

UCITS III News

Pan-European UCITS III Newsletter

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As the end of the year approaches, the Commission is progressing on its implementing measures regarding the clarification of definitions related to eligible assets for UCITS.

A first working document was produced by the European Securities Committee of the Commission in mid-March 2006.

The legal form of the proposed draft implementing measure was that of a regulation, i.e. an instrument which is directly applicable in all Member States, without further need for national implementation.

In September, a second draft was produced by the Commission's services which, quite surprisingly, takes the form of a directive. The somewhat awkward reasoning behind this change of mind is, according to the accompanying background paper, twofold: one, the proposed measure could *"impact existing Member States' rules implementing the UCITS directive and Member States should hence be given the freedom to transpose the measure in their legal order in the most appropriate way."* Second, *"[...] some provisions of the directive are addressed to Member States' authorities and not applicable directly to individuals, leaving Member States' authorities some margin of appreciation."*

Whatever political or legal fight stands behind this change, it surely goes against the maximum harmonisation desire, expressed by many, to finally reach common ground as regards the definition of eligible assets!

Without analysing in depth this second ESC draft, which is still subject to change, one can see a few trends emerging:

- The end of the famous "look-through" approach for structured financial instruments ("SFI").

Still used by UCITS asset managers and auditors of Luxembourg, Austrian or French funds to determine whether a given SFI (listed or unlisted) is an eligible asset for a UCITS, the look-through approach consists of identifying the assets which back, or provide performance to, the SFI and assess whether these are in line with UCITS requirements. For example, a non-listed synthetic bond linked to oil or hedge funds is currently **not** permissible in the above countries: it will, however, become permissible, if the working paper remains as is in its final form, and provided always the SFI does not embed a derivative.

- In the same manner, financial indices are now, under certain conditions, admissible, even if their underlying is not an eligible asset. CESR had already opened the door for commodity and property indices: the current wording of the working document would also permit indices on hedge funds or other previously prohibited underlying assets! It remains to be seen what will be the outcome of CESR's review on the question of hedge funds indices, scheduled for this fall.
- As regards derivatives, the working document clearly excludes derivatives on commodities. A closed-ended fund would become a transferable security subject to several conditions, often difficult to verify – no look-through approach would be required, as for SFI's.

If implemented as such in its final form, which is expected in January 2007, the draft directive will provoke quite a few changes in some countries' practice as regards eligible assets.

We have tried to update the chart issued in our last UCITS III News of April 2006, prepared on the basis of a survey made in February 2006. The survey concerned the eligibility of certain instruments in the 10% trash ratio:

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-ended F	☺ (1)	☺ (2)	☹	☺	☺	☹ (5)	☺	☹	☺	☹	☺
	Closed-ended HF	☺	☺	☹	☺	☺ (4)	☹ (5)	☺	☹	☺	☹	☹
	Open-ended HF	☹	☹	☹	☺	☺	☺ (?) (7)	☹	☹	☺	☹ (9)	☹
	Open-ended REF	☹	☹	☹	☺	☺	☺ (?) (7)	☹	☹ (8)	☺	☹	☺
	FoF	☹	☹	☹	☹	☺	☺	☹	☹	☺	☹	☹
	Gold Bullion Securities	☹	☹	☹	☹	☹	☹	☹	☹	☺	☹	☺
	Others	☹	☹	☺ (3)	☹	☹	☺ (6)	☹	☹	☹	☹	☹

- (1) Including closed-ended 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-ended funds do not exist in France but potentially eligible if comply with 13 AMF criteria to accept foreign funds in UCITS
- (6) Subscription rights, warrants, promissory notes, master-feeder-funds, venture capital funds (if 13 criteria by AMF are met)
- (7) Irish regulator not that clear on eligibility of open-ended hedge funds or real estate funds
- (8) Open-ended real estate funds in principle eligible but must comply with such stringent requirements that impossible in practice!
- (9) Various conditions apply for eligibility

The colour-coded changes as compared to the last time are mainly due to CESR's technical advice to the Commission, dated January 2006. Austria and Belgium have for example changed their mind regarding eligibility of closed-ended funds. Germany, even if this is not shown on this chart, has now accepted the principle of derivatives on commodity indices. Luxembourg, inspired by

France, has decided to accept open-ended hedge funds and fund of funds into its trash ratio; further, gold bullion securities will also be accepted, subject to certain strict requirements.

Many countries nonetheless remain reluctant to accept closed-ended funds' units in their UCITS, as for example Germany, France, Italy, Sweden and, to a lesser extent, the United-Kingdom.

News in Ireland and France

Also worthwhile mentioning in this news flash is the issuance by the Irish regulator of a Guidance Notice on Financial Derivative Instruments, in May 2006, which will impose an obligation on promoters to file annually with the authority an "Annual FDI Report", in line with Art. 21 of the UCITS III Product Directive. This report seems unique in Europe and is

meant to allow the regulator to review UCITS use of FDI during the year, to review any risk breaches and to allow the UCITS to update its risk management process.

France has also issued new guidance on the use of derivatives and the use of different risk management approaches earlier this year, in its AMF Instruction of 24 January 2006. Things are still moving on the UCITS front...

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