

# Eligible Assets: Latest Developments regarding UCITS

By Claude Kremer, Michèle Eisenhuth and Florence Stainier, Arendt & Medernach, Luxembourg

Luxembourg is Europe's leading investment fund centre and the second fund domicile in the world after the United States of America. A flexible and robust legal and regulatory framework put in practice by a pragmatic and business-oriented supervisory authority undoubtedly contributes to the success of Luxembourg in attracting investment funds. Indeed, Luxembourg was one of the first EU Member States to implement the UCITS III Directive (UCITS is an abbreviation for: Undertakings for Collective Investment in Transferable Securities). On the product side, the UCITS III Directive widened investment opportunities by extending the range of eligible assets in which a UCITS can invest (i.e. in addition to the traditional investments in transferable securities, investments in money market instruments, cash deposits, other UCIs and financial derivatives are now allowed). As a result of such increase in the variety of the financial instruments dealt on financial markets, a certain degree of uncertainty with respect to the eligibility of certain asset classes arose. In this respect, the European Commission mandated CESR (Committee of European Securities Regulators) in October 2004 to clarify the definitions contained in the UCITS III Directive. Although CESR issued its final advice in January 2006 on the 'Clarification of definitions concerning eligible assets for investments of UCITS', there remained however some need for further clarification of certain definitions.

Directive 2007/16/EC of 19 March 2007 (the Eligible Assets Directive, 'EAD') has brought legal certainty with respect to the main conclusions contained in the CESR advice and regarding the main categories of financial instruments. The EAD has been implemented into Luxembourg law by a Grand-Ducal Regulation of 8 February 2008. The Grand-Ducal Regulation is binding on all existing Luxembourg UCITS from 23 July 2008 and has to be read together with the CESR guidelines implemented by CSSF Circulars 08/339 and 08/380.

This regulatory and legislative work has comforted promoters in launching highly sophisticated UCITS in a stable and well-defined framework. The latest statistics of the Luxembourg industry show that as of 30 September 2008, net assets under management in

UCITS funds amounted to EUR 1375.104 bn, which, for UCITS, positions Luxembourg in terms of assets under management in front of France and Ireland.

## New asset classes

As set out above, the UCITS III Directive has considerably broadened the investment possibilities for UCITS III funds, by admitting besides investments in transferable securities, investments in money market instruments, cash deposits, other UCIs and financial derivatives (which, under UCITS I were allowed on an ancillary basis only).

The purpose of the EAD was to allow a uniform interpretation of the UCITS III Directive in order to avoid regulatory arbitrage within Member States of the European Union. Rather than establishing an exhaustive list of eligible financial instruments, the EAD has defined a certain number of criteria allowing a huge range of new financial products with different features and different levels of liquidity to become eligible.

In order to assess whether a specific asset is eligible, a long series of tests has to be effected in certain circumstances. For example, transferable securities listed on a stock exchange, which under UCITS I benefited from a presumption of liquidity and were eligible whatever be the relevant underlying asset, now have to be analysed in detail. The systematic carrying out of asset tests, in particular regarding the entering into derivatives, goes together with the more and more complex risk management processes that UCITS must put in place in order to adequately manage their risk exposure in relation to the financial instruments in their portfolio.

## Exposure to non-eligible assets under UCITS III

Besides enlarging the list of eligible assets, the EAD and the interpretation thereof by CESR allow exposure to non-eligible assets, such as e.g. real estate, private equity, commodities or hedge funds.

The exposure to these asset classes may be achieved through structured financial instruments qualifying as transferable securities, through

derivatives, closed-ended funds and, to a certain extent, through open-ended funds.

In order to assess whether the relevant assets are eligible, the two following elements need to be analysed:

Application of the look-through principle: assessing whether the assets underlying the relevant structured financial instrument, derivative or closed-ended fund are themselves eligible

Exposure to non-eligible assets through eligible instruments: ensuring that the liquidity and diversification requirements of UCITS III are complied with and avoiding that the UCITS receives a non-eligible asset.

**Exposure through structured financial instruments qualifying as transferable securities**

For structured financial instruments, the EAD sets out that the non-look-through principle has to be applied. Thus, the underlying of a structured financial instrument can e.g. be commodities, private equity, real estate or hedge funds. The following conditions need however to be complied with:

- liquidity, negotiability, as well as accurate, reliable and regular valuation available
- existence of regular, accurate and comprehensive information on the security
- security does not qualify as fund unit
- no physical delivery of non-eligible underlying
- security may not embed a derivative (in which case a look-through principle should apply).

**Exposure through derivatives**

Based on the fact that derivatives need to have eligible assets as underlying, the only way to access non-eligible assets is to use derivatives on indices (including e.g hedge fund indices or commodities indices). Indeed, the non-look-through principle applies both regarding the eligibility of the index components and for purposes of investment restrictions calculation.

**Exposure through closed-ended funds**

Closed-ended funds are considered to be transferable securities and as such are eligible, provided they comply with the conditions applying to transferable securities. There is a presumption that they do not embed a derivative and there is no look-through requirement. However, they must have corporate governance mechanisms in place and the investment manager of the relevant fund must be subject to national regulation for the purpose of investor protection. Thus, closed-ended

real estate, private equity, hedge or commodity funds are eligible investments for UCITS.

**Exposure through open-ended funds**

According to Luxembourg regulatory practice, open-ended funds giving exposure to non-eligible assets may be held under the 10% trash ratio, together with any unlisted securities. The open-ended target fund must be regulated and subject to equivalent prudential supervision in its country of origin, and there must be a cooperation between the relevant supervisory authorities.

**Convergence between sophisticated UCITS and alternative strategies**

The exposure to non-eligible asset classes, as well as the possibility to use structured financial instruments and derivative instruments, have enabled fund promoters to implement completely new investment policies, with additional diversification and to explore new markets. Long-only strategies are now completed by a full set of alternative strategies under UCITS funds, attracting alternative asset managers into the UCITS landscape. Examples of alternative strategies under UCITS III are investments into indices providing a hedge fund-type return, or the so-called ‘130/30’ strategy, where the UCITS has exposure to long positions on attractive undervalued stocks representing 130% of its assets and to short positions on unattractive overvalued stocks making up 30% of its assets.

The above outlined developments show that UCITS III funds offer interesting investment opportunities for investors and promoters, without compromising the quality of the brand. Risky investments are counterbalanced by an accrued liquidity of investments and a robust risk-management process. The reason for the tremendous success of UCITS III must undoubtedly be sought amongst others in the pragmatic approach of the Luxembourg regulator and in the ability of industry participants to fully integrate the complexity of the new products available.

	Name: Claude Kremer, Partner and Head of Investment Management Email: <a href="mailto:claud.kremer@arendt-medernach.com">claud.kremer@arendt-medernach.com</a>
	Name: Michèle Eisenhuth, Partner Email: <a href="mailto:michele.eisenhuth@arendt-medernach.com">michele.eisenhuth@arendt-medernach.com</a>
	Name: Florence Stainier, Partner Email: <a href="mailto:florence.stainier@arendt-medernach.com">florence.stainier@arendt-medernach.com</a> Sector: Investment Management Phone: (+352) 40 78 78 207