UCITS VI

New consultations on UCITS

First steps toward UCITS VI

The latest European Commission's consultation paper on product rules, liquidity management, depositary, money market funds and long-term investments, colloquially referred to as UCITS VI, demonstrates the on-going regulatory scrutiny and is paving the way for further improvements of the UCITS framework.

The thematically wide-ranging UCITS VI consultations question a review of eligible assets for UCITS and put in particular money market funds under further scrutiny.

Recent findings and international discussions on shadow banking in mind, the Commission explores feasible policy options for the use of securities lending, repo's and OTC derivatives within the UCITS product.

Furthermore, the EC is gathering feedback on the available toolkit to manage liquidity bottleneck under exceptional circumstances required by some UCITS during crisis related market turmoil's, and on a few suggested rectifications of UCITS IV framework.

The UCITS VI consultation paper also seeks industry and regulator feedback on two more conceptional topics: The introduction of a European passport for depositary banks and on measures to foster long-term investments for retails investors.

Striving to keep pace with the international regulatory agenda, the level of granularity at which the Commission is seeking industry feedback, evidence and guidance across the different topics for UCITS VI suggests that impacts for the different stakeholders of any proposed changes are carefully considered.

The continuation of the UCITS success story, keeping the regulatory framework up to the state of art of the market environment appears to be at the forefront of the agenda.

Keeping you up to date with the on-going regulatory discussions, please find a summary of the key area's under review for UCITS VI here below.

Eligible assets

The consultations are driven by the Commission's concerns about the appropriateness of the application of highly sophisticated investment strategies for a UCITS product as well as the current common practice to gain exposure to non-eligible assets through financial derivatives instruments which are linked to indices, closed-ended funds or structured transferable securities.

Besides a review of the overall scope of eligible assets, the necessity to refine liquidity rules for eligible assets and the exposure to non-eligible instruments by adopting a look-through approach or diversification rules at the level of the underlying assets.

The consultations also explore the appropriateness of VAR and commitment approach for calculation of global exposure. Anticipating the post-EMIR environment the question of whether only financial derivative contracts which are cleared through CCPs should be eligible for a UCITS, is raised.

Efficient portfolio management techniques (Sec lending & repo's)

Transparency, disclosure, counterparty risk and the quality of collateral, as well as the re-investment of collateral are the key concerns of the employment of Efficient Portfolio Management technique (EPM: Securities lending and repurchase agreements) for the regulator.

Considering the widespread use of EPM, the Commission seeks to understand the current market practice and the associated issues and risks. Questions towards limitations of the use of EPM, specification of criteria for the eligibility, liquidity and diversification of collateral along with the re-use of collateral are raised.

Also, the introduction of mandatory haircuts and liquidity considerations for the determination of the duration of the EPM transactions are examined.

OTC derivatives

With the post-EMIR environment in mind, the consultations focus on the appropriate assessment of counterparty risk for OTC derivatives for UCITS.

Consistency of collateral requirements for OTC and EPM transactions, measures to mitigate risks if a UCITS contracts with a single counterparty, the introduction of the new requirements for the calculation of OTC counterparty risk and issuer concentration on a daily basis, are among the proposed policy options for which the European Commission is querying industry feedback.

Extraordinary liquidity management tools

Recent market turmoil's created liquidity bottlenecks for a number of UCITS, hence the European Commission aims to assess whether additional rules and liquidity management tools in exceptional market circumstances (i.e. introduction of time limits for temporarily suspended redemption orders, use of side-pockets, introduction of liquidity safeguards for investors in secondary ETF markets) and a common understanding for what is meant by exceptional circumstances would enhance investor protection, keeping the appropriate balance between the interests of investors redeeming from and remaining in the UCITS.

Money market funds

Further to the 2010 published non-binding CESR guidelines for European Money Market Funds (MMFs), the potential systemic importance of MMFs and their related investors demand as a refuge asset call for further scrutiny of the regulatory framework for MMFs.

A particular concern is the wide-spread investor perception of money market funds as safe-haven for cash investments (even as substitute for bank deposits in the case of Constant NAV Money Market Funds (CNAV)).

Especially CNAV (approx. 40% of the EU MMFs as per EC estimate) which apply amortised cost valuation method are in the focus of attention as they are particularly prone to investor runs ("break the buck phenomenon") and may under such circumstances no longer offer redemption at par.

The introduction of additional rules such as stronger capital requirements (for example through introduction of buffers), but also a reduction or phasing out of the activities are contemplated policy options within the consultation paper.

Moreover policy measures to deal with or prevent liquidity bottlenecks, such as a liquidity fee for first redeemers, redemption restrictions (limits on share purchases, retention scenarios) and liquidity constraints (investments in securities with set maturities) are under review.

Furthermore, the Commission sees the reliance of money market fund industry on credit ratings as critical. To unbundle this interdependence, the EC aims to re-assess the definition of money market instruments, to evaluate consequences of the introduction of a rating ban for MMFs and a prohibition of investment criteria related to credit rating.

The Commission also seeks industry feedback on the necessary requirements for an internal assessment of the credit risks associated with target investments (independent from external ratings).

Enhancements to UCITS IV framework

The European regulator identified four areas of improvement of UCITS IV, which came into force in July 2011:

- Self-managed investment companies (ensuring that level 2 measures apply to investment companies and management companies alike)
- Master-feeder structures: coverage of the scenario "feeder UCITS converts into ordinary UCITS"
- Improvement of notification procedure between member states (reg. changes of the marketing materials and marketing of a new shareclass)
- Notification for cross-border mergers: clarification 20 working days rules to improve legal certainty

Acknowledging different granularity in the provisions on "organisational rules, delegation, risk and liquidity management rules, valuation, reporting or calculation of leverage" between AIFM Directive and the UCITS regime, the Commission also seeks industry feedback whether further harmonisation and alignment of both regimes is needed "to improve consistency of rules for the European asset managers".

Depositary passport

With forthcoming AIMFD and UCITS V taking measures towards the harmonisation of the regulatory framework of the depositaries within the EU, the introduction of a European depositary passport is seen as logical achievement for a single European market.

In a next step the Commission is now looking to establish drawbacks and advantages, which different market participants would incur under the introduction of such a passport, what it would mean for local regulators in the member states and which further harmonisation measures (i.e. harmonisation of capital requirements for depositaries, definition of tasks and permitted activities, calculation of NAV, etc.) would have to be adopted prior to the introduction of an EU-Pass for depositories.

Long-term investments

Recognising that funds with long-term investment objectives generally have a low level of liquidity, are often associated with lock-up periods and thus reserved to institutional investors, the EC is looking to establish a common framework (within UCITS or as an additional framework, definition of eligible assets, diversification rules, use of leverage, level of investor protection, etc.) allowing retail investors to invest into funds, which assist to fulfill marcoecononomic growth objectives through investments into infrastructure projects (transportation, energy, health, education).

Contact

Lou Kiesch
Partner – Regulatory Consulting
lkiesch@deloitte.lu

Xavier Zaegel
Partner – Capital Markets/Financial Risk Leader
xzaegel@deloitte.lu