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UCITS III/IV News

A Pan-European Newsletter

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We all thought UCITS IV was just around the corner…yet here we stand, mid-March, with not even an official proposal to look at!!

What has happened to the passport?

A recent article of the FT fm shows the picture of a passport with the logo “cancelled” on it and that sums it all up. In an ideal single market, such a passport would allow a German KAG to set-up and manage a Luxembourg FCP or a French SICAV, without the need, in the Grand-Duchy or France, for any further presence but the fund in question (and its custodian). Management, in the UCITS sense, encompasses asset management, administration and marketing and all these functions would hence be done by the German KAG, for its German and foreign funds. This is what the Commission has been pushing for, as true advocate of the single market, be it in its colored papers and in its impact assessments, all having highlighted the benefits of such a management company passport.

In its Exposure draft of March 2007, the Commission did not, however, allow the full remote management such a passport would entail: some activities, relating to shareholder register and NAV calculation still had to be performed in the fund’s domicile, so as to allow proper supervision by regulator, custodian and auditor and avoid taxation issues. The regulators of Luxembourg and Ireland, two popular fund domiciles, indeed feel uneasy with the responsibility of supervising funds with no local substance and records! These arguments, valid as they may be, were opposed by a large part of the industry and by major EU countries such as France, Germany and the UK. There must have been a bit of muscle flexing by representatives of these countries at the Commission, because the proposed UCITS IV directive, announced for February 2008 still has not seen official light and should not do so before May. According to the press, an unofficial Commission proposal for a recast UCITS directive, currently circulating in press rooms and at the regulators’, no longer even mentions the management company passport, be it full or partial.

With the heated reaction already expressed by some, notably by France who will take over the Presidency of the EU as from July 2008 and with upcoming elections at EU Parliament level early 2009, could it be that we are heading straight towards UCITS V?

The product harmonization is not fully achieved either…

The whole purpose of this newsletter has always been to keep track of the implementation of UCITS III rules in major EU countries and to show the main differences, if any, remaining despite the harmonization efforts undertaken notably thanks to CESR. In a recent survey of this sort, conducted early February 2008 with major Member States, we had a look at some features arising e.g. out of the Eligible Assets Directive 2007/16/EC of 19 March 2007 (the “Directive”), which has already been implemented by many of the countries surveyed, save for Belgium, Spain, Italy and Austria (where only a draft version exists).

We asked in particular about those investment possibilities that have arisen following CESR’s work and the Directive and concretely, on structured products (such as the German certificates) replicating the performance of an underlying with a 1 to 1 ratio, without any derivative component providing leverage, as well as on the treatment of closed-end funds and the requirement to “look-through” them. Another hot topic is the physical short selling of securities in a UCITS fund and the use that can be made of the 10% borrowing powers in a UCITS fund.

Structured Products

	AT	BE	DE	ES	FR	IE	IT	LU	NL	UK
Are structured products replicating the performance of an underlying with a 1 to 1 ratio without any derivative component eligible?	☺	😐[1]	☺	☹	☺	☺	☹	☺	☺	😐
Can the underlying be “non-eligible”?	☺	☹	☺	☹	😐[2]	☺	☹	☺	☺[3]	😐

[1] CBFA is still hesitating on the treatment of these instruments - in principle, it would always require eligibility of the underlying. The implementation of the Directive in Belgium, due to occur shortly, should provide a definitive answer on this issue.
[2] Currently under discussion in France.
[3] But underlying cannot be a derivative.

It should be noted on this topic that the BaFin interpretation on the 1:1 performance replication allowing investment in non-eligible assets, which created a bit of turmoil when it came out last year in the summer after intense industry questioning, is currently being discussed within a CESR task force. The UK has already indicated that, although legally sustainable, this interpretation very much resembles a *“circumvention of the rules and principles of the directive”*, which is in principle prohibited! …

Closed-end funds

	AT	BE	DE	ES	FR	IE	IT	LU	NL	UK
Closed-end funds eligible as transferable securities ("TS") or funds ("F")?	TS	F[4]	TS	F	TS	TS	TS	TS	TS	TS
No requirement to apply "look-through" principle?	☺	☹	☺	😐	☺	☺	☹	☺	☺	☺[5]
Can these funds have "non-eligible" assets in their portfolio?	☺	☹	☺	☹	☺	☺	☹	☺	☺	☺

[4] Closed-ended funds are a separate asset class in the current Belgian legislation
[5] No need to look-through, however an authorized fund manager should not invest the assets of a UCITS in closed-end funds for the purpose of circumventing the investment limits.

Despite CESR's work and the Directive, some countries continue to hold closed-end funds as funds and hence either require a look-through approach (Belgium) or, like Spain, impose strict conditions (on liquidity, country of origin, regulated status etc..). Spain, who is in the process of implementing the Directive, will in principle not change its rules on that issue. Belgium will.

Strategies

	AT	BE	DE	ES	FR	IE	IT	LU	NL	UK
Are long-short strategies accepted (e.g. 130/30)?	☺	☺	☺	☺	☺	☺	☺	☺	☺	☺
Are physical short positions accepted?	☹	☹	☹	☹	☺[6]	☺	☹	☹	☹	☹

[6] If covered by reverse repurchase transactions.

On the strategy side, UCITS seem to take over some hedge fund strategies like the 130/30, which consist in combining long equity positions representing 130% of the assets of a UCITS together with short equity positions representing 30% of its assets, resulting in a net market exposure of 100%. While all countries surveyed accept this type of strategies, there is also a large agreement that the short exposure can only be achieved by using derivatives. Ireland has created quite a buzz last fall when announcing that, as long as they are covered through securities borrowings, the physical shorting is alright (this is also being discussed at CESR task force level). France even goes further since a decree of last August: while before that date, shorting of securities was only permitted if covered by reverse repos up to 10% of net assets, the limit for such reverse repos (and hence shorting possibilities) has been extended to 100%!

UCITS whose strategy consists in swapping the return of bonds or other debt instruments against the return of commodity or hedge fund indices are currently not permitted in Spain. France allows them for commodity indices, but is still uncertain on hedge funds indices. Austria allows both, but these strategies are not pursued in practice.

Borrowings

	AT	BE	DE	ES	FR	IE	IT	LU	NL	UK
Is it possible for a UCITS to borrow for investment purposes?	☺	☹	☺	☹	☺	☹	☺	☹	☺	☺

Since the inception of UCITS, in 1985, funds have always been limited in their leverage through borrowings (10%) and the sums so borrowed, on a temporary basis to face redemptions, could not be used for investment purposes. Luxembourg and Ireland still do not allow such leverage. The UK, Germany, Austria, Italy, the Netherlands and France have no issue with investing the borrowed amounts, Germany even considering this "short-term investment" to be able to last up to one year!

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