

KEY POINTS

- The EU Commission has produced various guidelines on the assets that are eligible for investment by Undertakings for Collective Investment in Transferable Securities ('UCITS') – so-called pan-European investment funds.
- Allowing UCITS to invest in financial derivative instruments has enabled UCITS to gain exposure to a variety of new asset classes and to adopt different investment strategies.

Feature

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The Eligible Assets Directive under UCITS III: something for everyone

UCITS III¹ extended the range of assets that can be invested in by a UCITS by allowing investments in money market instruments, derivatives, funds of funds, bank deposits and index tracker funds. Having adopted UCITS III, the next issue was whether and to what extent some financial instruments could be considered eligible investments (ie 'eligible assets') for a UCITS in compliance with the relevant provisions of UCITS III. The EU Commission identified the need to clarify the definition of certain eligible assets under UCITS III in order to ensure a consistent interpretation of UCITS III across the EU. This resulted in the EU Commission, in consultation with the Commission of European Securities Regulators ('CESR'), producing various guidelines clarifying those definitions of eligible assets. These guidelines have been incorporated in the Eligible Assets Directive² which was adopted on 19 March 2007 (the 'EAD'). Member states of the EU are required to adopt the EAD by 23 March 2008.

TRANSFERABLE SECURITIES Structured financial instruments (SFI's) as transferable securities

SFIs are financial instruments that are designed to meet specific investment objectives and whose value is linked to, or derived from, underlying assets such as equities, bonds and currencies. These underlying assets may have varying degrees of liquidity and/or may not be directly eligible for investment by a UCITS. The EAD allows a UCITS to invest in SFIs provided that they fall within the definition of 'transferable security' in UCITS III and they satisfy the following criteria:

- total loss exposure under the SFI must not exceed the amount paid for the SFI;
- the SFI must be negotiable and sufficiently liquid so as to enable a UCITS to comply with its redemption requirements;
- there must be actual, reliable and regular

The purpose of this article is to highlight some of the significant opportunities now available to UCITS arising from the various clarifications of eligible assets in the Eligible Assets Directive ('EAD').

- prices for the SFI; and
- there must be regular, accurate and comprehensive information available to the market on the SFI.

With regard to the liquidity of the underlying assets of the SFI, the EAD clarifies that there is a presumption that transferable securities admitted to trading on a regulated market are liquid. If the UCITS knows or ought to know that any particular security is not liquid the UCITS must assess the liquidity risk of the underlying asset. This is done by considering such matters as: (i) the volume and turnover in the transferable security; (ii) where necessary, an independent analysis of the bid and offer prices over a period of time to indicate the relative liquidity and marketability of the instrument; (iii) assessing the quality of the secondary market activity in the instrument; and (iv) if the price is determined by supply and demand in the market, the issue size, and portion of the issue that the UCITS plans to buy.

Transferable securities embedding derivatives

Difficulties have arisen under the UCITS rules in determining whether an instrument embeds a derivative. Examples of transferable securities that have embedded derivatives include credit linked notes, convertible bonds, exchangeable bonds and SFIs whose performance is linked to a basket of shares or a bond index. Collateralised debt obligations and asset backed securities will generally qualify as SFI's embedding derivatives if (i) they are not leveraged; and (ii) they are sufficiently diversified.

Merely embedding a derivative element into a financial instrument does not of itself transform that instrument from what would

otherwise be an eligible transferable security into a derivative for UCITS purposes. However, to avoid such transferable securities with embedded derivatives circumventing the rules for derivatives under UCITS III, the EAD provides that a transferable security (the so-called host contract) is deemed to embed a derivative where it contains a component which satisfies the following criteria:

- By virtue of that component some or all of the cash flows required by the instrument are linked to a specified interest rate, financial instrument price, foreign exchange ('FX') rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a standalone financial derivative instrument ('FDI').
- The economic characteristics and risks of that component are not closely related to the economic characteristics and risks of the host contract.
- It has a significant impact on the risk profile and pricing of the transferable security or money market instrument in question.

If the transferable security embeds a derivative then it will have to satisfy the counterparty, valuation and exposure rules that apply to a UCITS investing in derivatives. In addition, the underlying asset of the derivative must be on the list of eligible underlying assets for a derivative listed in art 19(1) of UCITS III, namely, a transferable security or money market instrument listed or traded on a regulated market, a financial index, interest rate, foreign exchange rate or currency or any combination thereof. Accordingly, an SFI linked to the price of a commodity such as gold or oil which qualifies as a transferable security embedding a derivative would not be eligible

Feature

Biog box

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since the underlying asset of the derivative component, here gold or oil, does not fit in that list of eligible underlying assets for a derivative.

Closed ended funds as transferable securities

EAD clarifies the type of closed end funds (including closed-ended real estate investment trusts ('REITs')) covered by the definition of transferable securities under UCITS III. Whether constituted as investment companies or unit trusts, such closed ended funds must be subject to corporate governance mechanisms equivalent to those that apply to companies, must be managed by an entity which is subject to national regulation and must comply with the requirements applicable to transferable securities generally under UCITS.

FDI

UCITS III provides that a UCITS can invest in FDI for investment purposes. Rather than provide a precise definition of FDI that are eligible for investment by a UCITS, the EAD identifies the criteria for assessing whether an FDI satisfies the criteria for investment by a UCITS. The EAD provides a list of eligible underlyings to an FDI consisting of one or more of the following instruments listed in art 19(1) of the UCITS III Directive, namely, transferable securities or money market instruments listed or traded on a regulated market, financial indices, interest rates, foreign exchange rates or currencies, or any combination thereof. Underlyings which are not permissible include non-financial indices and commodities. Allowing UCITS to invest in FDI has enabled UCITS to gain exposure to a variety of new asset classes such as:

Hedge fund indices

Although a UCITS may not invest directly in a hedge fund, it can gain an exposure to hedge funds by investing in a broadly diversified hedge fund index through an FDI.

Credit derivatives

A credit derivative, such as a credit default swap, is an eligible asset for a UCITS provided that it complies with the rules that apply to eligible derivatives under UCITS III and on termination of the credit derivative,

the UCITS receives only eligible UCITS assets, including cash.

Commodities indices

A UCITS may not invest directly in commodities but it may gain exposure to commodities by investing in a recognised commodities index through an FDI.

130/30 funds

A UCITS may create a long/short exposure to eligible assets through the use of FDI. Such structures are typically referred to as 120/20 or 130/30 type funds depending on the level of exposure. A UCITS is free to structure such a long/short strategy subject to certain counterparty exposure limits and not exceeding an overall global exposure through the use of FDI of 100 per cent of its net asset value.

MONEY MARKET INSTRUMENTS ('MMI')

UCITS III defines MMI as instruments normally dealt in on the money market, which are liquid and have a value which can be accurately determined at any time. The EAD provides that the reference to instruments 'normally dealt in on the money market' shall be understood to include financial instruments which undergo regular yield adjustments in line with money market conditions at least every 397 days.

Bank loans as MMI

The Irish Financial Regulator has taken the position that certain floating rate commercial bank loans satisfy the criteria for money market instruments in that they are normally dealt in on the money market (because they undergo regular yield adjustments in line with money market conditions at least every 397 days), they are liquid and they have a value which of its net asset value can be accurately determined at any time. The UCITS is permitted to invest up to 10 per cent of its net asset value in such bank loans.

EFFICIENT PORTFOLIO MANAGEMENT

UCITS III provides that certain techniques and instruments can be used by a UCITS for efficient portfolio management. The EAD clarifies what is meant by efficient portfolio

management by setting forth the following criteria for such techniques and instruments:

- they must be economically appropriate;
- they are entered into for one of these aims:
 - reduction of risk;
 - reduction of cost;
 - generation of additional capital or income for the UCITS with an appropriate level of risk; or
 - their risks are adequately captured by the risk management process for the UCITS.

These criteria are very broad. Nevertheless, some EU regulators appear to be interpreting these criteria very narrowly, in some cases preventing UCITS from investing in certain structured notes for efficient portfolio management purposes in circumstances where the UCITS wishes to invest in structured notes linked to securities in a particular country for the sole purpose of gaining exposure to these securities without having to register the UCITS in that country and without having to incur the cost of such a registration.

It should also be noted that the European Commission is currently considering a proposal of the Irish Financial Regulator to allow a UCITS to engage in physical shorting on the basis that the CESR clarification of what constitutes 'efficient portfolio management' under UCITS III allows a UCITS to create leverage using stock borrowing arrangements. If this is permitted, a UCITS will be able to structure 130/30 type funds not only through the use of derivatives but also through a combination of stock borrowing techniques and derivatives.

The eligible assets highlighted in this article are intended to give some indication of the significant product opportunities now available to a UCITS fund. It has caused long-only managers to consider using derivatives for investment purposes to gain long/short exposures and hedge fund managers to consider offering their expertise to traditional UCITS investors such as pension funds. ■

1 UCITS III Directive (Directive 85/611/EEC as amended by Directives 2001/107/EC and 2001/108/EC).

2 Directive (2007/16/EC).