

# UCITS III News

Pan-European UCITS III Newsletter

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**After the issue of its second consultation paper on eligible assets on October 21, 2005, already commented in our newsletter of December 2005, CESR has, in January 2006, issued its long awaited final recommendations on eligible assets.**

While clarifying some issues in a useful manner (for example, the interaction between Effective Portfolio Management and the use of derivatives!), it does not put an end to the diverging investment rules applicable to funds from one country to another. On another topic, one could have thought that questions relating to the transitional rules for UCITS funds were all cleared with CESR's recommendations of February 2005. Unfortunately, CESR has left unanswered the transitional situation of Self-Managed Investment Companies (SIAG), a popular vehicle in Luxembourg and Ireland.

## Eligible assets

The mission statement of CESR in relation to eligible assets was to find a common answer to questions raised in relation with specific products, such as structured financial instruments, closed-end funds, other UCIs, credit derivatives etc., and the conditions for their admissibility in a UCITS III fund. The purpose of this exercise being notably to build trust amongst regulators as to the instruments used by exporting UCITS. Pending EC regulation, expected to be issued in the second half of 2006, a wide gap remains today between countries' interpretation of the eligibility of certain instruments. In February 2006, we have made a short survey concerning the use of the 10% "trash ratio" by UCITS III funds located in 11 EU countries.

The results of this survey speak for themselves:

## Eligibility of "other transferable securities"

| Country   |                         | AT       | BE       | DE       | DK | ES       | FR       | IR           | IT       | LU | SW       | UK       |
|---|-------------------------|----------|----------|----------|----|----------|----------|--------------|----------|----|----------|----------|
| Which financial instruments currently fall under the scope of Art. 19 (2) (a) of the Directive? | REITS                   | ☺        | ☺        | ☺        | ☺  | ☺        | ☺        | ☺            | ☺        | ☺  | ☹        | ☺        |
|   | Closed-end F            | ☺<br>(1) | ☺<br>(2) | ☹        | ☺  | ☺        | ☹        | ☺            | ☹        | ☺  | ☹        | ☺        |
|   | Closed-end HF           | ?        | ☹        | ☹        | ☺  | ☺<br>(4) | ☹<br>(5) | ☺            | ☹        | ☺  | ☹        | ☹<br>(?) |
|   | Open-end HF             | ☹        | ☹        | ☹        | ☺  | ☺        | ☺        | ☹<br>(?) (7) | ☹        | ☹  | ☺<br>(9) | ☹        |
|   | Open-end REF            | ☹        | ☹        | ☹        | ☺  | ☺        | ☺        | ☹<br>(?) (7) | ☹<br>(8) | ☺  | ☹        | ☺        |
|   | FoF                     | ☹        | ☹        | ☹        | ☹  | ☺        | ☺        | ☹            | ☹        | ☹  | ☺        | ☹        |
|   | Gold Bullion Securities | ☹        | ☹        | ☹        | ☹  | ☹        | ☹        | ☹            | ☹        | ☹  | ?        | ☺        |
|   | Others                  | ☹        | ☹        | ☺<br>(3) | ☹  | ☹        | ☺<br>(6) | ☹            | ☹        | ☹  | ☹        | ☹        |

(1) Including closed-end real estate funds

(2) If unlisted and if underlying of the fund has its equivalent in Belgian legislation

(3) Promissory notes

(4) Provided they are similar to Spanish authorised HF products

(5) In principle not admissible as closed-end funds do not exist in France but potentially eligible if comply with 13 AMF criteria to accept hedge funds in UCITS

(6) Subscription rights, warrants, promissory notes, master-feeder-funds, venture capital funds venture capital funds (if 13 criteria by AMF are met)

(7) Irish regulator not that clear on eligibility of open-end hedge funds or real estate funds

(8) Open-end real estate funds in principle eligible but must comply with such stringent requirements that impossible in practice!

(9) Various conditions apply for eligibility

The main messages from this chart are (i) that every country is likely to accept REITS, save for Sweden; (ii) that both the French and the Spanish, traditionally seen as rather conservative authorities when it comes to foreign funds, seem fairly open to product innovation when it comes to their “trash” ratio. Germany, on the other hand, is quite in line with its principles: certain investments are not allowed in their domestic UCITS: hence it is difficult for BaFin to accept them in a foreign one. Some EU passports must burn more than others...

A second example of diverging interpretation, not even touched upon by CESR, is the application of the diversification rules now that the group concept has been introduced by Art. 22 (1) of the UCITS directive. This can lead to portfolios which would be regarded in one Member State as being compliant, in others as in breach. A general overview of the application of the group concept in the different Member States is given in the following table.

## Diversification rules

| Limits             | AT           | BE    | DE    | DK    | ES    | FR           | IR           | IT           | LU           | SW           | UK           |
|--------------------|--------------|-------|-------|-------|-------|--------------|--------------|--------------|--------------|--------------|--------------|
| 10%                | Legal entity | Group | Group | Group | Group | Legal entity | Legal entity | Legal entity | Legal entity | Legal entity | Legal entity |
| 5%/40%             | Legal entity | Group | Group | Group | Group | Legal entity | Group        | Legal entity | Legal entity | Legal entity | Legal entity |
| 20% combined limit | Group        | Group | Group | Group | Group | Group        | Group        | Group        | Group        | Group        | Group        |

## Transitional provisions for SIAGs

As already mentioned in our past newsletters, the transitional provisions for SIAGs are still unclear. As a reminder, the applicable CESR recommendations for transitional provisions state that all Management Companies must be UCITS III compliant by April 30, 2006 if they manage a UCITS III fund; the final deadline for all products created before February 2002 and not having launched any sub-fund thereafter, to be UCITS III compliant, is February 13, 2007. As the recommendations are mute about SIAGs, different regulators again may take different approaches regarding the treatment of UCITS III SIAGs which are not yet fully UCITS III compliant. Practically, what will happen between May 2006 and February 2007 with the registration abroad of e.g. a Luxembourg or an Irish SIAG, which is UCITS III compliant as per its home country rules (e.g. only the product

has been adapted), but not as per the host state's rules? We heard of different approaches from different regulators: they range from the pure acceptance of the UCITS certificate (Switzerland, Poland), to general acceptance of the passport, with however the need to contact the home state authority for “discussion” purposes only (Belgium), to further inquiries with regard to satisfaction of substance requirements (Italy, France), to the refusal of such products (Germany), or even the general prohibition of distribution (Austria).

In order to avoid the issues faced in the summer of 2004, where several regulators refused incoming UCITS because of their home country's interpretation of transitional provisions, SICAVs which are UCITS III compliant as regards product rules and which are sold on a cross-border basis should definitely attempt to be profession compliant sooner than later.

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