

# UCITS III & ELIGIBLE ASSETS

## Training Course

After a two year consultation process by the Committee of European Securities Regulators (CESR), the European Commission published the Eligible Assets Directive clarifying the eligibility of certain assets types for investment into by UCITS. This was accompanied by CESR's final Guidelines on Eligible Assets for UCITS. In this training course we consider the implications for UCITS Managers of the Directive provisions and the CESR Guidelines.

### Session 1. Introductions and Objectives

### Session 2. Relevant law, regulation and guidance

In this session we consider why the Eligible Assets Directive was required and review the Lamfalussy legislative background and how it will impact upon UCITS Regulation. We also identify recent regulatory developments relating to the interpretation of the Eligible Assets Directive and Guidelines, notably:

- EC Eligible Assets Directive - March 2007
- CESR's Final Guidelines on Eligible Assets - March 2007
- CESR's Guidelines on UCITS and Hedge Fund Indices - July 2007
- FSA Handbook Notice 73 - implementation of Eligible Assets Directive - Feb 2008
- CSSF Circular 07/308 on UCITS, Derivatives and the Risk Management Process - August 2007
- Grand Ducal Regulation of 8 Feb 2008 implementing Eligible Assets Directive and CSSF Circular 08/339
- CSSF Circular 08/356 on efficient portfolio management techniques, June 2008
- IFSRA Policy Change on Physical Short Selling
- IFSRA Revised Rules on OTC Valuation
- IFSRA Guidance Note 2/07 on Financial Indices
- BaFIN FAQ on the Eligible Assets Directive

### Session 3. Transferable Securities, Closed Ended Funds and Structured Financial Instruments

Here we consider the conditions laid down by the Eligible Assets Directive and CESR's guidelines in order for an instrument to be considered as a "transferable" security. We consider the challenges and resources available to Managers in considering whether an instrument is:

- A limited liability instrument
- Liquid
- Capable of reliable valuation with sufficient available information
- Negotiable

We also consider the requirements laid out in the Directive which provide that structured financial instruments and closed-ended funds may be considered to be transferable securities

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### **Session 4: Open Ended Schemes**

Here we consider the provisions laid down in CESR's Guidelines for "Other Collective Investment Schemes" and compare these provisions with those considered in Session 3 for closed end funds. We assess the comparative treatment of these fund types and the implications for UCITS as regards performing due diligence on such investments.

### **Session 5: Money-market instruments**

### **Session 6: OTC Derivatives – "Approved Terms"**

The UCITS Directive, EC Recommendations on Derivatives Usage and Eligible Assets Directive all set out particular requirements relating to UCITS investing into OTC derivatives. In this session, we navigate through these different texts in order to gain a complete understanding of the requirements.

These requirements include:

- Requirements for fair value
- Reliable and verifiable valuation
- Accurate and independent assessment of value

In particular we consider the concept of independence and contrast the provisions of the Directive and Guidelines compared to the provisions of the recently issued Luxembourg CSSF Paper on UCITS III Derivatives and Risk Management.

### **Session 7: Credit Derivatives**

In addition to the general provisions on derivatives, the Eligible Assets Directive also includes some particular requirements in respect of Credit Derivatives. In this short session, we give consideration to these requirements, including the subtle last minute wording changes made to the Directive, and assess their appropriateness and implications.

### **Session 8: Derivatives on Financial Indices**

The position (issuer-concentration) rules provide an exemption from the "look-through" requirements in respect of derivatives on financial indices. In this session, we explore the meaning of financial indices in this context including the requirements for:

- Financial as opposed to non-financial indices
- Sufficiently diversified
- Adequate benchmark
- Published in an appropriate manner

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### ***Hedge fund indices***

We also consider the additional criteria to be considered in respect of derivatives on hedge fund indices, pursuant to CESR's recent Guidelines on that issue. We consider the extent to which these Guidelines really introduce greater requirements for Managers as compared to derivatives on other financial indices.

### **Session 9: Index Tracking Funds**

The UCITS Directive provides for wider investment limits where a fund is tracking a financial index. In such cases the index must be:

- Sufficiently diversified
- Adequate benchmark
- Published in an appropriate manner

In the Eligible Assets Directive and CESR Guidelines, there is clarification as to what each of these terms constitutes. We review this clarification and consider in particular why different clarification has been provided compared to the requirements for financial indices which are to be appropriate underlyings for derivatives (as considered in Session 7).

At this juncture we also consider the provisions of IFSRA Guidance Note 2/07 on Financial Indices.

### **Session 10: Embedded Derivatives**

There is a need to "look through" to the underlying where a transferable security embeds a derivative. Yet not all instruments which are linked to or backed by the performance of another asset may necessarily fall to be considered as embedding derivatives.

Here we analyse the provisions of the UCITS Directive and Eligible Assets Directive in the context of a variety of instruments and consider whether they should be considered as embedding a derivative and what the "look-through" approach means in practice and the implications for the spread rules.

### **Session 11: Analysis – Commodities, Property and Hedge Fund Exposure for UCITS**

In this final session, we reflect on earlier sessions, the UCITS Directive and Eligible Assets Directive and their combined implications as regards:

- How UCITS can take exposure through the various routes of transferable securities, funds and derivatives to
  - hedge funds
  - property and
  - commodities
- the Compliance challenge posed by the Eligible Assets Directive and Guidelines

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- Differences which will remain between Member States in their implementation of UCITS Directive

#### **Session 12: Efficient Portfolio Management**

Efficient Portfolio Management (“EPM”) was the cornerstone of derivatives usage under UCITS I. Now the Eligible Assets Directive has re-introduced a definition of EPM into the UCITS III landscape. In this session, we consider what if any consequence the EPM provisions have as regards derivatives usage, investor communication and the risk management process.

We also consider the broader opportunities presented by the EPM provisions as regards stock lending, purchase / repurchase transaction etc and consider whether a UCITS may even be able to directly short sell stock by taking advantage of the EPM provisions.