay-off	The payoff at maturity is equal to the investor’s initial investment plus 120% of the positive performance of the Eurostoxx 50 index. At maturity: Scenario 1 - If the performance of the Eurostoxx 50 index is positive (e.g. +30%) then

	the payoff is equal to the initial investment (e.g. €1,000 plus 120% of the performance of Eurostoxx 50 index €1,000*(100%+(120%*30%))=€1,360 Scenario 2 - If the performance of the Eurostoxx index is negative then the payoff is equal to the initial investment i.e. €1,000

20. First of all, the fund must select an appropriate methodology to calculate global exposure between the one set out in the General Guidelines (i.e. commitment approach, relative VaR approach or absolute VaR approach).

21. If the commitment approach is used, the UCITS can either calculate its commitment on its whole investment portfolio or on individual scenarios.

22. The latter calculation relies on breaking down the final payoff of the UCITS into separate, alternative scenarios and on applying the commitment approach and diversification rules to each individual scenario. The outcome of this calculation depends on how the UCITS is structured.

The alternative scenarios into which the UCITS can be broken down are the following: Scenario 1: the payoff is equal to the initial investment plus 120% of the performance of the Eurostoxx 50 index (if the performance of the Eurostoxx 50 index is positive); Scenario 2: the payoff is equal to the initial investment (if the performance of the Eurostoxx 50 index is negative).

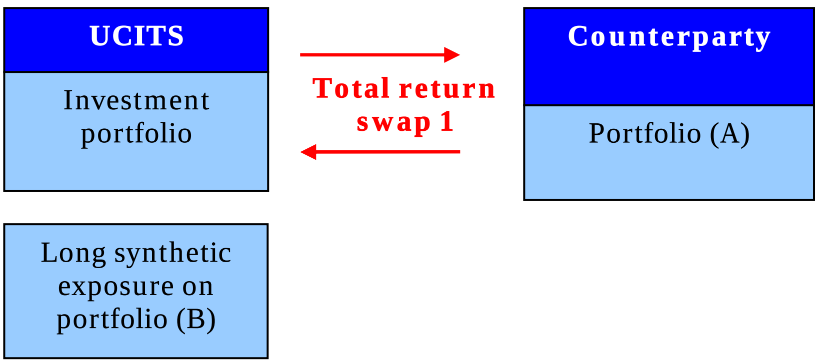
Case 1: The UCITS enters into a total return swap (including fully funded swaps) with a counterparty

In scenario 1, the UCITS can be seen as a combination of:

a) an investment portfolio;

b) a total return swap which exchanges the total return of the fund investment portfolio for a portfolio (A) which offers 100% of the initial NAV and 100% of the performance of Eurostoxx 50; and

c) a long synthetic exposure on a portfolio (B) which offers synthetic exposure on 20% of the performance of Eurostoxx 50.



23. Since the combination of (a) and (b) fulfils the criteria of Box 3 of the General Guidelines, the total return swap is not taken into account for the calculation of global exposure.

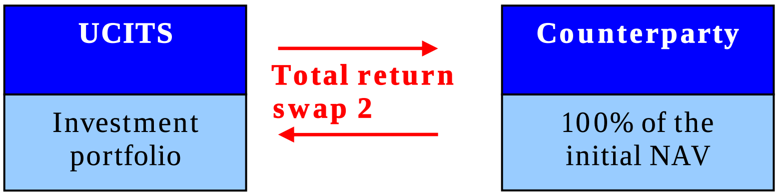
24. The long synthetic exposure on portfolio (B) is taken into account for the calculation of global exposure. Its commitment is equal to the market value of the underlying; that is 20% of the Eurostoxx 50 index.

25. Since the payoff under scenario 1 is equal to the initial investment plus 120% of the Eurostoxx 50, this leads to a global exposure of 0.2 for scenario 1.

In scenario 2, the UCITS can be seen as a combination of:

a) an investment portfolio; and

b) a total return swap which exchanges the performance of that investment portfolio for 100% of the initial investment.



26. Since the combination of (a) and (b) fulfils the criteria of Box 3 of the General Guidelines, the total return swap is not taken into account for the calculation of global exposure. This leads to a global exposure of 0 for scenario 2.

Case 2: The fund invests in risk-free assets and enters into a performance swap with a counterparty

In scenario 1, the UCITS can be seen as a combination of:

a) cash invested in risk-free assets;

b) a futures contract F1 on 100% of Eurostoxx 50; and

c) a futures contract F2 on 20% of Eurostoxx 50.

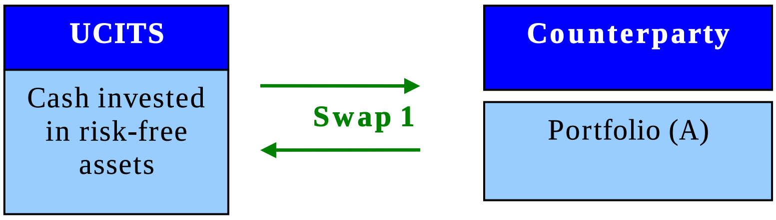
27. Since the combination of (a) and (b) fulfils the criteria of Box 4 of the General Guidelines, future F1 is not taken into account for the calculation of global exposure.

28. The futures contract F2 is taken into account for the calculation of global exposure. Its commitment is equal to 20% of Eurostoxx 50. Since the payoff under scenario 1 is equal to the initial investment plus 120% of Eurostoxx 50, this leads to a global exposure of 0.2.

In scenario 2, the UCITS can be seen as a combination of:

a) cash invested in risk-free assets; and

b) a swap which exchanges the return of that investment portfolio for 100% of the initial NAV.



29. Since the combination of (a) and (b) fulfils the criteria of Box 4 of the General Guidelines, the swap is not taken into account for the calculation of global exposure. This leads to a global exposure of 0 for scenario 2.

Case 3: The fund invests in high quality assets and enters into a swap with a counterparty

In scenario 1, the fund can be seen as a combination of:

a) cash invested in low-risk but not risk-free assets;

b) a futures contract F1 on 100% of Eurostoxx 50; and

c) a futures contract F2 on 20% of Eurostoxx 50.

UCITS
Cash invested in low-risk assets
A futures contract F1 on 100% of the Eurostoxx
A futures contract F2 on 20% of the Eurostoxx

30. Since cash is not invested in risk-free assets, (a) and (b) cannot be combined under the provisions of Box 4 of the General Guidelines. Commitment is thus equal to the commitment of the futures contract F1 plus the commitment of the futures contract F2. This leads to a commitment of 120% of Eurostoxx 50 and a global exposure of 1.2. The UCITS does not comply with global exposure requirements.

31. The UCITS can calculate its global exposure using the relative VaR approach provided the VaR model is adequate and captures the credit risk of the assets held by the UCITS.

32. Structured UCITS authorised prior to the implementation of the General Guidelines and which satisfy the criteria of paragraphs 2(a), 2(b), 2 (c) and 2(d) of Guideline 1 do not need to comply with Boxes 1 to 25 of the General Guidelines. This is due to the fact that the criteria in Box 1 were not in place when these UCITS where launched and if the UCITS portfolio were adjusted to comply with the new guidelines, this would affect the pre-defined payoff to investors at maturity. This would not be in the best interests of investors as they invested in the UCITS on the basis of the pre-defined payoff. While these existing structured UCITS may continue to accept new subscriptions, they cannot actively market their units. Structured UCITS can only benefit from this grandfathering provision using their current payoff profile; where a UCITS makes any changes to the derivative which results in a new payoff profile or scenario it must comply in full with the guidelines.

Guideline 2

1. UCITS management companies which make use of the approach for the calculation of global exposure outlined in Guideline 1 should ensure that the prospectus:

   (a) contains full disclosure regarding the investment policy, underlying exposure and payoff formulas in clear language which can be easily understood by the retail investor; and

   (b) includes a prominent risk warning informing investors who redeem their investment prior to maturity that they do not benefit from the predefined payoff and may suffer significant losses.

Explanatory Text

33. It is important that investors properly understand the impact of the different scenarios within a structured UCITS and whether, for example, their capital is protected. The prospectus should also disclose the impact on investors who redeem prior to maturity and do not benefit from the pre-defined payoff, including capital protection where relevant.

Annex I

Cost-benefit analysis

<u>Why to develop guidelines for the risk measurement and the calculation of the global exposure and counterparty risk for UCITS?</u>

34. Article 51(3) of the UCITS Directive places a cap on 'global exposure' (i.e. the extent to which the UCITS is impacted by movements in underlying asset values). While the assessment of such global exposure is relatively simple for straight equity funds, it can be more complicated for other funds. While Commission Recommendation 2004/383/EC outlined two broad methodologies (a so-called 'commitment approach' and an alternative methodology based on the calculation of Value-at-Risk (VaR) figures), there are significant variations at the national level, including as to the degree of prescription.

35. There is a high level of divergence regarding the implementation of the limit stipulated in the UCITS Directive (Article 51(3)). For instance, over one third of Member States require exposures arising from derivatives to be included; others do not. Less than half of the Member States adapt risk measurement methodologies to the risk profile of a UCITS – the 'Commitment' approach, VaR or other sophisticated methodologies are allowed to varying degrees, and Member States differ widely as to the parameters they require to be used within these methodologies. A half of the Member States require stress testing to help manage risks related to abnormal market movements, while only some Member States require back-testing of the risk measurement model against historic circumstances.

36. Article 41(3) of the Commission Directive 2010/43/EU provides that Member States may allow management companies to calculate global exposure by using the commitment approach, the value at risk or other advanced risk measurement methodologies as may be appropriate. According to the same Article, "VaR" shall mean a measure of the maximum expected loss at a given confidence level over a specific time period.

37. Article 42 of the Commission Directive 2010/43/EU provides some level of prescription for the use of the calculation of the global exposure with the commitment approach. Indeed, each financial derivative instrument position shall be converted into the market value of an equivalent position. Netting and hedging arrangements when calculating the global exposure may be allowed by Member States and temporary borrowing arrangements entered into on behalf of the UCITS need to be included in the global exposure calculation.

38. Level 2 measures do not prescribe what should be for instance the methodology for the conversion of financial derivative instrument position into the equivalent market value or what should be the parameters for the computation of the global exposure when using the VaR approach. Therefore, CESR considered whether or not it should provide with detailed rules on how to apply the provisions provided by the Commission Directive 2010/43/EU in terms of risk measurement for the calculation of global exposure and counterparty risk. The outcome of the absence of CESR guidelines in this field would be that UCITS depending on where they are established could calculate the global exposure or the counterparty risk in a different manner which would be detrimental for investor protection.

39. Therefore, it was decided that the Commission Directive 2010/43/EU should be accompanied by CESR's guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS. In July 2010, CESR published guidelines in this area (Ref. CESR/10-788).

Why to develop guidelines for the risk measurement and the calculation of the global exposure for certain types of structured UCITS?

40. There are certain UCITS that offer investors a predefined payoff at the end of a specific maturity on the understanding that they remain invested until the maturity of the fund. These types of fund are passively managed and structured to achieve at maturity the pre-defined payoff and hold at all times the assets needed to ensure that their pre-defined payoff will be met. The structured return usually depends on the value of underlying assets. Investors who redeem their units prior the maturity will not benefit from the agreed payoff and will be exposed to the market risk of the underlying portfolio of the swap.

41. In the consultation paper (Ref. CESR/10-118) setting out CESR's proposed guidelines for Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR sought stakeholders' views on the need for a specific regime for the calculation of the global exposure for certain types of structured UCITS.

42. Indeed, structured UCITS are managed in order to provide investors with a predetermined pay-off at the maturity of the fund. They can achieve this, for example, by entering into derivatives transactions that guarantee that the pre-determined pay-off will be achieved. The manager of the fund thus does not have much flexibility to follow the requirements set out in the guidelines. He is completely constrained to achieve the pre-determined formula that has been promised to investors and therefore may infringe the guidelines in a purely passive way.

43. The pay-off may depend on some conditions related to some specific securities. For example, the manager will enter into barrier options and, if the value of the security is close to the barrier/trigger price of such option and if the maturity is close, the delta of such option can be very significant and volatile, and could lead to an infringement of the global exposure limit (even with a VaR methodology) as set out in CESR's consultation paper on the proposed guidelines.

44. In order to be able to take into account fully the feedback from the public consultation on this issue, CESR committed itself to carry out further work to assess whether it would be appropriate for certain types of structured UCITS to use other methodologies to calculate the global exposure.

ESMA's proposal for guidelines

45. Taking into account the discussion with industry representatives and further reflection on this issue, CESR published a consultation paper (Ref. CESR/10-1253) on 18 November 2010 setting out a proposition for an alternative approach to the application of the existing guidelines.

46. The specific approach consists of the calculation, for each scenario to which investors can be exposed at any one time, of the global exposure using the commitment approach. Under this approach, each

scenario must comply at all times with the 100% global exposure limit using the existing CESR's guidelines. Therefore, CESR's proposal consisted in an alternative application of the commitment approach as set out in existing guidelines rather than a specific regime.

47. ESMA considered that the scope of this alternative approach must be clearly defined. Therefore, a list of all the criteria with which structured UCITS should comply in full in order to be able to benefit from this specific approach was developed by ESMA. These criteria and the possible alternatives are, inter alia:

- The UCITS is passively managed and structured to achieve at maturity the pre-defined payoff and holds at all time the assets needed to ensure that this pre-defined payoff will be met.

  The alternative approach for the calculation of the global exposure for structured UCITS using the commitment approach cannot be used by actively managed UCITS or by UCITS which do not follow a formula-based approach and offer investors a pre-defined payoff. However, ESMA considered that there should be some flexibility allowing asset managers to actively manage the relations with derivatives counterparties, managing collateral and restructuring the derivative where necessary. Indeed, if ESMA would not have adopted this approach, it would have been detrimental for investors since asset managers of structured UCITS must be able to make the necessary adjustments to the swap during the life of the fund in order to be able to deliver the promised payoff to investors at maturity.

- The UCITS has a final maturity not exceeding 9 years.

  ESMA considered whether to impose a cap on the final maturity of funds wishing to make use of this optional approach. Not imposing a cap would have potentially allowed structured UCITS to be created with extremely long maturities; ESMA was of the view that this would have increased volatility risk for investors who redeem before maturity. Even taking into account the possible mitigation of this risk via disclosure, ESMA was of the view that a cap of some kind was nonetheless necessary. The next step was to decide the appropriate level for the cap. One option was to extend the maturity limit to 15 years in order to take into account the future demands in the market (e.g. pension plans). However, ESMA did not consider this option appropriate as there would still have been an unacceptably high volatility risk borne by investors redeeming before maturity. Therefore, ESMA decided to impose a maturity limit of 9 years on the basis that it represented an appropriate balance between flexibility for UCITS managers in structuring their offerings while taking due account of potential risks for the investor.

- The UCITS does not accept new subscriptions from the public after the initial marketing period.

  ESMA considered whether to require structured UCITS to be closed for new subscriptions after the initial marketing period. Indeed, when UCITS adopts the optional regime for the calculation of global exposure, it calculates the global exposure on each individual scenario. This calculation method is appropriate when the subscription is done during the initial offer period. The next step was to decide if the structured UCITS should be legally closed or if a requirement not to accept new subscriptions from the public was sufficient. ESMA's preference was for the latter on the basis that if structured UCITS are required to be closed to new subscriptions, this may have a negative impact on the price of the underlying financial derivatives obtained by the fund (as counterparties would know that trades in the secondary market would be in one direction (selling)).

- The maximum loss the UCITS can suffer when the portfolio switches from one payoff profile to another must be limited to 100% of the initial offer price.

  ESMA considered whether to require a limit to the loss the UCITS can suffer when the portfolio switches from one payoff to another. Not imposing a limit would have potentially allowed asset managers to develop structured UCITS with a very large gap between the scenario where there is a much greater likelihood to have a negative performance rather than a positive one. Therefore, ESMA decided to limit this gap to 100% of the initial offer price.

- The impact of the performance of a single underlying asset on the payoff profile when the UCITS switches from one scenario to another complies with the diversification requirement of the UCITS Directive.

  ESMA considered whether the performance of a single underlying asset of the swap on the payoff profile should be limited or not. Not imposing a limit could potentially lead to situations where the impact of the performance of a single underlying asset on the payoff profile would be very significant. Thus, UCITS must take into account the diversification requirements of the UCITS Directive in considering the impact of one constituent in the underlying basket on the overall payoff when the UCITS switches from one scenario to another.

- Structured UCITS that comply with certain of the criteria set out in Box 1 of ESMA's guidelines and that have been authorised before 1 July 2011 should not be required to comply with the provisions of Boxes 1 to 25 of the existing CESR guidelines, provided they comply with any rules set by their home State competent authority for the calculation of global exposure.

  The alternative approach would have been to oblige all existing structured UCITS to comply with the existing CESR guidelines. This approach would have been detrimental for UCITS investors because it would have force asset managers to change the swap or the structure of the payoffs that were sold to the investor. Therefore, ESMA decided to grant a grandfathering rule for structured UCITS that have been authorised before 1 July 2011.

Annex II

Opinion of the Securities and Markets Stakeholder Group

48. According to Article 16 of the ESMA Regulation[1], when developing guidelines, ESMA shall, where appropriate, request opinions or advice from the Securities and Markets Stakeholder Group (SMSG). Article 37 of the Regulation provides the possibility for not consulting the SMSG if actions must be taken urgently and consultation becomes impossible.

49. In July 2010, CESR published the Guidelines on Risk Measurement and the Calculation of the Global Exposure and Counterparty Risk for UCITS (the General Guidelines). These guidelines will become applicable on 1 July 2011, the deadline for the transposition of the UCITS IV Directive. Structured UCITS cannot comply in full with the General Guidelines. Non-compliance by these funds would be detrimental to the interest of the investors that have invested in these funds.

50. As such, it was crucial that the Guidelines to competent authorities on risk measurement and the calculation of global exposure for certain types of structured UCITS be published as soon as possible in order to enable Member States to make the necessary legislative arrangements by 1 July 2011, when the General Guidelines will enter into force.

51. As the SMSG is yet to be established and in view of the urgency, the Board of Supervisors of ESMA decided to issue the guidelines without consulting the SMSG in order to avoid any further delay.

[1] 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)

Annex III

Feedback statement on the public consultation on the CESR's guidelines on risk measurement and calculation of global exposure for certain types of structured UCITS (Ref. CESR/10-1253)

Question 1: Do you agree with the proposed approach for the calculation of global exposure by certain types of structured UCITS which satisfy the criteria in paragraph 2 of Box 29[2]?

52. The proposed approach was overwhelmingly welcomed by respondents to the consultation. However some of them expressed concerns regarding the criteria in Box 29.

53. One respondent asked for clarification on the use and scope of the VaR approach to calculate global exposure for structured UCITS.

54. According to one stakeholder, the proposed approach was not relevant since these types of funds are designed to be held until maturity and it should not be necessary to calculate the global exposure via either the standard commitment approach, the optional commitment approach or the VaR approach.

55. One respondent took the view that all structured UCITS should comply with CESR's guidelines published in July 2010 and that there should not be any distinction in the calculation of global exposure for certain types of structured UCITS.

56. Confirmation was sought that structured UCITS should comply with all the criteria in Box 1 in order to be able to use this alternative calculation methodology.

57. Some respondents were of the view that the result of the calculation of the global exposure should give the same results regardless of how the fund is structured and that funds with the same payoff formula should have the same global exposure calculation.

ESMA deemed it necessary to stress that structured UCITS must comply with all the criteria of Box 1 in order to be able to use the alternative calculation methodology and amended the first sentence of paragraph 2 of Box 1 accordingly. Paragraph 90 of the explanatory text was also modified to clarify that structured UCITS may use the standard commitment approach or VaR approach to calculate global exposure but that they may also adopt an optional regime using the commitment approach in accordance with the provisions of Box 1.

[2] References in Annex III correspond to the numbering of the consultation on CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure for certain types of structured UCITS (Ref. CESR/10-1253)

Question 2: Do you agree with the proposed criteria for these structured UCITS?

58. Respondents to the consultation generally agreed with the proposed criteria except for the provision on the limitation on the maturity of the UCITS (criteria 2.e)) for which a majority of respondents asked for an extension to 15 years (see question 5) and the requirement to close the UCITS to new subscriptions after the initial marketing period (criteria 2. f)) (see question 6).

59. According to one respondent, criteria 2.h) was not necessary and not possible in practice because there will always be a market situation where the gap from one scenario to another would be higher than a predefined level. For the same stakeholder, the only practical approach to limit the loss between two scenarios is to do it through the payoff itself and this is what ESMA is proposing with the diversification rule.

60. One respondent disagreed with the criteria 2 c) because it conflicts with the reality and existing fund structures for which at any time before maturity there are usually several scenarios the investors could be exposed to. Therefore, a European trade association suggested redrafting the criteria along these lines 'at any given time during the life of the UCITS only one payoff profile applies to the investor'. This view was supported by a couple of stakeholders.

61. Some respondents also expressed concerns about the requirement that the structured UCITS must be passively managed. According to them, this should not prevent asset managers from actively managing the relations with derivatives counterparties, changing counterparties, managing inflows and outflows etc. On the same issue, one stakeholder was of the view that not only passively managed UCITS funds should be able to benefit from a different calculation approach and asked ESMA to define alternative risk measurement principles acceptable for actively managed structured UCITS funds.

ESMA took into the account the comment made by one respondent about the criteria 2.c) and modified the wording as follows: '*at any given time during the life of the UCITS only **one payoff profile** applies to the investor*'.

ESMA agreed with the remark formulated by some respondents about the passive management of the UCITS and acknowledged this requirement should not preclude a UCITS from actively managing its counterparty relationship. This would include changing counterparties, managing collateral and restructuring the derivative where necessary to take account of subscriptions and redemptions. Therefore, paragraph 14 of the explanatory text was modified to reflect this.

Question 3: Do you agree with the scope of the application of the alternative approach that derives from the criteria and global exposure calculation approach laid down in paragraph 2 of Box 29? If there are any specific criteria which could present difficulties for certain UCITS, could you elaborate on the reasons for your views and describe the types of UCITS concerned?

62. Respondents to the consultation generally agreed with the scope of the application of the alternative approach but some of them expressed the view that structured UCITS having an equivalent financial set-up and the same payoff should be submitted to an equivalent treatment.

Question 4: Can you suggest any alternative criteria?

63. No additional criteria were requested by stakeholders.

Question 5: Do you agree with the proposal to limit the maturity of structured UCITS which may apply the provisions of Box 29 to 9 years? Do you have any alternative suggestions?

64. A majority of respondents would have preferred a limitation of 15 years on the maturity of the UCITS in order to take into account the future demands in the market (e.g. pension plans). Stakeholders also stressed that the limit should start after the initial marketing period.

65. According to one stakeholder the limitation to 9 years was not appropriate and if there is to be a limit it should be determined on case-by-case basis.

66. Finally several stakeholders agreed with the proposed limit.

ESMA disagreed with the suggestion from stakeholders to limit the maturity of the structured UCITS to 15 years. Indeed, according to ESMA this would increase volatility risks for investors who redeem before maturity.

However, ESMA agreed with respondents that the maturity of the structured UCITS shall be measured as of the end of the initial offer period (i.e. when the derivative is entered into) but stressed that the offer period should not exceed 3-6 months.

Question 6: Do you agree with the proposal to prohibit these structured UCITS from accepting new subscriptions after the initial offer period?

67. A majority of respondents would have preferred a requirement that structured UCITS should not be actively marketed after the initial marketing period. According to these stakeholders, closing the fund would have a negative impact on the pricing of the derivatives obtained by the fund as counterparties would know that trades in the secondary market would be in one direction (selling).

68. Only six stakeholders fully agreed with the proposal.

ESMA recognised that the requirement to close the UCITS after the initial period could have a negative impact on the pricing of the derivatives.

Therefore, paragraph 2.f) of the Box 1 was modified requiring that UCITS should not accept new subscriptions from the public after the initial marketing period. The explanatory text (paragraph 95) was also modified to reflect this amendment.

Question 7: Do you agree with the proposed criteria to limit the maximum loss the UCITS can suffer under any individual scenario on any given day? Can you suggest any methods by which this loss can be limited or other safeguards which would deal with the risks posed by barrier-type features as described in Box 29?

69. Most of the respondents agreed with this criterion and stressed that the maximum loss was already limited by the diversification requirements.

70. However, one stakeholder disagreed with this proposition and asked for its deletion for capital protected structured UCITS. The same stakeholder was of the view that the need to have a limited difference between scenarios was disputable.

71. A couple of respondents sought confirmation from ESMA that this proposal does not mean that it is not acceptable to create a product where on a particular day the investor has suffered no loss, but on the following day the performance shifts the product into a different scenario and there is an extreme difference between the two payoffs.

ESMA considers it appropriate to amend the guidelines to limit the loss the UCITS can suffer when the payoff switches from one scenario to another. Indeed some respondents believe that the guidelines were vague with a requirement that the loss should be limited. Therefore, the final guidelines require the maximum loss the UCITS can suffer when the portfolio switches from one payoff profile to another must be limited to 100% of the initial offer price.

Two examples were added to the final guidelines in order to illustrate this requirement.

Question 8: Do you agree with the proposals regarding structured UCITS which were authorised before 1 July 2011? Do you have any alternative suggestions?

72. All the respondents except one welcomed the grandfathering rule introduced in the proposed guidelines.

Following the general agreement from respondents regarding the grandfathering rule, ESMA did not modify the guidelines.

However, it was felt necessary to clarify that only existing payoff profiles offered prior to the publication of these guidelines could benefit from the grandfathering rule and that in the case where existing structured UCITS want to create new formulas with different payoff profiles after the entry into force of these guidelines, they should comply with the guidelines.

Question 9: Are the examples provided in paragraph 97 useful in illustrating the diversification requirement?

73. Most of the respondents felt the examples provided in paragraph 18 were useful. However, some of them disagreed with the requirement that the impact of the performance of a single underlying asset on the payoff profile when the UCITS switches from one scenario to another should comply with the diversification requirements of the UCITS Directive based on the initial net asset value of the UCITS. According to one stakeholder, this requirement would ban some payoffs from the UCITS framework which would be detrimental for investor protection since the same payoffs will be sold using structured notes.

74. According to some respondents, to be more useful, these examples should be mutually exclusive and examples 1 and 2 should be drafted along the following lines: 'if the performance of one of all the shares is positive'.

75. According to one respondent, examples only refer to the 10% limit of the diversification requirements when they should refer to all the legal thresholds e.g. 5%/10%/40% rule. On the same issue, it was understood that only the 10% threshold should apply.

ESMA agreed with the comment made by some respondents about the examples and amended the guidelines accordingly. The guidelines were also amended to clarify that the reference to UCITS diversification requirements relates to all applicable restrictions set out in Articles 52-55 of the UCITS Directive depending on the asset class.

Question 10: Can you suggest alternative examples?

76. Some respondents suggested adding new examples to better illustrate the diversification rule. These examples clarify how payoffs based on 'the best performer' should be analysed.

ESMA agreed that the examples suggested by some stakeholders were useful and has added two of them in the guidelines under examples 7 and 8.

Question 11: Do you think the examples in paragraph 98 correctly explain how global exposure is calculated in different scenarios?

77. Most of the stakeholders believed that the examples in paragraph 98 correctly explain how global exposure is calculated in different scenarios.

78. However, several respondents suggested additional payoff structures that should be allowed. These structures are:
    - A fully collaterised repo with a counterparty + a performance swap;
    - Investment portfolio + performance swap + an external guarantee of the payoff.

79. Several stakeholders did not see the necessity for a different treatment for Case 2 versus Case 3. On the same issue, one respondent agreed that cash invested in non-risk free assets should lead to an increment of the product's global exposure, but found that the distinction between 'risk free' and 'high quality low risk' was arbitrary would lead to instability. Therefore, this stakeholder was of the view that the commitment approach should be allowed also for Case 3.

ESMA analysed carefully the comments received on the issue of the risk free assets. ESMA considers that several investment structures may be considered equivalent to an investment in risk free assets. However, ESMA decided not to give more details about this issue but to closely monitor market practices in relation to the interpretation of what is considered equivalent to risk free assets and consequently did not deem it appropriate to modify the final guidelines.

Question 12: Do you have alternative examples?

80. As stated in the question 11 above alternative examples were suggested.

Question 13: Do you agree with the proposed prospectus disclosure requirements in Box 30?

81. All the respondents except one agreed with the proposed prospectus disclosure requirements.

Following the general agreement from respondents for the proposed prospectus disclosure in Box 2 ESMA did not modify the guidelines.

Question 14: Is the terminology used in the guidelines clear? Are there any terms used for which you feel it would be helpful to have a definition?

82. Most of the respondents to the consultation considered that the terminology used in the guidelines is clear enough and did not consider it necessary to add further definitions to the glossary.

83. However, some respondents deemed it important to provide a definition for 'high quality', 'low risk', 'risk free', 'negligible and 'limited' in order to avoid any divergent interpretations.

ESMA did not consider it necessary to provide definitions for these terms but as stated in question 11 above it will closely monitor practices in relation to the interpretation of what is considered as equivalent to risk free assets.

Annex IV

Draft guidelines to competent authorities and UCITS management companies on risk measurement and the calculation of global exposure for certain types of structured UCITS

Table of Contents

I. Scope

1. These guidelines apply to *competent authorities* and *UCITS management companies*.

II. Definitions

2. For the purposes of these guidelines terms shown in italics have the meaning defined in the table below.

Competent authorities	Authorities designated under Article 97 of the *UCITS Directive*
UCITS management company	a company, the regular business of which is the management of UCITS in the form of common funds or of investment companies (collective portfolio management of UCITS)
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)
General Guidelines	Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS published by the Committee of European Securities Regulators (Ref. CESR/10-788)
ESMA	the European Securities and Markets Authority

III. Purpose

3. These guidelines supplement the requirements on calculation of global exposure relating to derivative instruments in Article 51(3) of the *UCITS Directive* and Articles 40 to 42 of Commission Directive 2010/43/EU. CESR was of the view that these provisions should be supplemented with more detailed guidelines on the calculation of global exposure, in order to avoid a situation in which the calculation method used by a UCITS could vary significantly depending on the rules of its home Member State. This led to the adoption of the *General Guidelines* in July 2010.

4. The purpose of these guidelines is to provide certain types of structured UCITS as described in guideline 1 with an optional regime for the calculation of the global exposure using the commitment approach.

IV. Compliance and reporting obligations

Status of the guidelines

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

6. Guidelines set out *ESMA*'s view of appropriate supervisory practices within the European System of Financial Supervision or of how Union law should be applied in a particular area. *ESMA* therefore expects all *competent authorities and* financial market participants to whom guidelines apply to comply with guidelines unless otherwise stated. Competent authorities to whom guidelines apply should comply by incorporating them into their supervisory practices, including where particular guidelines within the document are directed primarily at financial market participants.

Reporting requirements

7. *Competent authorities* must notify *ESMA* whether they comply or intend to comply with these guidelines, or with reasons for non-compliance, by [2 months after date of publication]. Notifications should be sent to [email address].

8. *UCITS management companies* are not required to report whether they comply with these guidelines.

V. Guidelines on risk measurement and the calculation of global exposure for certain types of structured UCITS

9. UCITS which comply in full with the criteria in paragraph 10 may calculate global exposure using the commitment approach in the way described in paragraph 11.

10. The criteria are:

    a) the UCITS is passively managed and structured to achieve at maturity the pre-defined payoff and holds at all times the assets needed to ensure that this pre-defined payoff will be met;

    b) the UCITS is formula based and the pre-defined payoff can be divided into a limited number of separate scenarios which are dependent on the value of the underlying assets and which offer investors different payoffs;

    c) the investor can only be exposed to one payoff profile at any time during the life of the UCITS;

[3] 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.

d) the use of the commitment approach as defined in the *General Guidelines* to calculate global exposure for the individual scenarios is appropriate taking into account the requirements of Box 1 of the *General Guidelines*;

e) the UCITS has a final maturity not exceeding 9 years;

f) the UCITS does not accept new subscriptions from the public after the initial marketing period;

g) the maximum loss the UCITS can suffer when the portfolio switches from one payoff profile to another must be limited to 100% of the initial offer price; and

h) the impact of the performance of a single underlying asset on the payoff profile when the UCITS switches from one scenario to another complies with the diversification requirements of the UCITS Directive based on the initial net asset value of the UCITS.

11. The calculation method is the commitment approach as defined in the *General Guidelines* but adjusted in the following way:

a) The formula-based investment strategy for each predefined payoff is broken down into individual payoff scenarios.

b) The financial derivative instruments implied in each scenario are assessed to establish whether the derivative may be excluded from the calculation of global exposure under the provisions of Box 3 or Box 4 of the General Guidelines.

c) Finally the UCITS calculates the global exposure of the individual scenarios to assess compliance with the global exposure limit of 100% of NAV.

12. UCITS which satisfy the criteria set out in paragraphs 10 (a), 10 (b), 10 (c) and 10 (d) above and which were authorised before 1 July 2011 are not required to comply with Boxes 1 to 25 of the *General Guidelines* provided they comply with any rules set by their home State *competent authority* for the calculation of global exposure.

13. UCITS management companies which make use of the approach for the calculation of global exposure outlined in these guidelines should ensure that the prospectus:

a) contains full disclosure regarding the investment policy, underlying exposure and payoff formulas in clear language which can be easily understood by the retail investor; and

b) includes a prominent risk warning informing investors who redeem their investment prior to maturity that they do not benefit from the predefined payoff and may suffer significant losses.