

UCITS VI –
Have your say

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UCITS VI

Introduction

The European Commission (the “**Commission**”) has recently published a consultation document on UCITS entitled “*Product Rules, Liquidity Management, Depositary, Money Market Funds, Long Term Investments*” (the “**Consultation Paper**”). The Consultation Paper can be found [here](#).

The Consultation Paper focuses on eight topics under consideration by the Commission and which may form the basis of a **UCITS VI**. It does not address, and is separate to the proposals concerning the UCITS depositary (liability, delegation etc.), remuneration and administrative sanctions commonly referred to as **UCITS V**.

The eight topics covered (as set out in further detail below) are:

- Eligible assets and the use of derivatives
- Efficient portfolio management techniques
- Over-the-counter (OTC) derivatives
- Extraordinary liquidity management tools
- Depositary passport
- Money Market Funds
- Long term investments
- Addressing UCITS IV

Given the topics addressed and the nature of the questions raised by the Commission which suggest that some fundamental changes are under consideration, it is vital that UCITS asset managers make their views known.

The Commission is inviting submissions in respect of various questions raised in the Consultation Paper by **October 18, 2012** to: markt-ucitsconsultations@ec.europa.eu . We would encourage any stakeholders with an interest in the UCITS product and its future development to consider the questions being raised and to provide feedback to the Commission.

Eligible assets and the use of derivatives

The Consultation Paper notes the range of eligible assets in which a UCITS can invest and that the current UCITS regime permits exposure to non-eligible assets in a number of ways (e.g. financial derivative instrument based on financial indices). The Commission queries whether the scope of assets that are deemed eligible for a UCITS should be reviewed. The concern seems to be that the list of eligible assets has gone further than what is appropriate for a retail product. It may be that the Commission's thinking is that the Alternative Investment Fund Managers Directive (**AIFMD**) will provide sufficient scope for alternative assets/strategies and that UCITS could therefore return to something along the lines of its pre-UCITS III existence.

In addition to the questions being asked on the eligibility of assets available for a UCITS, the Consultation Paper also asks whether market risk (or value-at-risk (**VaR**)) is a consistent indicator of global exposure or whether there should be a move to using the commitment approach only. This may create difficulties for asset managers who currently use VaR and would not come within the 100% limit using the commitment approach (although several assets managers consider that VaR is not an adequate risk measurement tool in any event). The Consultation Paper seeks information from asset managers in this context which such asset managers should respond to.

It is seems that the Commission is concerned with the development of UCITS adopting highly sophisticated investment strategies with complex risk profiles and whether such products and exposures are suitable for the retail market.

Efficient portfolio management techniques

UCITS have been permitted from the very beginning to employ certain techniques and instruments for the purposes of efficient portfolio management (**EPM**). Such techniques and instruments are used to reduce risk and cost and they include securities lending and repurchase agreement (repos). Several questions have been raised regarding (i) the transparency of the EPM techniques (ii) counterparty risk assumed by UCITS employing such techniques and (iii) collateral quality and reinvestment of collateral.

The Commission notes that regulators globally are assessing the systemic risk inherent in the use of EPM techniques and highlights that some of the above areas were addressed in the Commission Green Paper on Shadow Banking. Most respondents to the Commission Green Paper on Shadow Banking seemed to be in favour of increasing the level of transparency and consolidating current best practices in the industry and the Consultation Paper also notes that the recent publication by the European Securities and Markets

Authority (**ESMA**) of “*Guidelines on ETFs and other UCITS issues*” has provided an “*important first response to the issues raised by certain EPM techniques in the context of UCITS*”.

The Commission is seeking information on the types of transactions and instruments currently considered as EPM, including the involvement of counterparties. It also asks whether there is a need to define criteria on the eligibility, liquidity, diversification and re-use of received collateral.

Over-the-counter (OTC) derivatives

With the recent international focus on OTC derivatives and the publication of the European Market Infrastructure Regulation (**EMIR**), the Commission’s focus on assessing current UCITS limits on counterparty risk for centrally cleared OTC derivatives is not surprising.

EMIR was issued in July of this year and as it is a regulation it is directly effective (i.e. does not require transposition into the local laws of each Member State by national legislation). While we are still awaiting level 2 legislation, EMIR requires for a variety of OTC derivatives to be cleared through central counterparties and that raises the question of how OTC derivative transactions should be dealt with when assessing UCITS limits on counterparty.

In addition, the Commission expresses a concern with the fact that a UCITS is not currently required to calculate OTC counterparty risk and issuer concentration on a daily basis whereas a UCITS is required to calculate global exposure daily. The Commission highlights that this discrepancy could lead to different market practice which would have an adverse impact on investors and it asks for feedback on what the current market practice is in terms of frequency of calculation of counterparty risk and issuer concentration and whether there is merit in imposing a daily counterparty and issuer calculation requirement.

Extraordinary liquidity management tools

Given the continuing turbulent economic and financial environment, the liquidity of UCITS has become an important issue for asset managers. Liquidity management plays an important role in UCITS and the Commission notes that ensuring a high standard of liquidity management will better ensure investor protection and a better functioning of UCITS.

The Consultation Paper notes that the temporary suspension of redemptions is the only derogation from the general right to redeem units of UCITS on request (there are other options to limit redemptions) and notes that temporary suspensions are allowed only in

“exceptional cases where circumstances so require and there temporary suspension is justified having regard to the interests of the unit holders”.

Different interpretations of the above among Member States can undermine investor protection. With this in mind, the Commission is seeking feedback on whether there is need to further develop a common framework within the UCITS Directive for dealing with liquidity management issues and asks respondents to consider what the criteria would be for defining “exceptional cases” regarding temporary suspension of redemptions.

The Commission also raises the issue of the establishment of side pockets within a UCITS where a part of the assets in the portfolio becomes illiquid and requests information in relation to current market use of side pockets and whether such should be included in the UCITS Directive. This may be under consideration as UCITS affected by Madoff, Lehman, MF Global and similar events had few tools available to deal with the liquidity issues which those events caused, unlike their non-UCITS counterparts.

Finally, attention has also been drawn to a need for liquidity safeguards in secondary markets for Exchange Traded Funds (**ETFs**). The Consultation Paper refers to situations which may arise when an authorised participant providing liquidity cease to perform its duty.

Depositary Passport

At present there is no UCITS depositary European passport which would permit a depositary in one Member State to act as depositary for a UCITS domiciled in another Member State (although branches are allowed to do so in some jurisdictions). The issue of introducing a depositary passport has been discussed at an industry level in the past and it was felt that there would need to be harmonisation of the depositary rules and requirements before the introduction of a depositary passport.

While the harmonisation of the eligibility criteria, liability and safekeeping duties for depositaries under the current UCITS V proposal and the AIFMD would require implementation before a depositary passport could be introduced, the Commission is clearly thinking of a depositary passport and is seeking feedback on the advantages and drawbacks of such a passport and whether further harmonisation of other areas would be required first.

This should not just be seen as something which depositaries should be considering, but asset managers should also consider the potential opportunities that a depositary passport could mean for them. In this regard, the Commission specifically asks whether asset managers encounter problems stemming from the regulatory requirement that the depositary and the fund need to be located in the same Member State.

Money Market Funds

The Consultation Paper notes the recent international work on shadow banking, coordinated by the Financial Stability Board (**FSB**), which identified Money Market Funds (**MMFs**) as an area of investment funds requiring closer security.

Given that MMFs are widely used as a source of funding for governments, banks and companies, the Commission raises a concern regarding the potential systemic risk associated with MMFs and poses a number of questions, largely aimed at asset managers, as to the role MMFs play in the management of liquidity, what type of investors are MMFs mostly targeting and the types of assets which MMFs are mostly invested in.

In addition, the Consultation Paper divides the issues of MMFs into three areas, namely, (i) valuation and capital (ii) liquidity and redemptions and (iii) investment criteria and rating.

Valuation and Capital – the Consultation Paper mentions the concern surrounding MMFs that offer a constant Net Asset Value (**NAV**) which may give an impression that such funds contain a capital guarantee. There is a concern that the amortized cost valuation method (which is used by a constant NAV MMF) may distort the real value of the assets. The Commission not only asks whether such funds should be subject to additional regulation but also whether their activities should be reduced or even phased out.

Liquidity and Redemptions – the issue of liquidity and redemptions in the context of MMFs is also examined. This may not be surprising for some asset managers who would have experienced liquidity concerns with MMFs. The Commission in seeking to increase the stability of MMFs highlights three options for consideration, namely (i) imposing a liquidity fee on those investors that redeem first (ii) redemption restrictions and (iii) liquidity constraints. The Commission asks whether the three options are mutually exclusive or could be adopted together.

Investment Criteria and Rating – the Commission notes that the MMF industry relies extensively on credit ratings when assessing the credit risk associated with underlying assets. The Consultation Paper states that any credit ratings downgrade can cause a sharp decline in a fund's assets as investors redeem or switch to another fund. This can have systemic effects and can put pressure on an asset manager to sell off the affected assets. The Consultation Paper asks where MMFs should still be rated or what would be the consequences of prohibiting investment criteria. It also examines whether investors and asset managers should carry out a purely internal assessment without reference to ratings.

Long Term investments

The Commission is looking at the area of long-term investments in what seems to be an initiative aimed at using investment funds to foster a culture of long term investment within the internal market in order to generate financing for infrastructure projects such as transport and health. Long term investments could also offer new investment opportunities for investors and asset managers alike.

As long term investments tend to provide a low level of liquidity, long term investments would typically be reserved for non retail investors. The Consultation Paper states that long term investing remains segmented throughout Member States and notes that a variety of assets have been characterised as “long term”, including direct investments into unlisted companies, infrastructure projects and real estate assets.

The Commission is looking for feedback on whether there is investor demand for long term investments and whether this is something that asset managers are interested in. The diversification requirements and whether high standards of investor protection should be legislated for are some of the other questions the Commission is posing in relation to long term investments.

Addressing UCITS IV

The Commission has highlighted a number of areas introduced as part of UCITS IV which need to be examined in light of implementation of UCITS IV in July, 2011. The specific areas include;

Self-Managed Investment Companies – whether there is a need to prescribe more detailed rules for UCITS self-managed investment companies (which currently apply to management companies of UCITS).

Master-Feeder structures – whether more requirements are needed in relation to a feeder UCITS converting into an ordinary UCITS.

Fund mergers – potential revisions on the timeframe for mergers are being examined.

Notification procedure – consideration of whether the regulator-to-regulator notification procedure requires further amendment and clarification.

Alignment with AIFMD – the Consultation Paper notes that some of the provisions within AIFMD, including measures on organisational rules, delegation, risk and liquidity

management rules, valuation, reporting and calculation of leverage are more detailed than in the current UCITS Directive. The Commission queries whether further alignment is needed in order to improve consistency of the rules.

You should get involved

Many within the industry may feel that UCITS VI is a consultation too far (or too early) given that UCITS V is yet to be introduced and the industry is still grappling with UCITS IV. However, it is clear that developments in the global funds area, such as discussions by the International Organisation of Securities Commissions (**IOSCO**) and the FSB, are resulting in potential updates to the UCITS rules.

There is a sense when reading the Consultation Paper that the Commission is seeking to keep UCITS topical and in line with developments in the global financial markets which is something to be welcomed.

However, as the impact of potential changes in each of the areas covered could be quite significant and will present both opportunities and challenges, all interested parties should read the questions being asked in the Consultation Paper and contribute a response, as appropriate. The responses will act as important input for the Commission.

As mentioned above, the timeframe for submitting contributions is **October 18, 2012** to: markt-ucitsconsultations@ec.europa.eu. If you are of interested in making a submission, you should discuss with your usual Dillon Eustace contact.

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