

Background note
on the
ESC working document
Elements for a possible Commission Regulation on the clarification of definitions under
the UCITS-Directive

ESC/14/2006

The UCITS-Directive creates a harmonised framework for investment funds. It specifies the core features of this financial product such as risk-diversification, redemption of units on the request of unit-holders, regular valuation, and oversight by a depositary. The UCITS-Directive also contains detailed provisions prescribing the assets which are eligible for investments by UCITS. Directive 2001/108/EC has expanded this list beyond transferable securities to include also money market instruments, units of UCITS and other collective investment undertakings as well as banking deposits. The amendments also allow UCITS managers to manage index-replicating UCITS and to make greater use of derivatives. Financial derivative instruments may not only be used for the purposes of hedging, but also to increase returns.

The UCITS-Directive is not a Lamfalussy-Directive. However, Art. 53a of the Directive 85/611/EEC, as amended, confers delegated powers to the Commission to clarify definitions of the Directive in order to ensure a uniform application of the Directive throughout the European Union. The UCITS-Directive contains several definitions which are related to the assets which are eligible. This includes the definition of the UCITS which foresees that it is solely invested in transferable securities and/or other liquid financial assets. The Directive also contains a definition of transferable securities and a definition of money market instruments. All these definitions are also linked to each other. There is a variety of financial instruments which are now traded on modern financial markets. There are uncertainties among competent authorities and market participants as to whether certain of these instruments might be encompassed by the definitions of the Directive. In order to provide competent authorities and market participants with more certainty in this respect, the Commission has decided to make use of its empowerment in Art. 53a of the Directive and to clarify the meaning and the scope of these definitions, and, as the case may be, their application to certain financial instruments.

This clarification of definitions seeks to ensure that the definitions are interpreted in the light of the principles of the UCITS-Directive such as risk-diversification and limits to exposure, the ability of the UCITS to redeem its units at the request of the unit-holders and to calculate its net asset value any time units are issued or redeemed. This approach allows an understanding of the definitions which takes recent market developments and the necessary product innovation within UCITS into account. It also ensures that the definitions are understood in coherence with the overall context of the Directive. This will promote a common understanding of the features of the UCITS-product. It will enhance a common reading as to whether certain assets are eligible for investment under the UCITS-Directive. It will reduce the potential of divergent interpretations of the Directive and will thus help to improve the functioning of the product passport. The clarification provided by this regulation will improve legal certainty and enable a more coherent interpretation of Directive 85/611/EEC.

In developing this approach the Commission has taken particular care that the limits of the delegated powers which are confined to the clarification of definitions are respected. Any clarification of definitions cannot have the effect of imposing new obligations on competent authorities or market participants.

Therefore, the clarifications provided by this regulation do not of themselves give rise to any new behavioural or operational obligations for competent authorities or market participants. The clarifications also refrain from establishing exhaustive lists of concrete financial instruments or transactions which would fall under the definitions. Given the rapidity of financial innovation such lists would incur the risk of being incomplete or quickly outdated. The clarifications of this text rather limit themselves to elucidating basic criteria which help in assessing whether or not a class of financial instrument is encompassed by the scope of the definitions. The integration of these clarifications into the day-to-day supervision of UCITS and their use in assessing whether a concrete financial instrument complies with the definitions, as clarified by this text, falls to the national competent authorities. In order to ensure that these clarifications make the fullest contribution to the smooth implementation of Community law in this field, national competent authorities could work together – through the Committee of European Securities Regulators (CESR) – to develop common approaches on the practical day-to-day application of these clarifications. Such work could comprise, inter alia, the development of a common approach towards the application of the criteria for derivatives on financial indices to indices composed by assets which are not referred to under the Directive as a possible investment for UCITS.

The eligibility of an asset for a UCITS must be assessed not only with regard to whether it falls within the scope of the definitions as clarified by this text. Investments by UCITS into financial assets need also to be undertaken in a manner which is consistent with other relevant provisions of the Directive. Relevant in this respect are, inter alia, the requirements of the Directive on control procedures and risk-management and the way how UCITS-manager should organise such processes with respect to certain risks such as liquidity assessment. It goes beyond the scope of this clarification of definitions to codify the steps national authorities or UCITS-managers should undertake to ensure that investment in eligible assets, as clarified by this text, takes also place in conformity with these provisions. A convergent approach on the day-to day implementation of these elements would further contribute to the sound implementation of the UCITS-Directive. Such work which could be undertaken by competent authorities – through the Committee of European Securities Regulators (CESR) – would also help to complement this clarification of definitions and improve the functioning of the product passport.

The Commission services envisage bringing forward this draft implementing measure in the form of a regulation. The nature of this exercise is confined to the clarification of the reading of existing provisions of the Directive. This lends itself to a Regulation. The technical and detailed provisions of this implementing measure are capable of direct application to all UCITS, without the need for national transposition. In addition, it is desirable to avoid both potential for divergences in transposition of these provisions and unproductive extension of delays before the measures take effect.

This document reflects the contents of the technical advice produced by the Committee of European Securities Regulators (CESR) which assists the Commission in the preparation of technical implementing legislation on the basis of a Commission mandate. The Commission issued its mandate in October 2004. In January 2006, CESR has communicated its final

advice to the Commission. The advice reflects the results of two round of market consultation which had a significant impact on its final content and shape. This process has helped to clarify implications of the envisaged clarifications for the implementation of the Directive and to build confidence that the envisaged clarifications will not lend to undue disruption to the market place.

Annex to the background note

Explanation of Articles

1. Article 1: Transferable securities

This Article clarifies the definition of transferable securities as referred to under Art. 1 (8).

It clarifies that the definition has to be understood in coherence with the other provisions governing the features of a UCITS. It further clarifies the application of the definition of transferable securities to closed end funds and certain structured financial instruments.

a) Paragraph 1: Transferable securities

The UCITS-Directive defines transferable securities exclusively from a formal-legal point of view. Because of this, the definition of transferable securities is applicable to a wide range of financial instruments with differing features and different levels of liquidity. In all these cases coherence between the definition of transferable securities and the other provisions governing the features the UCITS have to be ensured: The ability of the UCITS to redeem or repurchase its units at the request of the unit-holders, its ability to calculate its net asset value any time units are issued or redeemed. Therefore, this paragraph aims at putting these formal criteria into the context with these other provisions to ensure a coherent reading of the definition of transferable securities.

b) Paragraph 2: Closed end funds

The 2nd paragraph clarifies the application of the definition of transferable securities to closed end funds.

Closed end funds are an asset class which is not explicitly referred to as an eligible asset for a UCITS under the Directive. The "dual nature" of closed end funds gives rise to particular uncertainties as regards their categorisation. On the one hand closed end funds are collective investment undertakings which could justify a treatment distinct from the concept of "share in a company" or "security equivalent to a share in a company" as referred to under the definition of transferable securities. On the other hand, their units are often treated as similar to any other transferable security, for instance their admission to trading on a regulated market often gives grounds to treat them as transferable securities. It was therefore necessary to provide market participants and competent authorities with certainty as to whether closed end funds would fall under the definition of transferable securities in accordance with the Directive. It has been clarified that units of closed end funds whether constituted in the form of investment companies or common funds which are subject to corporate governance mechanism applied to companies or mechanisms equivalent to those applied to companies can be transferable securities within the meaning of the UCITS-Directive insofar as they comply with the criteria for transferable securities. The clarification, however, takes also into account that closed end funds are collective investment undertakings for which the asset management activity is often or regularly, as in case of contractual closed end funds, carried out by an entity on behalf of the closed end fund. To ensure an appropriate level of investor protection in these cases it is clarified that this entity is subject to national regulation for the purpose of investor protection.

c) Paragraph 3: Financial instruments backed by or linked to the performance of other assets

This provision clarifies the scope of the definition of transferable securities with respect to financial instruments which are backed by or linked to the performance of other assets.

The categorisation of these instruments (often referred to as "structured financial products") gives rise to uncertainties, particularly if the backing or linked assets are not themselves eligible under the UCITS-Directive, e.g. instruments referring to the oil price or to commodities. The document clarifies that such instruments are transferable securities if they comply with the criteria set out in this text. Whether the linked or backed assets are themselves eligible for UCITS investment in accordance with Art. 19 (1) of the Directive is not relevant for this qualification. This approach is based on the consideration that the Directive does not require such a "looking-through approach."

If the instrument contains an embedded derivative element it is a transferable security embedding a derivative element under the rules of Art. 21 (3) 4th sub-paragraph of the Directive. This has the consequence that the derivative component has to comply with the limits on global exposure and issuer risk in order to make the entire instrument eligible for a UCITS.

Art. 1 para. 3 also clarifies that not all forms of linkage to other assets should be construed as embedding a derivative element. There is only an embedded derivative element if the linkage amounts to an embedded derivative element in accordance with the criteria developed for the identification of embedded derivatives in Art. 4 of this text or if there is another element which has to be qualified as an embedded derivative according to this text. This means that there should be an identifiable host contract whose cash-flows are modified by the linkage. If, for instance the instrument merely replicates the performance of a certain underlying (e.g. oil price) at a ratio of 1:1, there would be no embedded derivative element in accordance with these criteria. The instrument has to be considered a "plain" transferable security if it complies with the criteria of Art. 1 para. 1 of this text.

Article 2: Money market instruments

This Article clarifies the definition of money market instruments as referred to under Art. 1 (9) of the Directive.

a) Paragraph 1: Clarification of the criteria "normally dealt in on the money market", "liquid" and "accurate value"

Art. 2 para. 1 aims at ensuring a uniform application of the criteria which a financial instrument has to fulfil in order to fall under the definition of money market instruments. For this clarification certain market practices e.g. as regards valuation methods are taken into account. It also seeks to clarify that the criteria have to be understood in coherence with other principles of the UCITS-Directive, particularly with respect to the obligation of the UCITS to be able to redeem or repurchase its units on the request of unit holders.

In particular, it is clarified that financial instruments with a maturity or residual maturity of 397 days fulfil the criterion "normally dealt in on the money market". This will clarify that UCITS are not prevented from investing in a number of money market instruments issued in

the USA which have often a maturity of 397 days. As regards the criterion "value which can be accurately determined at any time" this document clarifies that this criterion is fulfilled for instruments for which accurate and reliable valuation systems are available whereby these systems can be based on amortised cost methodology. This approach reflects the way how a major proportion of the European money market fund industry price money market instruments. The clarification takes also into consideration that there are financial instruments which have longer maturities than 397 days, but which have following an in-depth assessment a risk profile which corresponds to that of the instruments referred under this paragraph – particularly as regards credit and interest risks.

b) Paragraph 2: Scope of the definition

This provision recalls that all money market instruments under the Directive; i.e. both those which are admitted to trading on a regulated market and those which are not admitted to trading according to Art. 19 1 (h) and Art. 19 (2) of the UCITS-Directive have to comply with the criteria as set out under Paragraph 1.

It is also clarified that for instruments which are traded on a regulated market in accordance with Art. 19 (1) a,b,c of the Directive the compliance with the criteria of liquidity and accurate can be presumed.

c) Paragraphs 3, 4, 5: Criteria for money market instruments not dealt in on a regulated market in accordance with Art. 19 (1) h.

The definition of money market instruments of the UCITS-Directive extends to other financial instruments which are not admitted to or dealt in on a regulated market for which the Directive sets out criteria further in addition to the general criteria for money market instruments. It is therefore equally necessary to clarify these criteria in the light of investor protection requirements and taking into principles of the UCITS Directive such as portfolio liquidity.

Paragraph 3:

This paragraph refers to the criterion "issue or issuer itself regulated for the purpose of investor protections" as referred to under Art. 19 (1) h first paragraph of the Directive. It aims at reconciling this general requirement with the four indents of Art. 19 (1) h.

For this purpose CESR advice makes reference to criteria of the STEP project of ACI, FBE and ECB which aims at promoting a transparent and liquid European money market.

From these STEP standards the following generic criteria for all instruments under Art. 19 (1) h can be derived: Availability of appropriate information, a minimum issuance amount and free transferability of the instrument. Those criteria would also help to reconcile Art. 19 (1) h with the four indents of Art. 19 (1). These criteria are reflected in point 3 of this implementing measure.

CESR advice, however, proposes specifications of the criterion "availability of information" which differentiate between different products.

a) For commercial papers issued by certain corporate issuers as well as for certain papers issued by local authorities or public international bodies appropriate information means

- ❖ availability information on both the issue or the issuance program and the legal and financial situation of the issuer
- ❖ regular up-dating of this information
- ❖ control of by specialised independent body
- ❖ availability of reliable statistics regarding the issue or issuance program

b) For certificates of deposits issued by credit institutions and for papers issued by sovereigns and those papers issued by local authorities and public bodies which do not fall under a) appropriate information means

- ❖ availability information on both the issue or the issuance program **or** the legal and financial situation of the issuer

This differentiation takes into account that e.g. certain certificates of deposits would have difficulties to comply with the criteria under point a).

Particular attention should be devoted when considering these elements for the reasons set out below:

- The approach under a), particularly the reference to an independent body, would exclude an important fraction of the European commercial paper market from being eligible for a UCITS. Such a body is not foreseen in all EU-jurisdictions. The approach under a) would also rule out non-European issuers of commercial papers. The Directive does not foresee such limitations. It also conflicts with the clarification given under para. 1 of this Article which encompasses all money market instruments of the Directive and explicitly aims at including money market instruments issued in the USA.
- The reference to an "independent body" gives also raise to concerns since it result in the institutionalisation or formalisation of the role of a particular structure or body. To the extent that only one body exists which could play such role, such an approach incurs the risk of formalising a particular market structure.
- There are also concerns that the different criteria regarding banks as issuers and corporate issuers could lead to distortions within the European money market.

Paragraph 4:

Paragraph 4 refers to the criterion "issued by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by community law". It clarifies that the criterion means instruments which comply with the criteria for money market instruments under paragraph 1 and which are issued by an issuer located in the EEA, the G 10 countries, by an issuer which

has at least investment grade rating or by an issuer for which it can be demonstrated that the prudential rules are at least as stringent as those laid down by community law.

Paragraph 5:

Paragraph 5 clarifies that the criterion "issued by an entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line" as referred to under Art. 19 (1) h last indent last alternative only refers to a very specific type of commercial paper which is built on a two-tier structure and which is secured by a banking credit enhancement which is secured by a financial institution.

This clarification is based on the wording of the Directive which considers as the issuing entity for such papers not the securitisation vehicle itself but the entity which is dedicated to the financing of this securitisation vehicle.

d) Paragraph 6: Financial instruments backed by other assets

This paragraph aims to clarify under which conditions asset backed commercial papers can nevertheless be considered as money market instruments within the meaning of the Directive and thus eligible for a UCITS.

It is clarified that these instruments which comply with the criteria for money market instruments as set out under paragraph 1 and which are either traded on a regulated market according to Art. 19 a,b,c of the Directive or which are not admitted to trading as referred to under Art. 19 (2) of the Directive (10%-limit) fall also under the definition of money market instruments and are eligible.

It should be noted that asset backed securities with longer maturities than money market instruments which comply with the criteria of Article 1 of this text are transferable securities within the meaning of the Directive as clarified by Art. 1 para. 2 lit c of this text.

Article 3: Financial derivatives

This Article provides clarifications in respect of financial derivative instruments

a) Paragraph 1: Criteria for financial derivative instruments

The Directive considers derivative financial instruments as financial liquid assets within the UCITS-definition, if they fulfil the criteria set out by the Directive. These, inter alia, circumscribe the underlying of a derivative or contain specific liquidity standards for OTC-derivatives.

It is clarified that these criteria have to be understood in coherence with other provisions of the Directive; in this respect it is clarified that financial derivative instruments fulfil these criteria if they have the following underlyings: Assets listed in Art. 19 (1) of the Directive which includes financial instruments having one or several characteristics of these assets (e.g. dividends), interest rates, foreign exchange rates or currencies, combination of these underlyings and financial indices. Also some important criteria regarding OTC-derivatives which particularly request a uniform application, notably the criterion "to be sold, liquidated or closed by an offsetting transaction at any time at their fair value" and the criterion "subject

to a reliable and verifiable valuation on a daily basis." Therefore, this text clarifies these criteria taking into account the principles of the Directive regarding NAV calculation, redemption of units on the request of unit-holders and portfolio liquidity.

There was uncertainty as to whether credit derivatives can be considered as a financial derivative within the meaning of the Directive, and thus a financial liquid asset. However, the provisions of the Directive regarding the underlyings of a derivative, as further clarified by this text, do not exclude derivatives which are built on the credit risks of those underlyings. It is therefore clarified that credit derivatives which comply with the criteria for OTC-derivatives of the Directive, and which result in the delivery or in the transfer of assets as referred to under Art. 19 (1) of the Directive including cash are derivative instruments within the meaning of the Directive. Credit derivatives meeting these criteria are hence eligible for treatment as financial liquid assets. For this clarification the risks of asymmetry of information which are particularly relevant in case of OTC-derivatives have to be taken into account. This is especially the case of credit derivatives which are concluded with counterparties which might have access to non-public information on firms referenced by credit derivatives.

b) Paragraph 2: Derivatives on financial indices

The need to clarify the criteria for derivatives in coherence with other provisions of the Directive is particularly relevant for derivatives on financial indices. On modern financial markets, there is a wide range of financial indices which function as an underlying of a derivative. These indices may vary as regards their composition or the weighting of their components. In all cases it has to be ensured that the UCITS is able to fulfil its obligations as regards portfolio liquidity and the calculation of the net asset value and that these obligations are not negatively affected by the features of the underlying of a derivative. It is therefore clarified that derivatives on financial indices whose composition is sufficiently diversified, which represent an adequate benchmark to the market to which they refer and which are subject to appropriate information regarding the index composition and calculation fall under the category of derivatives as financial liquid assets within the meaning of the Directive.

It is also clarified that derivatives on indices which are composed by assets in accordance with Art. 19 (1) but which do not comply with the criteria for financial indices have to be considered as derivatives on a combination of eligible assets. Consequently, they are also derivatives within in the meaning of the Directive and hence eligible for treatment as financial liquid assets.

The categorisation of these derivatives is relevant with respect to the application of Art. 21 (3) 3rd sub-paragraph:

Derivatives on indices which comply with the criteria set out by this paragraph are considered derivatives on "true" indices. They are therefore subject to the preferential treatment as provided for by Art. 21 (3) 3rd sub-paragraph last sentence. This means that the underlying assets do not have to be combined with the other assets in the fund in accordance with the issuer concentration rules of Art. 22.

Derivatives on indices which are composed by assets in accordance with Art. 19 (1) but which do not comply with these criteria do not benefit from a preferential treatment: The underlying assets composing the index have to be combined with the other assets in the UCITS in accordance with Art. 21 (3) 3rd sub-paragraph 1st sentence.

c) Paragraph 3: Derivatives on commodities

This provision clarifies that – taking into account the rules of the Directive - derivatives on commodities are not derivatives within the meaning of the Directive and thus not eligible for treatment as financial liquid asset.

Article 4: Transferable securities and money market instruments embedding derivatives

Article 4 gives some clarification on transferable securities and money market instruments embedding derivatives.

The Directive recognises as a sub-category of transferable securities and money market instruments those which embed a derivative element. Embedding a derivative element into a transferable security or money market instrument does not transform the whole financial instrument into a financial derivative instrument which would fall outside the definition of transferable security or money market instrument. However, embedding a derivative into a transferable security or money market instrument incurs the risk that the rules for derivatives imposed by the Directive, such as the limit to global exposure or the issuer concentration limits are bypassed. For this reason, the Directive requires identification of the embedded derivative element and compliance with these limits.

To achieve more certainty in this respect, this document establishes criteria for this identification. These criteria are inspired by paragraph 10 and 11 of IAS 39; they take, however, into account that IAS standards have a purpose which is distinct from that of the UCITS-Directive. It is clarified that a component which modifies the cash-flows of the transferable security or money market instruments which functions as host contract, which is not closely related to the economic risks of the host contract and which has a significant impact on the host contract constitute an embedded derivative. This approach will facilitate the identification of the embedded derivative for the purposes of the Directive.

Article 5: Techniques and instruments for the purpose of efficient portfolio management

In order to determine the boundaries of the definitions of "transferable securities" and "money market instruments" Art. 5 of the text clarifies the criteria for the identification of the transactions which fall under the techniques and instruments for the purpose of efficient portfolio management.

Pursuant to the Directive techniques and instruments relating to transferable securities or money market instruments for the purpose of efficient portfolio management in accordance with Art. 21 (2) do not fall under the definitions of transferable securities and money market instruments. To clarify the boundaries of these definitions this text sets out criteria to identify the transactions which would fall under these techniques and instruments.

On the basis of these criteria such techniques and instruments include e.g. repurchase agreements or security lending transactions. The clarification, however, refrains from establishing an exhaustive list of the types of transactions which would fall under these techniques and instruments. Considering that there is already a wide variety of techniques and

taking into account that financial markets permanently generate new types of transactions such list would incur the risk of being incomplete and quickly outdated. This would unnecessarily stifle product innovation within UCITS. Instead, this text sets out generic criteria to assess the compatibility of a given technique or instruments with the Directive. These criteria make clear that these techniques and instruments have to be understood in coherence with the other obligations of a UCITS, particularly as regards the risk-profile of a UCITS including the restrictions of the Directive on short sales and borrowing, risk-management and the detailed rules on risk-diversification. This will provide the necessary degree of flexibility within UCITS, but ensures at the same time that these techniques and instruments do not lead to overlooking these provisions of the UCITS-Directive.

Article 6: Index replicating UCITS

This Article clarifies the criteria of the UCITS-Directive which define index replicating UCITS.

The UCITS-Directive contains criteria to define UCITS which replicate bond or share indices. For UCITS which comply with these criteria it is permissible to have a higher exposure towards one and the same issuer than foreseen by the issuer concentration limits of Art. 22 of the Directive. In view of this preferential treatment it is necessary to develop a clear understanding of these criteria and to ensure their uniform application in all Member States. The clarification therefore aims to provide more clarity as to whether a UCITS falls under the definitions of index replicating UCITS and thus more certainty about the conditions which justify the preferential treatment of index replicating UCITS. Otherwise, there would be the risk that the increased investment freedoms are misused, e.g. by declaring simple baskets of shares or bonds an "index" in order to circumvent the investment limits of the Directive.