

Ucits evolution: plain vanilla to alternatives

Derbhil O’Riordan of Dillon Eustace looks at the history of the Ucits regime, and its expanding reach as an EU investment product

Undertakings for Collective Investment in Transferable Securities, commonly referred to as Ucits, are collective investment schemes, established and authorised under a harmonised European Union (EU) legal framework; under which a Ucits fund established and authorised in one EU member state can be sold cross-border into other EU member states without a requirement for additional authorisation.

Originally introduced over twenty years ago, Ucits have become the gold standard EU investment fund product, recognised not only by the European financial services community but also internationally, with many jurisdictions from Asia to the Americas accepting

down the legal forms which Ucits could take, their permitted investment and borrowing rules, liquidity requirements, prospectus disclosure rules, rules relating to reporting and to the role and duties of Ucits custodians/depositaries and their management companies.

Importantly, however, Ucits is not a product which has stood still, rather it continues to evolve, with a significant broadening of permitted asset classes and more robust governance requirements being introduced in 2002 and clarified in 2007 (referred to generally as ‘Ucits III’). More recently, a series of additional changes have been implemented under the Ucits IV Directive in order to further simplify the

of fund types and exposures, from relatively plain vanilla equity and bond products through to Ucits taking exposures to hedge fund and commodities indices, with fund of funds, money market and cash funds and index replicators also provided for. We have focused in this paper on Ucits investment in financial derivative instruments (FDI), index-tracking Ucits, and Ucits investing in FDI on financial indices to demonstrate the broad spectrum of fund types that fit within the Ucits structure.

Ucits investment in FDI

Prior to the introduction of Ucits III, Ucits could only employ FDI for efficient portfolio management purposes. Now, however, Ucits may invest in FDI for investment purposes subject to a variety of conditions relating to the nature of the exposures taken, the leverage generated through such positions, the process employed by the Ucits to manage the risks arising from derivatives investment as well as rules relating to OTC counterparty exposure and to the valuation of FDI.

Ucits investment in FDI must comply with the following conditions:

- the underlying asset relates to Ucits eligible assets, financial instruments having one or several characteristics of these assets, financial indices, interest rates, FX rates or currencies;
- the counterparties to OTC FDI are institutions subject to prudential supervision and belong to categories approved by the regulator (in Ireland,

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Ucits as suitable for retail sale into their domestic markets. While they are sold across the full spectrum of investor types, Ucits have been designed principally for the retail market as open-ended diversified, liquid products with their parameters, permitted asset classes and investment and borrowing restrictions enshrined in EU law.

Evolution

The original 1985 Ucits Directive set

European passport process, introduce master/feeder type structures, create a framework for cross-border fund mergers, replace the Simplified Prospectus and introduce further measures in relation to the Management Company Passport.

Given the increased investment opportunities granted under Ucits III and the subsequent clarification of the terms ‘transferable securities’ and ‘money market instruments’, Ucits provide for a very broad spectrum



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the Central Bank of Ireland, with a minimum (or an implied) credit rating (in the case of counterparties which are not credit institutions)) of A2 or equivalent, or guaranteed by an entity with a rating of A2;

- OTC FDI are subject to reliable and verifiable daily valuation and must be capable of being sold, liquidated or closed by an offsetting transaction at any time at fair value at the initiative of the Ucits;
- counterparty exposure is limited to 5% of net asset value or 10% for certain credit institutions; and
- netting may be applied before counterparty exposure is calculated. Also, risk will be reduced where a counterparty provides acceptable collateral to the Ucits.

FDI positions may create long or synthetically short exposure to the underlying asset and may result in leverage to the Ucits portfolio. The rules for measuring global exposure and leverage differ depending on whether a Ucits is characterised as 'sophisticated' or 'non-sophisticated'. The Central Bank has not provided a formal definition of what constitutes 'sophisticated' or 'non-sophisticated', but the use of OTC derivatives might indicate the Ucits is more sophisticated and the complexity of the transaction should also be considered.

The Central Bank requires that the global exposure and leverage of a non-sophisticated Ucits should be measured using the commitment approach. A Ucits fund's global exposure may not exceed its net asset value, thus a leverage limit of 100% applies. A sophisticated Ucits is required to use an advanced risk measurement methodology to measure global exposure and the Central Bank recommends the use of the Value-at-Risk (VaR) method, meeting certain quantitative and qualitative criteria and calculated using an acceptable proprietary or commercially available model.

Index-tracking Ucits

One of the cornerstones of Ucits since the introduction of the original Directive in 1985, has been the imposition of strict risk spreading requirements. This has been enshrined in what is commonly known as the 5/10/40 rule which is that a Ucits may invest no more than 10% of its net assets in transferable securities or money market instruments issued by the same body, provided that the total value of transferable securities or money market instruments held in issuing bodies in each of which it can invest more than 5% is less than 40%.

This fundamental Ucits principle created problems for Ucits wishing to track an index where the weighting of a constituent element of the index exceeded the 5% limit or where the relationship between two or more constituent elements of the index meant they were considered to constitute a single issuer resulting in an aggregation of the exposure. However, since the introduction of Ucits III, Ucits, whose policy is to replicate an index, are permitted to invest up to 20% of net assets in shares and/or debt securities issued by the same body, with the 20% limit being raised up to 35% in the case of a single issuer where justified by exceptional market conditions. This flexibility is permitted where the relevant index is recognised by the regulator on the basis that it is sufficiently diversified, represents an adequate benchmark for the market to which it refers and is published in an appropriate manner.

Ucits investing in derivatives on financial indices

FDI are increasingly being used to access financial indices comprising assets that are not traditional target investments of Ucits, including hedge funds, and there are specific rules relating to what is acceptable as a permitted financial index underlying an FDI. The requirements are that the

index must: be sufficiently diversified; represent an adequate benchmark for the market to which it refers; be published in an appropriate manner; and be managed independently from the management of the Ucits. It is necessary to submit the relevant index to the Central Bank for prior approval if (a) the index is comprised of ineligible assets or (b) the index is comprised of eligible assets but it would not be possible for the Ucits to invest directly in such underlying assets without breaching the Ucits risk spreading limits (assuming the Ucits does not wish to apply a look-through approach).

Hedge fund indices may qualify as financial indices to which exposure can be taken through FDI provided that they meet the index criteria indicated above and where:

- the index methodology has a set of predetermined rules and objective criteria for the selection and rebalancing of index components;
- the index provider does not accept payments from potential index components for the purpose of being included in the index; and
- back-filling is not permitted.

Ucits continue to evolve to meet the requirements of markets, both commercial and practical, and while at times the pace of change may be too fast for some and too slow for others, to date, Ucits has generally achieved the right balance. The changes introduced by Ucits IV demonstrate the continued endeavours of European regulators to further evolve the Ucits brand, and maintain its position as the gold standard EU investment fund product. As new concerns arise surrounding global financial markets, and 'shadow banking', Ucits, a fully regulated structure with an independent depository and custodian function, provides a proven track record and an answer to the question of regulation in the alternative space.