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■ ELIGIBLE INVESTMENTS FOR UCITS

The Financial Regulator has recently issued clarification in relation to a UCITS ability to invest in unlisted securities and the use of subsidiaries.

Investment in unlisted securities

Article 19(2) of the UCITS Directive permits a UCITS to invest no more than 10% of its net assets in unlisted transferable securities and money market instruments. To date investments in this “10% unlisted bucket”, as it is commonly known, has been interpreted so as not to allow, for example, investment in unregulated funds to fall within this limit. The Financial Regulator has reconsidered its interpretation of Article 19(2). It has confirmed that a UCITS is permitted to invest up to 10% of its net assets in aggregate in any type of unlisted securities and unregulated investment funds, including hedge funds, provided the investment complies with the eligibility criteria for UCITS. As long as the aggregate investment is less than 10% of the net asset value of the fund, a fund can invest in unregulated investment funds, whether open-ended or closed-ended, without regard to the Financial Regulator’s guidance note on acceptable investments in funds.

The eligibility criteria which must be met in relation to such investments are those requirements set out in Article 1(8) of the UCITS Directive, as amended by the Eligible Assets Directive, which are as follows:

- (a) the potential loss which the UCITS may incur with respect to holding the investments is limited to the amount paid for them;
- (b) the liquidity of the investments will not compromise the ability of the UCITS to comply with Article 37 of the UCITS Directive (i.e. to meet its redemption obligations);
- (c) there must be a reliable valuation of the investments on a periodic basis;
- (d) there must be regular and accurate information available to the UCITS on the investments;
- (e) the investments must be negotiable;
- (f) the investments must be consistent with the stated investment objectives of the UCITS; and
- (g) the risk of the investments must be adequately captured by the risk management process of the UCITS.

If an existing UCITS wishes to take advantage of this new interpretation to invest in unregulated schemes we recommend that additional disclosure be included in the prospectus to address this. The investment policy of the UCITS should be amended to refer specifically to the ability to invest in unlisted securities and specifically unregulated funds. Shareholders

should be notified of this amendment to the investment policy. An assessment of how the eligibility criteria will be satisfied in relation to each such investment would also need to be undertaken.

Investment in subsidiaries

The UCITS Directive, as amended, provides that a UCITS may invest in a subsidiary company provided it only carries on the business of management, advice or marketing in the country where the subsidiary is located. By way of example, since the implementation of the UCITS III Directive, the Financial Regulator has taken the position that a UCITS could not establish a Mauritian subsidiary in order to make investments in India on the basis that the

Mauritian subsidiary was not carrying on business in Mauritius. The Financial Regulator has now indicated that it is a matter for the directors of the fund to confirm that the establishment of the subsidiary complies with the requirement that the subsidiary only carries on the business of management, advice or marketing in the subsidiary's country of establishment. In addition, the Financial Regulator's conditions relating to the operation and control of a subsidiary by the UCITS must be satisfied. Accordingly, the Financial Regulator will no longer apply a blanket restriction on a UCITS using a subsidiary to make investments in another country. It will however be a matter for the directors of the fund to consider and provide the necessary confirmation to the Financial Regulator if a fund wishes to invest in a subsidiary company.

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