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Moving towards UCITS VI

Rolling back on complexity?

Investment Management
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The European Commission published on 26 July a wide-ranging consultation paper that will form the basis of a further update to the UCITS framework. The consultation paper focuses on product rules, liquidity management, an EU depositary passport, money market funds and long-term investments. The consultation is complementary to recent work on shadow banking coordinated by the Financial Stability Board and the publication of 'Guidelines on ETFs and other UCITS issues' by the European Securities and Markets Authority (ESMA).

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This consultation is distinct from the UCITS V proposals published in July 2012, which will bring UCITS in line with the depositary and remuneration provisions of the Alternative Investment Managers Directive (AIFMD) and will also include a harmonised sanctions regime. All other updates which the European Commission decides to pursue will be included under UCITS VI and this consultation paper represents the start of that process. UCITS VI could represent a significant rolling back from UCITS III in terms of the use of derivatives to achieve exposure to otherwise ineligible assets and to increase leverage in the fund. Measures on efficient portfolio management (EPM) techniques may curb practices in relation to securities lending, repos and reverse repos.

The consultation outlines eight key areas for consideration:

- Eligible assets and use of derivatives
- Efficient portfolio management techniques
- OTC derivatives
- Extraordinary liquidity management tools
- Depositary passport
- Money market funds
- Long-term investments
- Addressing UCITS IV

Eligible assets and use of derivatives

The Commission raises questions in relation to UCITS adopting highly sophisticated investment strategies and gaining exposure to non-eligible assets through the use of derivatives. It seeks information regarding current market practice and asks if all strategies currently observed in UCITS are in line with retail investor expectations. The consultation solicits views on whether further refining of the rules on exposure to non-eligible assets is necessary and whether the scope of eligible derivatives should be limited.

If such changes were to be adopted many sophisticated UCITS would breach UCITS investment rules and the leverage limit.

In particular, the Commission questions whether a “look though” approach for transferable securities, investments in financial indices or closed-ended funds should be adopted. The Commission also considers moving away from VaR as a method of global exposure and relying solely on the commitment approach as a measure of leverage. If such changes were to be adopted many sophisticated UCITS would breach UCITS investment rules and the leverage limit. The Commission also considers permitting in UCITS only derivatives which are traded on multilateral trading platforms and cleared through a Central Clearing Counterparty (CCP).

Efficient portfolio management techniques

The Commission acknowledges the significance of the use of efficient portfolio management (EPM) techniques across UCITS, which relate to activities such as securities lending and repos and reverse repos. It raises concerns regarding the transparency of EPM techniques, counterparty risk and the quality/reinvestment of collateral. The Commission seeks to assess current market practice and systemic risk related to the use of EPM techniques.

A UCITS is not permitted to borrow or lend but the Commission is concerned that certain EPM techniques are the equivalent of borrowing or lending. The consultation considers making EPM transactions recallable at any time and putting a limit on the amount of portfolio assets that may be the object of EPM.

OTC derivatives

The Commission raises questions in relation to the treatment of OTC derivatives, particularly with a view to the European Market Infrastructure Regulation (EMIR), which will require certain OTC derivatives to be cleared through central counterparties. The Commission is concerned about a UCITS exposing its entire portfolio to a single OTC derivative counterparty, which can happen if that counterparty provides collateral for more than 90% of the exposure of the UCITS. The consultation seeks information on what measures could be taken to mitigate counterparty risks, referring to the possibility of counterparty risk calculation on at least a daily basis.

Extraordinary liquidity management tools

The consultation observes that during the financial crisis some UCITS were confronted with ‘liquidity bottlenecks’ such that they were unable to redeem units on request. The paper asks whether more developed rules on a European-wide basis may help fund managers facing liquidity bottlenecks. The Commission wants to consider the use of “extraordinary liquidity management tools” such as side pockets and is also concerned about ensuring sufficient liquidity in secondary markets for ETF investors.

Depositary passport

The Commission notes that both AIFMD and UCITS V will harmonise EU depositary rules and therefore possibly create the basis for an EU depositary passport. This means that a depositary located in one EU member state would be able to provide depositary services to a UCITS established in another EU member state. The Commission requests views on the advantages and drawbacks that such a passport would create.

Money market funds

The Commission recognises money market funds (MMFs) as an important source of funding and liquidity, requesting views on their 'potential systemic importance' due to their central role in short term funding and their possible susceptibility to 'runs' by investors and contagion. In response to these concerns the Commission outlines three areas where measures relating to MMFs may be required – valuation and capital; liquidity and redemptions; and investment criteria and rating.

- **Valuation and capital**
  The Commission questions whether Constant NAV (CNAV) MMFs give the impression of a capital guarantee to investors and whether CAVs should be subject to additional regulation or even phased out. The paper asks whether capital buffers should be imposed on CNAV funds and if only mark-to-market valuation methodologies should be allowed in stressed market conditions.

- **Liquidity and redemptions**
  The Commission notes that MMFs allow investors to withdraw on demand but at the same time MMFs invest in assets that mature in the future and which do not necessarily display daily liquidity. The Commission considers that this situation might impede an MMF's ability to face large redemption requests from investors. The Commission solicits opinion on different options to address these concerns, including liquidity fees, redemption restrictions and liquidity constraints.

- **Investment criteria and rating**
  The Commission notes that the MMF industry relies extensively on credit ratings and expresses concerns about the systemic consequences of a downgrade in an MMF's AAA rating. This is because investors may want to switch their positions quickly to another MMF leading to a sharp decline in the downgraded fund's assets. It is argued that banning the rating of MMFs would force investors to assess for themselves the risk/reward profile of the funds instead of relying on credit rating agencies' opinions. This, the Commission considers, would increase their monitoring and reduce the potential for systemic overreactions to sudden new developments

Long-term investments

The Commission considers the economic and social benefit of long-term investment among retail investors and is considering a common EU approach in this area to promote the Internal Market. The Commission outlines a range of long-term investments including investments into unlisted companies (early or mature stage), infrastructure projects, 'real' assets (real estate, other physical assets), and third-party managed funds making investments in unlisted companies. The paper requests views on whether there would be appetite among retail investors for long-term investment products and whether this could be best achieved through modifications to the UCITS rules or as a stand-alone initiative.

Addressing UCITS IV

The Commission outlines a number of proposed measures to address various aspects relating to the new provisions under UCITS IV. This includes empowering the Commission to prescribe more detailed organisational rules for UCITS self-managed investment companies. Certain changes to facilitate the smoother operation of master-feeder structures, fund mergers and the notification procedure are also envisaged. However, the consultation does not consider any of the tax barriers that have given rise to challenges in availing of the efficiency-enhancing measures provided for under UCITS IV.

The Commission outlines that some of the organisational and operational provisions included under AIFMD are now more detailed than comparable provisions under UCITS. These include measures on organisational rules, delegation, risk and liquidity management rules, valuation, reporting and calculation of leverage. The Commission requests feedback on whether further alignment between the AIFMD and UCITS frameworks is required in order to ensure consistency.

Next steps

This initial consultation represents the first step towards a UCITS VI directive. The Commission has invited contributions by 18 October 2012. It will then prepare a feedback statement and proposals which it is expected will be subject to further consultation before they are presented to the Council of Ministers and European Parliament for adoption under the co-decision procedure. It may take several years before the proposals are adopted and then implemented nationally.

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