

The Eligible Assets Directive – a summary

Notwithstanding the current considerations for the next phase of UCITS developments, colloquially referred to as UCITS IV, UCITS III introduced a number of changes that have assisted the evolution of the UCITS product. The next three articles look at this evolution and include consideration of UCITS and the use of hedge fund indices, short selling and 130/30 funds and the first of these articles discusses eligible assets.

When the UCITS Directive (85/611/EEC) was first adopted in 1985, it provided for the simplest of definitions as to what constituted eligible assets for UCITS – the UCITS Directive simply referred to UCITS being permitted to invest in ‘transferable securities’. This definition was expanded to include ‘other liquid financial assets’ when the UCITS Directive was amended in 2001 by virtue of Directive 2001/108/EC (“UCITS III”). The absence of detailed guidance on this point led to a divergence of interpretations in different jurisdictions as to what constituted an eligible asset.

In order to promote consistency in the interpretation and application of the UCITS Directive and, in particular, in the interpretation of what constituted an eligible asset, the Commission issued a mandate to CESR requesting its technical advice regarding clarification of definitions relating to eligible assets in October 2004. CESR undertook an extensive consultation process with interested parties and issued its advice to the Commission in January 2006. The Commission gave legislative effect to this advice by virtue of Commission Directive 2007/16/EC (the Eligible Assets Directive) which was adopted on 19 March 2007. In accordance with the Lamfalussy process, CESR issued Level 3 guidelines covering those issues which were included in CESR’s advice but not in the Eligible Assets Directive. The Eligible Assets Directive was transposed into Irish law by S.I. No. 832 of 2007 (the Eligible Assets Regulations) on 19 December 2007.

The Eligible Assets Regulations provide clarification and guidance in relation to the following instruments and techniques:

Money market instruments

The existing definition as set out in UCITS III, namely, “instruments normally dealt in on the money market which are liquid, and have a value which can be accurately determined at any time”, has been revised to include further criteria which must be satisfied in order for an instrument to be an eligible money market instrument.

“To promote consistency in the interpretation and application ... of what constitutes an eligible asset.”

Under the Eligible Assets Regulations:

- » the reference to money market instruments as instruments normally dealt in on the money market is a reference to financial instruments which either have a maturity at issuance of up to 397 days inclusive, have a residual maturity of up to 397 days inclusive, undergo regular yield adjustments in line with money market conditions at least every 397 days or have a risk profile which corresponds with one of these requirements;
- » the reference to liquidity in the context of money market instruments has also been clarified and refers to those financial instruments which can be sold at limited cost, in an adequately short time frame, taking into account the obligations of the UCITS to repurchase or redeem its units at the request of any unit holder; and
- » the reference to money market instruments as instruments which have a value which can be accurately determined at any time refers to those instruments for which accurate and reliable valuations systems, which fulfil certain criteria, are available;

Transferable securities

The scope of the term ‘transferable securities’ has been expanded and the Eligible Assets Regulations outline criteria which these instruments must satisfy in order to be eligible assets. For example, among this criteria is the requirement that the potential loss which the UCITS may incur with respect to holding transferable securities is limited to the amount paid for them, reliable valuation and information must also be available in respect of these instruments, they must be

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negotiable, their acquisition must be consistent with the investment objectives or policy or both of the UCITS and their risks must be adequately captured by the risk management process of the UCITS.

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Financial derivative instruments

These provisions have been amended to clarify that the underlying assets of financial derivative instruments must be eligible assets and that derivatives on commodities are not eligible assets. Clarification in relation to the valuation of over the counter derivatives has also been included. Over the counter derivatives shall be subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value at the initiative of the UCITS. In this context, the term fair value refers to the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction, while the term reliable and verifiable valuation refers to a valuation which does not only rely on market quotations by the counterparty, but which satisfies a number of additional criteria;

Financial indices

The criteria to be satisfied by financial indices has been inserted and guidance as to how these criteria may be satisfied is also included. For example, such indices must be sufficiently diversified, represent an adequate benchmark for the market to which they refer and must be published in an appropriate manner. Further expansion of this criteria is outlined in the Eligible Assets Regulations.

Efficient portfolio management

The criteria to be satisfied by transactions made for efficient portfolio management purposes has been set out. For example the techniques and instruments used must be realised in a cost-effective way, they must be utilised in order to either reduce risk, reduce cost, or generate additional capital or income for the UCITS with a level of risk consistent to the risk profile of the UCITS, and their risks must be adequately captured by the risk management process of the UCITS;

Embedded derivative

The criteria to be considered when determining whether a transferable security or money market instrument contains an embedded derivative are set out. In the event that a derivative is embedded, the derivative must meet the criteria for eligible assets and it must be monitored by the UCITS risk management process;

Index funds

The criteria to be applied to funds whose investment objective is to replicate a particular index has been set out, for example, the index's composition must be sufficiently diversified, the index must represent an adequate benchmark for the market to which it refers and the index must be published in a manner which is accessible to the public and independent from the index replicating UCITS. The Eligible Assets Regulations also clarify that the replication of an index can take place by means of direct investment or through the use of derivatives.

The Financial Regulator has amended its Notices and Guidance Notes to reflect the introduction of the Eligible Assets Regulations. The Financial Regulator has taken the opportunity of this revision to introduce a number of additional amendments, for example, concerning acceptable collateral for repurchase/reverse repurchase and stocklending agreements for the purposes of efficient portfolio management.

Advisers to UCITS funds continually engage with the Financial Regulator to agree the process required for existing funds in meeting/complying with these regulations.

Hedge fund indices – scope, accessibility and associated issues

UCITS funds seeking exposure to hedge fund indices must consider certain criteria as set out in CESR's guidelines.

With the publication and subsequent implementation of Directive No. 2001/108/EC (UCITS III) the investment universe open to UCITS funds was expanded to include a variety of additional investment opportunities including the ability, for the first time, to invest in financial derivative instruments (FDIs) for direct investment purposes. This, in particular, was quite a departure from a UCITS perspective as previously there had only been an ability to use FDIs for efficient portfolio management purposes. Under UCITS III, investment in FDIs by a UCITS fund is acceptable on the basis that the underlying assets on which the FDI was based consisted of, amongst others, financial indices. It was clear from the outset that a financial index which consisted of “eligible assets” (i.e. those assets in which a UCITS fund could invest directly), was acceptable. What naturally followed was the question of whether, through the use of FDIs, a financial index comprised of UCITS-ineligible asset classes such as commodities, property or hedge funds would be acceptable, the reason being that there would then be no requirement to “look through” the financial index exposure to the ineligible assets.

Concerns about hedge fund indices

The proposition was initially accepted in relation to property and commodity indices. Concerns relating to the composition of hedge fund indices (HFI) meant it needed further consideration. The concerns included the perceived unrepresentative nature of HFIs, the absence of a definitive database of hedge funds thereby resulting in the universe of hedge funds being somewhat of an unknown, the fact that hedge fund databases are dependent entirely on voluntary reporting by the hedge funds themselves (resulting in a possible situation where smaller, strongly performing hedge funds report to boost their profile, larger hedge funds possibly not seeing the need to report performance, and underperforming hedge funds not reporting poor performances) and “backfilling” i.e. the ability of hedge funds to join a

database once positive performance has been attained thereby showing a positive performance history (with it being unlikely that a hedge fund would join a reporting database from inception of the fund thereby exposing itself to a track record which could include negative or underperformance). As a result, therefore, there was caution in permitting indices based on hedge funds to be accepted as financial indices for UCITS funds.

Commission of European Securities Regulators (CESR) deliberations

In recognition of general market appetite to gain exposure to a variety of previously inaccessible assets, CESR issued a series of consultation papers to market participants to achieve clarification on the eligibility of certain assets as investments of UCITS. This process of deliberation culminated in CESR's guidelines of July 2007 (CESR/07/434) (the CESR July advice) which set out the criteria with which a hedge fund index must comply to be acceptable for use by a UCITS. The CESR July advice provided that, for a UCITS fund to gain exposure to a hedge fund index the UCITS fund must: -

- i. be satisfied that the hedge fund index meets the general requirements for a financial index, i.e.: -
 - » be sufficiently diversified;
 - » represent an adequate benchmark for the market to which it referred; and
 - » be published in an appropriate manner.
- ii. be satisfied that the hedge fund index provides for the selection and re-balancing of components of the hedge fund index on the basis of pre-determined rules and objective criteria in its methodology;
- iii. be satisfied that the hedge fund index does not accept payments from potential components of the index for the purposes of inclusion in the index;
- iv. be satisfied that the hedge fund index does not permit “backfilling”;

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- v. be satisfied that the hedge fund index complies with UCITS requirements for: -
 - » counterparties;
 - » valuation and the ability to close out positions;
 - » risk management and valuation processes; and
 - » risk exposure; and
- vi. carry out appropriate due diligence on the hedge fund index and keep a record of its assessment.

Eligible Assets Directive

As a result of the Eligible Assets Directive “sufficient diversification” requires the composition of a financial index to be diversified such that the performance of a single constituent does not affect the performance of the index as a whole. In addition, the index cannot contain individual components representing more than 20 per cent of the index (while recognising the ability of a single component to have an individual weighting of up to 35 per cent of the index in “exceptional circumstances”).

An adequate benchmark, under the Eligible Assets Directive, refers to the appropriate measurement and performance of a representative group of underlying assets, the periodic revision and rebalancing of the index and sufficiently liquid underlying assets to enable replication of the index if necessary.

Finally, publication in an appropriate manner envisages “sound procedures” on the collection of the price of the underlying asset, together with calculation and publication of the value of the financial index. It also refers to the availability and publication of material information relating to the index calculations, their rebalancing methodologies, changes and operational difficulties in providing the information on a timely basis.

CESR’s guidelines

Of particular note is the extent to which the CESR July 2007 advice imposes significant due diligence requirements on UCITS funds seeking exposure to hedge fund indices. These require consideration of a set of the above-mentioned six criteria a UCITS, “must at least consider”.

These criteria oblige the UCITS fund to assess and to keep records of its assessment of (a) the comprehensiveness of the hedge fund index methodology, i.e. the extent to which information on weighting, classification and treatment of index constituents is adequate and whether the index itself represents an adequate benchmark for the type of hedge funds to which it refers; (b) the availability of information about the index including a clear description of what the index intends to represent in terms of underlyings, whether the index is the subject of an independent audit (and related matters such as the scope of the audit) and (c) the manner in which the index constituents are treated, for example, the level of detail about the index components, their prices and the manner in which sufficient diversification is achieved.

The CESR advice is a welcome development and confirms the approach originally adopted by the Financial Regulator. Hedge fund index providers have been seeking to assist the due diligence process required of the board of directors of UCITS funds by engaging with regulators, including the Financial Regulator, in seeking to obtain “pre-approval” of their indices and are now actively engaging with UCITS promoters to bring the product to market.

Short selling and UCITS 130/30s

Investors are increasingly turning to 130/30 funds to combine the investment potential of hedge funds with the security of traditional long-only funds.

Following the introduction of UCITS III and the capacity to use financial derivative instruments (FDIs) for direct investment purposes, UCITS funds gained the ability to short synthetically and thus allowed for the creation of long-short products in UCITS. The most prolific long-short product at the moment is the 130/30.

A 130/30 fund combines a long portfolio exposure of 130 per cent with a short portfolio of 30 per cent. The extra 30 per cent long exposure is a leveraged exposure financed by the 30 per cent short sale of assets the investment manager believes are overvalued. This structure is a generic term for many combinations of short extension funds and may adopt variations such as 140/40 or 120/20 funds, with 150/50 being the maximum allowable given the 100 per cent leverage limit for UCITS. The 130/30 structure, however, appears to be the generally accepted critical mass for producing an optimal beta plus alpha risk/return for investors.

Unlike a market neutral fund, which targets an absolute return, a partial short strategy remains benchmark driven but allows the manager to greater freedom in their bid to outperform. The theory behind the product is that shorting increases the portfolio optimisation and allows the investment manager to better reflect their investment views. A 130/30 fund is managed to a benchmark, like a long only fund, however, in a long only fund a manager may only underweight stocks that he does not like whereas 130/30 permits that manager to actually short those stocks. The manager is still in a position to continue to underweight and overweight other stocks so there is an enhanced profit possibility that should produce a better risk adjusted return than a long only fund.

Managers claim that 130/30 funds typically deliver excess return for a lower level of risk than traditional high alpha products. In practice, swaps may be used to generate synthetic short exposure and additional leveraged long exposure. Using FDIs in a UCITS fund must be in accordance with the Financial Regulator's requirements and in conjunction with a risk management process that has been agreed with the Financial Regulator. That risk management process will detail how exposure generated through the use of an FDI is measured. Daily calculations of exposure are required and leverage generated through the process cannot exceed 100% of the NAV of the fund. Counterparties in over-the-counter arrangements must have a minimum credit rating and exposure to

the counterparty must not exceed a maximum of 5% or 10% (where the counterparty is a credit institution). The UCITS must also have a contractual netting agreement in place with the counterparty.

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Some commentators have expressed concerns that traditional long only managers may not have the expertise required to utilise short selling strategies effectively, whether they use fundamental or quantitative based approaches. Managers that have in place investment processes with a proven track record of good stock picking and also identifying weaker stocks are the ones more likely to succeed. Notwithstanding the additional infrastructure and compliance required by UCITS structures, the market place is also seeing the entry of hedge fund managers who are seeking additional flows and traditional managers merging their long capabilities with the infrastructure and shorting experience of their related hedge fund operations. Hedge fund managers have the capabilities and experience in shorting and indeed the existing relationships with the counterparties that are needed for the shorting activity.

It seems that significant interest in the 130/30 product is from institutional investors and pension funds and 130/30 within a UCITS structure can be seen as a transitional step to investing in an alternative strategy. While 130/30 is a product that will sit within a core equity allocation, or can form part of a core-satellite approach for some investors, a key interest is that it constitutes a move toward a more alternative strategy while retaining the risk management and control processes that are associated with UCITS and give comfort to such investors.