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UCITS III News

Pan-European UCITS III Newsletter

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Since our last newsletter of May 2005, the regulatory surge surrounding the asset management industry in general, and UCITS III-related issues in particular, has kept its rapid pace.

After the launch of CESR's first consultation on eligible assets, the Commission issued, in July 2005, its long awaited Green Paper on the future of asset management. On October 21, CESR issued its second consultation on eligible assets. This paper was closely followed by a consultation on the simplification of notification procedures.

Eligible assets

As discussed in Issue 11 of our UCITS III News, CESR had, in its first consultation on eligible assets, suggested several conditions for an instrument to be considered as a transferable security ("TS"). Further, the conditions under which a closed-ended fund would become UCITS III eligible, either as a TS, if listed, or under the 10% route of art. 19 (2) (a), appeared very burdensome. As a consequence, many closed-ended funds in which UCITS have today invested would potentially become prohibited investments. Finally, in the first consultation, CESR expressed some doubts on the use of derivatives for reasons other than "efficient portfolio management"!

Not surprisingly, the industry response to the consultation has been significant (more than 50 responses!), many of them quite strong. In a prudent move, CESR has agreed to launch the recently expired second consultation, concentrating on those issues which caused most controversy.

The proposed measures show a general relaxation of regulators. For example: concerning liquidity of TS, CESR now seems to accept to view liquidity as a whole at the portfolio level, rather than at the level of each security. Its prior position to assess liquidity security by security was unacceptable for many active asset managers!

CESR also indicates that closed-ended real estate and closed-ended private equity funds can be admissible in a UCITS, obviously provided they comply with the eligibility criteria applicable to TS. However, closed-ended hedge funds will probably still be excluded. This reluctance vis-à-vis hedge funds can also be found in CESR's position on derivatives on financial indices. Giving in to industry pressure, CESR is now willing to accept derivatives on commodity indices. But derivatives on hedge fund indices are, for the time being, still excluded. It seems that CESR still has doubts on the construction of these indices and their general representativeness. However, its position may evolve in one-year's time, as it undertakes to monitor this issue and hence gain additional experience.

Final advice from CESR to the Commission is expected mid-January 2006. It will be interesting to see how the transition for those UCITS, which may cease to be UCITS because they hold instruments now declared ineligible, will be tackled!

Notification procedure according to Section VIII of the UCITS Directive

Surfing on what can be seen as a real success, i.e. its February 2005 guidelines regarding transitional provisions, CESR has issued, on October 27, its consultation on future "guidelines for supervisors regarding the notification procedure". Again based on Level 3, this document, once finalised, should represent the general framework applicable on a voluntary basis by regulators in the context of the notification procedure a foreign fund must fulfil prior to being able to sell its units in a host member state.

The guidelines purport to clarify and simplify this procedure, which many recent reports and surveys have highlighted as being the "promoter's nightmare" in terms of time and costs. In addition to clarifications on translation and certification requirements, a proposed harmonised interpretation on the 2-month period and the question of marketing only selected sub-funds within an umbrella, CESR has devised useful standardised wording for the notification process. This includes (i) model attestations to be issued by the home state regulator; (ii) a model notification letter to be sent to the host state regulator, along with a list of all documents to be provided in accordance with the Directive as well as additional information requested by the host state; and (iii) an annex which should be completed by all regulators and posted on their website, listing those topics which are not harmonised by the Directive: national marketing rules and other specific national regulations.

This third proposal embodies the flaws of this simplification exercise, due to the fact that CESR is limited by provisions of the Directive. Indeed, art. 44 (1) and 45 leave residual powers to host member states regarding the marketing arrangements of UCITS. Failing a EU-wide definition on the meaning of “marketing”, a loophole that the Commission has been asked to urgently fill by CESR, the door remains open for local EU regulators to officially question the appropriateness of marketing arrangements, when they really want to question the fund’s investment policy itself!

Whereas hopes are getting higher on the subject of eligible assets, which includes clear comitology provisions, this current effort by CESR is unfortunately considered with significant scepticism by both the industry and regulators themselves.

In the meantime…

Failing harmonisation on the eligible assets and other issues, each country adopts its own interpretation which, for asset managers, raises the issue of an arbitrage in the choice of location!

Many examples exist – here is a few: Gold bullion securities can be acquired as a TS by a UK UCITS, but not a Luxembourg or French fund. Open-ended hedge funds are, under certain conditions, eligible for a French UCITS, open-ended real estate funds are eligible for French and Luxembourg UCITS, under the 10% “trash ratio”. Diversification rules are interpreted differently from one country to another: for example, the 10% limit of article 22 is envisaged at legal entity level in France, Ireland and Luxembourg. Germany and UK look at it at group level. Counterparty exposure calculations for OTC derivatives will be made differently whether the fund is established in France, Germany, Ireland, Luxembourg or the UK. This means that the risk level of the same transaction will not be the same depending on the fund’s country of origin!

Definitions (or absence thereof) of sophisticated UCITS, triggering specific risk measurement requirements, are far from being uniform in the five countries noted above, as are the parameters for the VaR approach.

There is still a long way to go…

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