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News from:

Across Europe

- UCITS IV: where does the fund industry stand?
- Physical short selling under UCITS: the end of the story?
- CESR consults on risk management principles for UCITS
- VAT issues for the funds industry

Ireland

Luxembourg

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Introduction



Sean Quinn
EMEA Head of Fiduciary Services

Welcome to our third edition of *European News & Views* this year. While we were printing our last edition in June, we were eagerly awaiting the expected update from the European Commission (EC) on the decision on how to progress with possible amendments to the UCITS Directive (generally referred to as "UCITS IV"), which were finally published on 16 July 2008.

In our article entitled, "UCITS IV: Where Does the Fund Industry Stand?," we provide you with the six key topics that UCITS IV focuses on, which, if adopted by the EU Council of Ministers and the European Parliament in the second quarter of 2009, will come into force in mid 2011. In this article, our focus is on the Management Company Passport (MCP) and on the master-feeder structures.

In the last few months we have seen a number of updates at an EU level. In this edition of *European News & Views* our focus is on highlighting some of those key updates, which we hope will lead

to more consistency across EU Member States.

Since October 2007 one of the most significant debates within the UCITS industry has been on the suitability of physical short sales of securities within the UCITS framework. In our article, "Physical Short Selling Under UCITS: the End of the Story?," we summarise the EC's position on this subject as a result of recent regulatory initiatives by the EC and The Commission of European Securities Regulators (CESR).

One step forward to further assist in protecting investors from risks that UCITS are exposed to, as part of the performance of activities associated with collective portfolio management, is the recent CESR consultation on risk management principles under UCITS, which is the topic of one of our articles. CESR's consultation closed in October 2008, and as the focus was on organisational and governance requirements, it is anticipated that a further consultation will be launched before the end of this year to cover the more technical and quantitative issues associated with risk management.

We also take a brief look at VAT across Europe and ask, is the tax regime harmonised? Find out more by reading our article, "VAT Issues for the Funds Industry," which we hope you will find interesting.

At national level, one topical subject in Ireland, over recent months, has been the issuance of the Financial Regulator's Guidance Note 1/08 relating to the valuation of assets of money market funds. We welcome this guidance and provide an article on this subject that, we believe, clarifies for the funds industry the rules for the establishment, operation and valuation of money market funds.

With reference to Ireland, following the EC's stance on effectively prohibiting UCITS from engaging in physical short

selling for UCITS, the article, "130/30 Funds: Market Sentiment and the Use of Derivatives," provides a brief overview of the use of derivatives in relation to so-called "130/30 funds" while capturing the perceived view in respect of the funds industry.

We thank Anne Mergeai-Laurent at PricewaterhouseCoopers, Luxembourg, for an update and summary on the long-awaited Commission de Surveillance du Secteur Financier (CSSF) Circular 08/356, published in June this year. The changes introduced by Circular 08/356 can be described as innovative, and relate to those rules applicable to UCITS when they employ certain techniques and instruments relating to transferable securities and money-market instruments.

Finally, we bring to you a further update for Luxembourg. In our article, "The CSSF Defines Rules for Prime Broker Selection," we summarise the salient points detailed in the CSSF Circular 08/372, which defines the conditions applicable to a depositary bank of an investment fund that adopts alternative investment strategies and utilises the services of a prime broker.

We continue to include a short glossary of abbreviations and acronyms that are commonly referred to in this edition but not necessarily defined in the articles.

We hope you will find this edition of *European News & Views* interesting, and as always, we welcome your invaluable feedback.

UCITS IV: where does the fund industry stand?

On 16 July 2008, the EC published its long-awaited UCITS Directive¹ proposed amendments. When implemented, such amendments, generally referred to as UCITS IV, will substantially modify the EU's retail investment fund framework.

Overview of UCITS IV

Most market practitioners are already familiar with the process that has led to the current text of UCITS IV. Citi has already published a few articles on this in previous issues of *European News & Views*, which we recommend you review for further information.²

In a nutshell, UCITS IV focuses on six key issues:

- **The UCITS notification procedure**, which relates to the freedom for UCITS to be marketed in all EU MS on a cross-border basis, making use of a simple notification procedure;
- **Funds mergers**, which seeks to harmonise merger procedures (with a specific focus on cross-border mergers) to allow a consolidation of funds, therefore increasing their size, which should eventually bring economies of scale;
- **Asset pooling**, which is seen as an alternative way to achieve scale without the need of going through complex or expensive merger procedures (here UCITS IV proposes the introduction of so-called master-feeder structures);
- **Simplified prospectus/investor disclosures**, which seeks to redress one of the most notable failures of UCITS III, i.e. the establishment of a simplified information document available to retail investors;
- **Supervisory cooperation**, with the purpose of improving cooperation mechanisms between regulators and allowing a more effective supervision

of funds and financial institutions on a cross-border basis; and

- **The Management Company Passport (MCP)**, probably the most contentious of the issues, which relates not only to the freedom of providing management company services on a cross-border basis, but which has profound implications on the entire fund services value chain, from safekeeping to distribution.

The MCP relates not only to the freedom of providing management company services on a cross-border basis, but has profound implications on the entire fund services value chain.

If adopted by the EU Council of Ministers and the European Parliament in the second quarter of 2009, UCITS IV will come into force in mid 2011. In this article, we focus on the MCP and on master-feeder structures.

The MCP

As we have briefly mentioned before, the MCP is probably the most contentious issue. Feedback received from the consultation process established by the EC more than one year ago, when the initial draft of UCITS IV was initially published, suggested that, although regulators' and industry players' views were different and sometimes conflicting, a common theme was emerging – the MCP was very complex and had to be dealt with separately. At the same time, cognisant that no one could really afford UCITS IV going ahead without the MCP, the

EC asked for advice from CESR hoping that it could make proposals on time for inclusion in the UCITS IV package.

The objective was very ambitious, in the sense that CESR will have to find a good compromise between those who advocate a full passport and those who advocate UCITS to meet substance requirements in those countries where they are domiciled.

Considering that any proposal will have an impact on the way regulators, depositaries and auditors carry out their activities, and the legal nature of UCITS (that may be established in corporate as well as in contractual form) may be such that no single framework is adequate to cover all possible structures. Therefore, it is no surprise that most of the regulators and industry players consider the definition of a functioning MCP a very challenging task.

CESR published a call for evidence on this subject, asking all interested parties to submit their comments (Citi has decided to participate in the process, and has submitted its feedback to CESR³). CESR has also released a draft advice for public consultation. The draft advice has also been subject to a public debate held at CESR's premises in October.

CESR's final advice has by now been published, and we look forward to providing you with an article on the insights and next steps in a future edition of *European News & Views*.

Master-feeder structures

Although the MCP is the most debated issue, the real novelty in UCITS IV is the introduction of master-feeder structures, all the other proposals being substantially an improvement of the existing framework (notification process, key investor documentation) or a clarification on some already established practices (funds mergers).

From a practical point of view, qualifying as a master does not pose significantly increasing obligations on a UCITS - apart from enhanced communication obligations

UCITS funds are generally seen, when compared to similar products in the US market, as sub-optimal in size, and their proliferation is creating a heavy burden on the fund industry and investors. Increasing fund size (and possibly reducing their number) through mergers is a solution that may not always be the most appropriate, taking into account that different categories of investors may require UCITS that are tailored to their needs. The pooling of assets among fund entities to permit co-management of the assets of different funds is seen as another method of achieving economies of scale.

According to the EC proposals, a feeder UCITS is a UCITS that invests at least 85 per cent of its assets in units of another UCITS (the master UCITS) or an investment compartment thereof.⁴ A feeder may hold up to 15 per cent of its assets in:

1. Ancillary liquid assets;
2. Financial derivative instruments; or
3. Movable or immovable property if necessary for the pursuit of its business (only in the case of a feeder established as an investment company).

Although the key regulatory issue in the creation of the master-feeder structure was increasing the maximum investment threshold of a UCITS into another UCITS to a significant amount (85 per cent represents a significant threshold), most of the EC proposals deal with disclosures,

investor information and cooperation mechanisms between depositaries, auditors and regulators involved, knowing that expectations are that master-feeder structures will be used mainly for cross-border pooling purposes.

Establishing cooperation mechanisms

From a practical point of view, qualifying as a master does not pose significantly increasing obligations on a UCITS. Apart from enhanced communication obligations, which we will analyse here, a feeder can be dealt with almost as any other investor.

Master and feeder are required, under UCITS IV, to enter into an agreement to enable the feeder to meet its regulatory obligations. This agreement should include provisions regarding:

1. The main characteristics of the investment objective and policy of the master;
2. The rules governing possible modifications of the master's investment objective and policy; and
3. Rights and duties of the feeder and of the master, and of their respective management companies (when applicable).

It should be noted that the EC has foreseen the adopting of specific implementing measures to define the details to be included in the agreement.

As mentioned above, cooperation mechanisms should be established for the following, too:

1. If the master and the feeder have different depositaries, an information-sharing agreement must be established between the two to allow both to perform their statutory duties; and
2. If the master and the feeder have different auditors, an information agreement must likewise be established between the two parties.

The EC has also foreseen the adopting of specific implementing measures to define the details to be included in the agreement. In the case of the depositaries' agreement, specific reference is made to the definition of those "irregularities" that should be reported by the master depositary to the feeder depositary.

The initial investment of the feeder into the master is subject to all the relevant agreements becoming effective.

For cross-border master-feeder structures, enhanced cooperation will be required not only between auditors and regulators, but also, and probably more crucially, between regulators in MS.

Chapter VIII, Section 6 of the UCITS IV proposals deal with "obligations and competent authorities". Cooperation between regulators is based on two pillars:

1. Notification of the master to its regulatory authority, of the identity of each feeder investing into it. For cross-border investment, the master's regulatory authority should in turn notify the feeder's regulator authority of the event.
2. Oversight and enforcement: any decision, observation of non-compliance with the directive shall be communicated by the master's regulatory authority directly to the feeder or, in case of cross-border structures, to the feeder through the competent regulatory authority.

It would be helpful if the final version of the proposal identified the type of issues that needed to be reported and set materiality levels.

Additional considerations

The UCITS IV proposal will bring new operational and regulatory challenges, some that have already been identified by the EC and that may require a Level 2/Level 3 clarification exercise:

- **Market timing/arbitrage opportunities:** the master and the feeder must take appropriate measures to ensure that no units of either the master or the feeder can be issued, sold, repurchased or redeemed for the same business day after either the master or the feeder published the issue, sale, repurchase or redemption price of its units for that day. In this respect, the EC may be issuing further implementing measures clarifying the concept of “appropriate measures”.
- **Dealing suspension:** if a master temporarily suspends the repurchase or redemption of its units, whether at its own initiative or at the request of its competent authorities, each of its feeders will be entitled to suspend the repurchase or redemption of its units within the same period of time as the master.
- **Oversight of the feeder:** the feeder (or its management company when applicable) shall “monitor effectively” the activity of the master UCITS, as part of its obligation to act in the best interest of the unit-holders. The extent of this monitoring obligation, which can be based on documental evidence received by the master, its management company, depositary or auditor, is not clarified.

- **Remunerations and commissions:** the prospectus of the feeder must contain a description of all remuneration or reimbursement of costs payable by the feeder by virtue of its investment in units of the master, and of the aggregate charges of the feeder and the master. The question as to whether or not the same or a comparable level of fees should be applicable for a master and for a feeder is, however, not answered. Additionally, where, by virtue of an investment in the units of the master, a commission is received by the feeder, the commission shall be paid into the assets of the feeder and not to the feeder’s management company (or other party).

Conclusion

More practical issues may surface in the coming months as we approach the moment when the new provisions will become reality. Reforming UCITS is a complex process that has an impact on not only the EC legislation but also on the plethora of national laws or regulations that constitute the overall regulatory framework.

As of now, however, nobody can truly say whether or not UCITS IV will become reality or be abandoned in limbo until a new European Parliament is elected. This year’s market events have shifted for sure the attention of regulators, lawmakers and market practitioners to maybe more compelling issues.

Notes

- ¹ Council Directive of 20 December 2005 85/611/EEC, also referred to as UCITS III, following amendments introduced in 2001.
- ² “Filling the Gap for Retail Investors: Is the KID Moving Forward?”, *European News & Views*, Second Edition 2008, and “Possible EC adjustments to the UCITS Directive: Getting Ready for UCITS IV”, *European News & Views*, October 2007.
- ³ Citi’s feedback is publicly available on CESR’s website.
- ⁴ From now on, we will refer feeder “UCITS” and “master UCITS” as “feeder” and “master”, respectively.

Physical short selling under UCITS: the end of the story?

During the last few months, there has been a widespread debate within the UCITS industry about the suitability of physical short sales of securities within the UCITS framework. The debate gained momentum in October 2007, when the Irish Financial Regulator published policy changes that allowed these practices.¹

However, in October 2008, CESR made public on its website the contents of a letter it had received from the EC (hereafter “the EC’s letter”)² that effectively closed the matter by stating that “physical short selling of borrowed securities is inconsistent with important provisions of the UCITS Directive”³ Following the receipt of this letter, CESR has also published updated Level 3 guidelines on eligible assets for UCITS.⁴

In this article, we will review, in a nutshell: the key considerations that prompted the Irish Financial Regulator to permit covered short sales in October 2007; the EC’s position; and the resulting amendments introduced by CESR. Furthermore, we summarise those areas where it may be advantageous to have further clarification or guidance on the eligibility and monitoring of the physical short selling of securities (should it be revisited at any point in the future).

Physical short selling in Ireland

We have already reviewed this matter extensively in a previous edition of *European News & Views*, which we invite you to read for additional information.⁵ In a nutshell, the Financial Regulator’s approach was based upon three key considerations:

1. Article 42 of the UCITS Directive prohibits uncovered sales. Therefore short selling is possible, if the short position is covered through a securities-borrowing arrangement.

2. CESR’s Level 3 guidelines (in their original wording) stated that “if UCITS are authorised to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operations must be taken into account to calculate the global exposure of the UCITS”.⁶ Therefore, leverage can be generated by selling securities borrowed.

3. Synthetic short selling is a common practice since the publication of the EC Recommendation 2004/383/EC that allows for UCITS entering into financial derivative transactions that are cash settled to hold as cover assets other than the specific underlying instrument of the financial derivative.⁷

Therefore, the Financial Regulator’s policy-changes document on UCITS-covered short sales contained additional guidance mainly in terms of the RMP. However, the key message, at this time, was that physical short selling was considered an eligible technique under UCITS.

The UCITS Directive did not contemplate the right for UCITS to engage in physical short selling.

The EC’s position

The EC’s letter suggests that there is little or no guidance in the text of the UCITS Directive governing exposures generated through physical short selling. Furthermore, it references that this technique is inconsistent with parts of the UCITS Directive, namely:

1. “The mere existence of a stock-borrowing agreement to accompany the short sale does not mean that

the transaction can be equated with a ‘covered sale’ – and thereby escape the prohibition of article 42 ‘on uncovered sales’.” In particular, “the mere fact of borrowing a security to cover potential obligation to settle the short sale does not mitigate the exposure of the UCITS to potentially unlimited market risk.”

2. “The existence of a stock-borrowing agreement contravenes the prohibition on borrowing set forth by article 36 of the UCITS. The prohibition on borrowing laid down in this Article – except on a limited and temporary basis – is not confined to borrowing money but also extends to securities.”

3. No harmonised provisions exist in the UCITS Directive governing risk management controls for physical short selling, which gives rise to market risks, operational risks, counterparty risk and implies additional settlement risk if compared with similar exposures generated through derivatives.

The EC’s letter also states that “EU legislation in UCITS does not provide any clear or explicit rules governing the extent to which UCITS funds can assume risk through physical short selling, or on the requirements for managing the related risk”, unlike leverage generated through derivatives where guidance is widely available. Therefore, it concludes that “the UCITS Directive did not contemplate the right for UCITS to engage in physical short selling.” If physical short selling were to be allowed, it would take place, to quote the EC’s letter, “in an EU legal vacuum”.

Therefore, the relevant sections of CESR’s Level 3 guidelines (CESR/07-044, March 2007) risked incorrect interpretations that would have been incompatible with the EC’s understanding of the Level 1 UCITS Directive.

CESR/07/044 (old guidelines)	CESR/07/044b (updated guidelines)
<p>Techniques and instruments relating to transferable securities and money market instruments include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending and securities borrowing. The requirement to comply with the provisions of Article 21 of Directive 85/611/EEC imply in particular that if UCITS are authorized to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operations must be taken into account to calculate the global exposure of the UCITS.</p>	<p>Techniques and instruments relating to transferable securities and money market instruments include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending. The requirement to comply with the provisions of Article 21 of Directive 85/611/EEC imply in particular that if UCITS are authorized to use repurchase agreements or securities lending, these operations must be taken into account to calculate the global exposure of the UCITS.</p>

Level 3 guidance reviewed

On the basis of the EC's technical interpretation, CESR has therefore published in October 2008 revised Level 3 guidelines. The changes relate only to Article 11 of the Eligible Assets Directive, as shown in the table above.⁸

With the deletion of the reference to the generation of leverage through re-investment of collateral in Level 3 guidance, does this also mean that there is a prohibition for UCITS to reinvest cash or rehypothecate assets received as collateral – for example, in the case of securities lending transactions?

The reference to the generation of leverage through the reinvestment of collateral has been removed in reaction to the updated policy changes provided by the Irish Financial Regulator in October 2007. Our interpretation, which has been confirmed in informal discussions with the EC, is that the amendment of Level 3 guidelines should be read only and exclusively in relation to physical short-selling techniques.

Physical short selling: is this the end?

It may be difficult at this point to argue that there is any space for resurrecting physical short-selling techniques under UCITS owing to recent market conditions. However, should the EC reconsider physical short selling in the context of the UCITS Directive, at some point in the future further clarification or guidance on the eligibility and monitoring of the following would be advantageous:

- 1. Transaction type.** Clear definition on what transaction type may or may not qualify as cover for a short sell.
- 2. Adequate guidelines.** Clear guideline restrictions implemented for any transaction type that may qualify as a short sell (including leverage monitoring and borrowing and counterparty exposure).
- 3. Valuation.** Clear definitions on the pricing and the timeframe of any transaction type associated with a short sell.
- 4. Counterparty (settlement risk).** Clarity on counterparty selection, exposure and monitoring.
- 5. RMP.** Well defined risk indicators and a robust process for early identification of any material risk associated with a short-sell position.

Conclusions

As of now, physical short selling of securities under UCITS is not permitted. Should this be revisited, the clarity on its eligibility under UCITS, we believe, would be a necessary process not only to eliminate any uncertainty but also to avoid uneven regulatory interpretations.

Notes

- ¹ Financial Regulator, *Collective Investment Schemes – Policy Changes and Related Matters*, "UCITS – Covered Short Sales" (Ireland: Financial Institutions and Funds Authorisation, October 2007).
- ² Deputy Director-General, DG Internal Market and Services, European Commission, in a letter entitled, "Physical short-selling in the context of the UCITS Directive – March 2007 CESR guidelines on eligible assets", addressed to the Chairman of CESR (ref. MARKT/G4/dm/D(2008) 4056).
- ³ UCITS Directive refers to the Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS).
- ⁴ CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044b, March 2007; updated September 2008).
- ⁵ "Physical Short Selling Under UCITS: Time to Reconsider?", *European News & Views*, first edition 2008.
- ⁶ CESR's guidelines concerning eligible assets for investment by UCITS (CESR/07-044, March 2007).
- ⁷ Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments for undertakings collective investment in transferable securities (UCITS).
- ⁸ CESR's official documents do not include tracked changes, which have been added by us for ease of reference.

CESR consults on risk management principles for UCITS

In August 2008, CESR published a consultation paper on risk management principles for UCITS (hereafter “the Consultation”).¹ The Consultation follows on from a survey conducted by the CESR’s Investment Management Expert Group on how the European Commission’s Recommendation on the use of financial derivative instruments (FDIs) for UCITS had been implemented across EU Member States.²

Regulatory background

During the first half of 2008, the fund management industry waited eagerly for the long-expected draft of UCITS IV Directive. Despite the attention this initiative has raised, there are several aspects of the current UCITS Directive³ that still require investigation and clarification. For risk management the following should be considered:

- **Articles 5f and 13c of the UCITS Directive** require investment companies or management companies to have “sound administrative and accounting procedures, control and safeguards arrangements for electronic data processing and adequate internal control mechanisms”.
- **Article 21 of the UCITS Directive** states that “the management or investment company must employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio; it must employ a process for accurate and independent assessment of the value of OTC derivative instruments. It must communicate to the competent authorities regularly and in accordance with the detailed rules they shall define, the types of derivative instruments, the underlying risks, the quantitative limits and the methods which are chosen in order to estimate the risks associated with transactions in derivative instruments regarding each managed UCITS”.

- **The EC Recommendation** recommends that risk measurement systems should be adapted to the relevant risk profile of a UCITS, and accurately measure all material risks related to it.

The management or investment company must employ a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.

In the last two years, regulators have been producing regulatory guidance as a result of the EC Recommendation of 2004. Such guidance has resulted in substantial variances, in some EU jurisdictions, in terms of procedural arrangements, governance and what the EC Recommendation specifies as “appropriately calibrated standards to measure market risk”. Examples of these variances are the way in which Value at Risk (VaR) methodologies and relevant stress-testing processes are applied.

What is the focus of the Consultation?

CESR, in recognising that a risk management process (RMP) is crucial to identify the risks to which UCITS investors could be exposed in relation to the performance of collective portfolio management, has focused on two main areas for the risk management principles of UCITS to be implemented:⁴

1. **The risk management policy of the company/UCITS:** a “set of internal rules that govern the process of identification, measurement and management of the risks incurred by UCITS investors”; and

2. **Supervision:** where the “principles regarding risk management at the company level are supplemented by supervisory principles which should guide the review of these processes for the purpose of investor protection.”

Below we summarise and review in more detail the five principles within these two main areas.

The five principles

1. **Supervision**⁵
“The adequacy and efficiency of the risk management process should be considered by the competent authorities as part of the process for licensing the UCITS/Company, and subsequently monitored on an ongoing basis.”⁶
2. **Governance and organisation of the RMP**
Definition of roles and responsibilities
The Consultation identifies that an adequate and proportionate RMP should be structured, operated and maintained with the functional and organisational rules being established as part of the organisational rules adopted by each UCITS/management company.

A formal risk management policy should be established, approved and formulated in the procedures and organisational rules of the UCITS/management company. This policy should be regularly reviewed and updated by the UCITS/management company, board of directors and “the Board of Directors should be held accountable for the appropriateness of the risk management systems and procedures”.⁷

CESR considers that the risk management policy should identify the areas and personnel in charge of the different parts of the RMP and clearly set out the terms of interaction between risk management and investment management processes “in order

Table A

Risk management function ⁹	
Set-up structure	Key requirements
Identify appropriate unit, department or personnel responsible for performing the risk management function. Hierarchically and functionally independent from the operating units. Report directly to the board of directors and senior management.	Necessary and professional personnel with the skills, knowledge and expertise required to be accountable for the responsibilities placed upon them. Sound processes. Adequate techniques and IT Structures. A degree of separation from the Company's front office function.
Risk management function key responsibilities	
The identification, monitoring and measurement of risks. The implementation of the identified methods and processes. Drafting of related documentation including procedures.	Reports provided to senior management to enable them to assess the adequacy of the measures adopted to manage risks. Reporting directly to the board of directors/management company/UCITS so that they may exercise oversight between the level of risk incurred by the UCITS and its risk profile.

Table B

Outsourcing of the risk management function ¹⁰
Key requirements of the outsourcer
Written outsourcing agreement. Technical ability and professional capacity to provide a reliable and effective risk management function. Readily available access to data relating to the outsourced activities (for the company, its auditors and the appropriate regulators).
Key requirements of the company (board of directors)
Written outsourcing agreement. Oversight of governance, technical and business environment, remains the full responsibility of the board of directors. Appropriate technical due diligence concerning the risk management function methods, systems and data used by the outsourcer (including an assessment of any potential conflict of interests). In the event that an outsourcer may not perform the outsourced functions, either effectively or in compliance with applicable requirements, the company should take the appropriate action. Continuity of the RMP in the event of interruptions to the outsourced risk management function should be taken into account by the company.

to keep the UCITS risk profile under control and consistent with the UCITS investment strategy".⁸

The risk management function

Table A summarises some of CESR's proposals for establishing a risk management function, key requirements and associated responsibilities.

While CESR recognises that an RMP should run in parallel with and be integral to the investment process, it specifies that the "portfolio managers should not be responsible for the measurement of the risks which they themselves have taken on, nor for the review of the specific limits or the overall risk limit system. Notwithstanding this principle of separation of functions, the risk management process should operate in parallel with, and should be intrinsically tied to, the investment process."¹¹

CESR further recognises that where it is not appropriate or practical for an independent risk management function to be established, the relevant controls are implemented to ensure that adequate risk management is being performed independently.

Outsourcing

The outsourcing of risk management function "for the sake of efficiency" may be delegated to a professional third party. Table B illustrates some of the key requirements for the Outsourcer and the Company.

3. Identification and measurement of risks relevant to the UCITS

The RMP should assess and address all possible relevant risks incurred by the UCITS, according to the methods and principles defined by the risk management policy of the management company. To assess which risks are material for inclusion in the RMP, several factors should be considered such as: the objective and strategy pursued by the UCITS; the trading style adopted by the portfolio manager; and the valuation process. CESR recognises that the risk-identification exercise should not be static and should be subject to periodic revision to cater for: a) changes to market conditions; or b) the UCITS investment strategy.

Risk measurement techniques

The Consultation proposes that the risk-management techniques include: a) quantitative measures (regarding quantifiable risks): aimed at addressing the effects of market risk,

credit risk (which includes issuer and counterparty risk) and liquidity risk; and b) qualitative methods.¹²

The Consultation highlights that the risk measurement framework's key focus should be on the characteristics of the investment strategies of the UCITS being managed. The size and complexity of the business and structures of the companies can also be taken into account. Additionally "if UCITS invest in structured products, their multiple risk components should be appropriately identified and managed."¹³

CESR further suggests, "when quantitative measurement of the effects of some risk factors is not possible, or produces unreliable results, Companies may consider integrating and adjusting their figures with elements drawn from a variety of sources, in order to obtain a comprehensive evaluation and appraisal of the risk incurred by the UCITS."¹⁴ Similarly, where risks are non-quantifiable (e.g. risks associated

with the technical failures of trading, settlement and valuation procedures) and which directly impact UCITS performance and the interests of the UCITS investors, CESR proposes the same approach be applied.

Management of model risk

Another source of risk is constituted by model risk, e.g. the vulnerability of the risk management techniques and models. Model risk is mitigated by ensuring the risk measurement framework is subject to continuous assessment and revision, and by documenting its techniques, tools and mechanisms.

Table C below summarises the two key types of testing that CESR references for the purpose of verifying that the estimates/forecasts produced by models actually reflect the values of risk measured.

CESR refers to advance assessments for the "validity range, market conditions and any inherent or assumed limits of their risk

measurements".¹⁶ Similarly, it recognises that subjective scenario hypotheses based on facts relating to trading and market conditions may occur as part of the stress testing. Furthermore, CESR considers, risk measurement and asset valuation to be deeply interconnected. From one side, risk measures should be based on market data if those are available and reliable; on the other side, the risk management function should be capable of providing independent support to the valuation process, as far as illiquid, structured or complex instruments are concerned.

4. Management of risks relevant to the UCITS

Risk Management Procedures

The Consultation proposes that for each UCITS managed by the company, a risk profile (that takes into account the identified risk highlighted by its investment strategy) is defined by the board of directors and that any subsequent revision to a risk profile is advised to it. Risk management procedures should ensure that these

Table C

Types of testing ¹⁵	
Application	Purpose
Back-testing Tests verifying that model-based forecasts and estimates equate to the actual values of the relevant risk measures.	
<ul style="list-style-type: none"> Separately for each technique set up in the risk measurement framework. Prior to inception. Subsequently, on an ongoing basis. 	<ul style="list-style-type: none"> Verify accuracy of risks identified. Test model calibration and internal validation. Test the viability and robustness of the model over time.
Stress-testing Tests to cover all quantifiable risks, which affect, to a material degree, the value of the UCITS. This includes risks that are not represented with sufficient accuracy by the risk models used, e.g. "unexpected changes to price correlations or to asset (or even market) liquidity."	
<ul style="list-style-type: none"> Additional diligences and CESR references that risk management methods should be reviewed by the Company whenever needed. 	<ul style="list-style-type: none"> To capture potential rare and severe losses that may occur during market shocks and that are unlikely to be measured by the risk models.

risk profiles are consistent with the actual level of risks incurred by the UCITS as defined by the board of directors and take into account the following set of actions.¹⁷

- Identifying and measuring the relevant risks;
- Assessing their consistency with the UCITS risk profile;
- Fostering, through the appropriate reporting channels, the adoption of remedial measures in case of deficiencies; and
- Monitoring the efficacy of the action taken.

CESR recognises that an RMP is fundamental in order to protect investors from the risks that UCITS are exposed to as part of the performance of activities associated with collective portfolio management.

Risk limits system

For every UCITS, CESR recommends that a system of limits for the measures are applied to monitor and control the relevant risks (consistent with the UCITS' investment strategy), included in the risk management policy of the company and consistent with the UCITS risk profile. These limits should also be approved by the board of directors. Furthermore, CESR recommends that the company should ensure that "every transaction is immediately taken into account in the calculation of the corresponding limits."¹⁸

Effectiveness of the RMP

CESR recommends that "the risk management policy should define procedures that, in the event of breaches to the risk limit system of the UCITS, result in a prompt correction of the portfolio and provide for the timing of this."¹⁹ The effectiveness of an RMP is measured by its ability to allow actual control, on an ongoing basis, of the risk profile of the UCITS. The RMP should include warnings to be generated so that prompt action can be taken by fund managers to prevent, or close, breaches.

5. Reporting and monitoring

The management of risks is highly dependent upon both the quality of the reporting and the monitoring performed by the management company, UCITS and board of directors. However, CESR considers that an intermediate management layer, constituted by senior managers, should receive more frequent information on an ongoing basis.

Monitoring the overall RMP should be performed by the board of directors and the independent supervision/ oversight function (internal audit, compliance or a combination thereof).

The Consultation closed on 17 October 2008. As the focus was specifically on organisational and governance requirements, a further consultation is expected to launch before the end of 2008 to focus on the technical and quantitative issues related to risk management.

Although we have summarised CESR's proposals, we recommend the Consultation be read in its entirety.

Who do the risk management principles apply to?

CESR proposes the five principles apply to "both asset management companies and investment companies that have not designated a management company (self-managed UCITS)."²⁰

Conclusions

CESR recognises that an RMP is fundamental in order to protect investors from the risks that UCITS are exposed to as part of the performance of activities associated with collective portfolio management.

While CESR has made a significant step forward in the proposed principles, further clarification and/or guidance on the following may enable MS to apply more consistency and equal standards for the protection of European investors who invest in UCITS:

- **The role of the depositary/trustee, which has not been referenced in the Consultation.** Currently MS regulators have different applications on RMP, e.g. in the UK, "the depositary should take reasonable care to review the appropriateness of the risk management process in line with its duties under COLL 6.6.4 R (General duties of the depositary) and 6.6.14 R (Duties of the depositary and authorised fund manager: Investment and borrowing powers), as appropriate."²¹
- **How the risk management function will maintain independence and interact with the investment process to add the required value on the effective and timely escalation of material risks and avoid what may seem like repetition of existing control processes.** This includes clearer definitions on risk indicators generally and in particular relating to "multiple risk components" for application to structured or complex products. For example, under the current asset eligibility rules for UCITS, look-through does not apply in any circumstances, e.g. in the case of FDIs on financial indices or transferable securities linked to or backed by other assets.²²

- **How the RMP should reflect the valuation/verification of valuation processes.** The Eligible Assets Directive has assisted in clarifying the valuation, for example, of OTC derivatives, but there are inconsistencies to regulatory interpretation in other EU MS.²³
- **Further definition on the structure of UCITS (e.g. corporate, contractual, self-managed) in respect of application to an RMP.**

We consider that an RMP will benefit from: a robust system infrastructure (where possible); adequate data source providers (including connectivity with fund accounting systems and data providers); data-exception monitoring and maintenance controls; and clearly defined risk indicators (assessing inherent risk and likelihood risk versus the impact risk). All of these factors will have associated cost implications for the asset management and investment management companies. Still, the long-term benefits of being able to provide improved protection to the investors of UCITS may far exceed the short-term application of associated costs.

Notes

- ¹ Risk management principles for UCITS (CESR/08-616).
- ² Commission Recommendation of 2007 April 2004 2004/383/EC.
- ³ Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (as amended).
- ⁴ CESR/08-616, p. 10.
- ⁵ *Ibid.*, p. 10.
- ⁶ Where the company is "either the designated UCITS III management company or the self-managed investment company" (*Ibid.*, p. 5).
- ⁷ *Ibid.*, p. 11.
- ⁸ *Ibid.*
- ⁹ *Ibid.*, p. 12, 13.
- ¹⁰ *Ibid.*, p. 13, 14.
- ¹¹ *Ibid.*, p. 13.
- ¹² *Ibid.*, p. 16.
- ¹³ *Ibid.*
- ¹⁴ *Ibid.*
- ¹⁵ *Ibid.*, p. 17.
- ¹⁶ *Ibid.*
- ¹⁷ *Ibid.*, p. 19.
- ¹⁸ *Ibid.*, p. 20.
- ¹⁹ *Ibid.*
- ²⁰ *Ibid.*, p. 4.
- ²¹ *FSA Handbook*, COLL 5.2.25 G, Risk Management Process (2).
- ²² See "Is Asset Eligibility Still an Issue Under UCITS?", *European News & Views*, Second Edition 2008.
- ²³ Commission Directive 2007/16/EC of 19 March 2007, article 8.

VAT issues for the funds industry

Background

Although VAT across Europe is meant to be a harmonised tax regime, those who have had the pleasure of dealing with VAT issues associated with funds and in particular, supplies to funds, would paint a different picture.

The background to some of the discrepancies originates from the text of European legislation that exempts from VAT “the management of special investment funds as defined by Member States”.¹

This ambiguous wording has led to several fundamental concepts being questioned.

Some recent case law

There have been a number of cases, both domestic and European that have raised some interesting questions for the funds industry, for example:

- Are funds “taxable persons”?
- Where is the place of supply of cross-border management services provided to a fund?

In October 2004, the European Court of Justice’s (ECJ’s) decision, in the case of *Banque Bruxelles Lambert SA v Belgian State*, determined that UCITS are “taxable persons” for VAT purposes.

In concluding this, it follows that when services (such as management, legal, accountancy, etc.) are supplied from overseas to such funds, it is the funds’ responsibility to account for any VAT due (and, if necessary, register for VAT in order to account for this VAT).

This significantly led to a change in the Luxembourg Tax Authorities’ view and has led to many SICAVs established in Luxembourg having to register for VAT. The change took effect from 1 April 2007.

What is “management”?

The ECJ’s decision in the case of *Abbey National Plc, Inscape Investment Fund v Commissioners of Customs & Excise* (4 May 2006) concerned the definition of “management” for the purposes of the VAT exemption.

The ECJ confirmed that the concept of management has its own independent meaning and contrary to some interpretations of the exemption cited above, could not be determined by individual Member States (MS). Furthermore, the ECJ confirmed that the services covered by management could include the administrative management of the funds if “viewed broadly they form a distinct whole, and are specific to, and essential for, the management of those funds”.

However, the ECJ confirmed that the services of a depositary do not qualify as management and therefore are subject to VAT. Again, this led to a change in Luxembourg (from 1 April 2007), and VAT is now chargeable on depositary services.

What are special investment funds?

The most recent ECJ decision concerning funds was the case *JP Morgan Fleming Investment trust Plc v The Commissioners of HM Revenue & Customs* (25 August 2007) which concluded that the term “special investment funds” are capable of including closed-ended investment funds. In short, MS when defining special investment funds, must respect the objective of the exemption – namely, to facilitate investment in securities for investment undertakings.

Where are we now?

Although this case law has provided some clarity, there are still some open issues. In particular, there is a lack of consistency across the EU about what constitutes a special investment fund. For example,

this debate is ongoing regarding pension funds. We anticipate a UK Tribunal case on this issue shortly which may result in its elevation to the ECJ.

Secondly, there is still a question regarding outsourced services and the extent to which these can benefit from exemption. The ECJ’s decision in the *Abbey National* case helped clarify this matter and, consequently, extended the exemption available in some MS. The question of whether an outsourced service forms a “distinct whole” means that this area is still open to debate.

The ECJ confirmed that the services of a depositary do not qualify as management and therefore are subject to VAT. This led to a change in Luxembourg (from 1 April 2007, and VAT is now chargeable on depositary services.

Looking forward

The European Commission has been undertaking a review of the VAT Exemption for Financial Services and the modernisation of the (over 30 years old) legislation. It is hoped that this will bring some much-needed clarity in the funds industry.

The current proposed wording (issued by the Council of the European Union on 17 October 2008) for the exemption is as follows:

“The management of regulated investment funds, where established in the Community”.

Regulated Investment funds are further defined as “investment undertakings subject to rules designed to facilitate investment by the public or to protect investors”.

The current proposal does provide clarity to some extent, insofar as it suggests that pension funds are included within the exemption.

However, the funds industry has made a number of comments that we hope will be fed into the next round of working party discussions. These comments seek greater clarity in two respects:

1. The notion of exempted vehicles; and
2. The notion of management.

In particular, Industry has raised the following concerns:

1. That the treatment of outsourcing be clarified to ensure that the VAT exemption for management is available to third-party operators;²
2. That exemption be available for “any type of collective investment scheme as regulated (or explicitly exempt from regulation) by national law”;
3. That, contrary to the ECJ's decision in the Abbey National case, depositary services should also be treated as “management” and VAT-exempt; and
4. That it might assist to define the term “management” so as to include certain specified functions.

Conclusion

It is certainly time for the outdated EU legislation to be brought into the 21st century and we hope that by incorporating the comments of interested parties, the revised European legislation will afford the funds industry the certainty that has been lacking in the VAT arena in recent years.

The EC has been undertaking a review of the VAT Exemption for Financial Services and the modernisation of the legislation. It is hoped that this will bring some much-needed clarity in the funds industry.

Notes

¹ European Directive 2006/112, article 135 (g).

² This is a particular issue in Germany which has a particularly restrictive interpretation of the exemption.

Guidance Note 1/08:

valuation of assets of money market funds

In March 2007, when the European Commission implemented the Eligible Assets Directive¹ as an amendment to the UCITS III Directive² to clarify the existing issues around eligible assets for UCITS, CESR also published its "guidelines concerning eligible assets for investment by UCITS".³ In December 2007, the Eligible Assets Directive was transposed into Irish law pursuant to S.I. 832 of 2007, which amends the European Communities (UCITS) Regulations 2003 (the Regulations). These amendments are reflected in the Financial Regulator's Notice UCITS 9 and Notice UCITS 10. Minor amendments were also made to the Financial Regulator's UCITS Notice 6, 12 and 13 and to related Guidance Notes issued by the Irish Financial Regulator.

In August 2008, the amendments referenced above culminated in the Financial Regulator issuing Guidance Note 1/08, entitled "Valuation of Assets of Money Market Funds". This Guidance Note sets out the conditions under which a money market fund is permitted to (i) follow the amortised cost valuation methodology; and/or (ii) refer to "money market fund" in its title. The principles of the use of an amortised cost valuation methodology were previously included in Guidance Note 1/00, entitled "Valuation of the Assets of Collective Investment Schemes". However, these principles have now been replaced within Guidance Note 1/08.

Qualifying as a money market fund: Guidance Note 1/00 vs Guidance Note 1/08

The Financial Regulator permits both UCITS and non-UCITS collective investment schemes (CISs) to invest in money market instruments.

Prior to the introduction of Guidance Note 1/08, Guidance Note 1/00 referenced that where a CIS was a money market scheme, the use of amortised cost valuation methodology

as an alternative method of valuation was permitted. This valuation methodology could be "applied to securities with a residual maturity of 15 months or less".

However, the introduction of Guidance Note 1/08 requires that money market funds be "established as constant net asset value funds and/or accumulating net asset value funds with a principle objective to preserve principal and maintain liquidity."⁴

Furthermore, "only those money market funds which apply strict criteria to the construction and management of their portfolios" are permitted to:⁵

1. Follow an amortised cost valuation methodology; and/or
2. Refer to "money market fund" in its title.

The general principle of Guidance Note 1/08

According to Guidance Note 1/08, a money market fund must have a management company/investment manager who can demonstrate expertise in the use of the amortised cost valuation methodology in the operation of money market funds.

The Guidance Note further states that a money market fund must have one of the following:

1. Either a AAA rating;⁶
2. The management company/investment manager is, or has been, engaged in management of another AAA rated money market fund; or
3. In exceptional circumstances, the management company/investment manager can "demonstrate appropriate expertise" in the management of this type of money market fund (the Financial Regulator will consider this type of application for authorisation on a case-by-case basis).

The Irish Funds Industry Association (IFIA) issued comments to the Financial Regulator following Consultation Paper 31,⁷ objecting to the requirement to acquire AAA rating for existing money market funds as referenced in the draft version of Guidance Note 1/08. In response to these comments, the Financial Regulator has confirmed that existing CISs that apply the amortised cost valuation methodology to their money market instruments or have "money market fund" in the fund's title are "not required to obtain a triple-A rating from an internationally recognised rating agency".⁸

Use of amortised cost valuation methodology: Guidance Note 1/00 vs Guidance Note 1/08

Prior to the introduction of Guidance Note 1/08, Guidance Note 1/00 required a money market fund using the amortised cost valuation methodology:

1. To ensure that all procedures and reviews were clearly documented; and
2. To carry out a weekly review of discrepancies between market value and portfolio value of money market instruments. The size of the discrepancies determined how to proceed as follows:
 - (i) Where discrepancies were in excess of 0.3 per cent, a daily review was required; and
 - (ii) Where discrepancies were in excess of 0.5 per cent, the manager/directors were required to promptly consider what action must be taken to reduce the dilution.

Guidance Note 1/08 has introduced five conditions that must be met by a money market fund to permit the use of amortised cost as a method of valuation of assets. These conditions are detailed as follows:

1. A weekly review must take place to identify the discrepancies between market value and amortised cost value of the money market instruments where discrepancies:

- (i) Are in excess of 0.1 per cent, it must be brought to the attention of the management company or the investment manager.
- (ii) Are in excess of 0.2 per cent, it must be brought to the attention of senior management/directors of management company or the board of directors and the trustee.
- (iii) Are in excess of 0.3 per cent, a daily review must take place and the management company or the board of directors must inform the Financial Regulator what action will be taken to reduce the dilution.

It should be noted that recently the Financial Regulator issued a letter to the IFIA dated 16 October 2008, in relation to the requirement to complete a weekly review of market value vs amortised cost value. The letter stated that "due to recent market events, on a temporary and exceptional basis the Financial Regulator will permit money market funds to derogate from this requirement in respect of certain money market instruments with a residual maturity of three months and under. Therefore for the purpose of the mark to market calculation, these money market instruments may be valued at amortised cost" subject to a number of conditions which are included in the letter. The Financial Regulator will review this position on a quarterly basis.

2. Eligible assets must be cash or high-quality money market instruments as per the Regulations.

3. The assets of a money market fund are restricted to securities that comply with one of the following:

- (i) Maturity at issuance of up to and including 397 days;
- (ii) Residual maturity of up to and including 397 days;
- (iii) Undergo regular yield adjustments in line with money market conditions at least every 397 days;⁹ and/or
- (iv) The risk profile of the asset, including credit and interest rate risks, must correspond to that of financial instruments with a maturity as per (ii) above or are subject to a yield adjustment as per (iii) above.¹⁰

4. Weighted average maturity of the portfolio must not exceed 60 days.

5. Stress testing must take place on a monthly basis as part of a portfolio analysis examining the returns expected under various market scenarios. This analysis must be available for the Financial Regulator on request. In light of recent events in the credit markets, the Financial Regulator has highlighted this requirement as very important.

Non-money-market funds' use of amortised cost valuation methodology

Until the introduction of Guidance Note 1/08, Guidance Note 1/00 permitted non-money-market funds to value securities with a residual maturity not exceeding six months, using the amortised cost method.

Guidance Note 1/00 allows the amortised cost method to be applied to value money market instruments in a UCITS CIS where the individual instruments have a "residual maturity of less than three months and have no specific sensitivity to market parameters, including credit risk."¹¹

In relation to the valuation method used by non-UCITS CISs, the revised Guidance Note permits the amortised cost method

to be applied where such instruments have a "residual maturity not exceeding six months, where these instruments have no specific sensitivity to market parameters, including credit risk."¹²

All other CISs must use the valuation methods as described by Guidance Note 1/00.

Changes to constitutive documentation of a money market fund

To give effect to the Irish Financial Regulator's new Guidance Note, an existing money market fund must update its prospectus to reflect the new valuation rules and amend the valuation provisions of its constitutional document (the articles of association for an investment company or the trust deed for an investment trust).

Conclusion

We welcome the Irish Financial Regulator's new Guidance Note as it clarifies for the funds industry the rules for the establishment, operation and valuation of money market funds. In particular the Guidance Note identifies the requirements for using the term money market fund in a fund's title and gives guidelines on applying an amortised cost valuation methodology.

Notes

¹ Commission Directive 2007/16/EC of 19 March 2007.

² EC Directive 2001/107/EC and 2001/108/EC amending EC Directive 85/611/EEC.

³ CESR/07-044, March 2007.

⁴ The Financial Regulatory Guidance Notes 1/08 August 2008, p. 1.

⁵ Ibid, p. 1.

⁶ AAA by Standard & Poor's; Aaa/MR1+ by Moodys; or AAA/V-1+ by Fitch.

⁷ Consultation Paper 31 Amendments to the UCITS Notices and related Guidance Notes December 2007.

⁸ Letter addressed to the IFIA 15 August 2008.

⁹ If the fund is rated, the money market instruments must also meet the final maturity requirements of the rating agency.

¹⁰ Idem.

¹¹ The Financial Regulatory Guidance Notes 1/00 August 2008, p. 5.

¹² The Financial Regulatory Guidance Notes 1/00 August 2008, p. 5.

130/30 funds: market sentiment and the use of derivatives

Physical short selling

You may have already read our article, entitled “Physical Short Selling Under UCITS: the End of the Story?”, which makes reference to the publication of the EC’s letter on physical short selling in the context of the UCITS Directive¹. The letter states that “physical short selling of borrowed securities is inconsistent with important provisions of the UCITS Directive”, effectively prohibiting UCITS from engaging in the practice.

Confusion on the practice of physical short selling in the context of the UCITS Directive had resulted from the original wording in CESR’s Level 3 guidance on the eligible assets Directive.² The relevant extract stated as follows:

“The requirement to comply with Article 21 of Directive 85/611/EEC imply in particular that if UCITS are authorised to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operations must be taken into account to calculate the global exposure of the UCITS.”

It had been suggested that this wording constituted recognition that securities borrowing could be utilised to create leverage and sell securities short. This interpretation was, in fact, agreed with by the Irish Financial Regulator, who issued a circular to the industry in October 2007 stating that physical shorting by Irish UCITS was permissible subject to certain conditions.³ The position was later retracted, and the recent publication by CESR would appear to bring closure on the issue. CESR has since published updated Level 3 guidelines on eligible assets for UCITS.⁴

130/30 funds: market sentiment and the use of derivatives

The concept of the 130/30 fund is now broadly understood in the investment industry, so there is little necessity to provide a detailed explanation here.

The publication of the EC’s letter, however, means that the 130/30 strategy cannot now be achieved through physical shorting in a UCITS, but only through the use of derivatives, which can be utilised on a speculative basis under UCITS III, subject to extensive restrictions. Some of those restrictions have been interpreted differently in jurisdictions throughout EU Member States, and these interpretative differences should be assessed for impact on a particular strategy and choice of domicile.

Interest surrounding the 130/30 strategy increased in Europe throughout 2007. The opportunity to generate sufficiently more alpha than traditional long-only funds, while maintaining a beta of one, has been publicised as the most significant advantage for 130/30 funds.

The majority of positive sentiment, summarised below, primarily results from theoretical analysis. There have been simply too few 130/30 funds launched with too short a lifespan to date to make any sound empirical deduction as to their performance. In addition to the greater potential for alpha generation, it is argued that, theoretically 130/30 funds may offer greater potential for diversification and reduction of risk.

In a long-only portfolio, expression of negative sentiment towards particular securities in a benchmark is limited to the percentage make-up of the securities in that benchmark. The 130/30 fund manager, on the other hand, can take further advantage of the potential downside by actually shorting the positions. In addition, it is argued that 130/30s are ideal for protection in falling markets, and the fees are comparatively lower than a total return hedge fund strategy.

From a negative viewpoint, risk management and operational costs may tend to be higher because of the more complex strategy and nature of investments when compared to a

traditional long-only fund. These costs effectively act as negative alpha from the outset of the fund that must be recouped before any positive alpha can be generated.

In terms of stock selection, a question arises as to the best fit for management of 130/30 strategies in UCITS funds. The traditional managers may be unproven in shorting techniques and hedge fund managers may not be familiar with the extensive restrictions imposed by the UCITS regulations on the use of derivatives.

However, as of now it is impossible to draw any definitive conclusion on market sentiment in the current market environment and until the 130/30 fund strategy is more widely employed.

Risk management and UCITS restrictions

There are four primary restrictions relating to the use of derivatives in a UCITS fund. These are: global exposure; liquidity cover requirements; counterparty exposure; and position or issuer exposure. From the outset, a UCITS must declare itself to be a sophisticated or non-sophisticated user of derivatives in its risk management process (RMP) document. All of the restrictions are measured in the same way for both sophisticated and non-sophisticated UCITS, with the exception of global exposure.

A sophisticated user is required to use advanced risk measurement techniques to measure exposure, such as VaR. Non-sophisticated users can use more simplified methods of exposure calculations such as the commitment approach.

While EU regulation is consistently applied across European jurisdictions, interpretation of the regulation is not consistent. Also, in Ireland and Luxembourg, interpretation as to how exposures should be measured has been included in local regulation. In the UK, interpretation is set out as guidance.

The following provides examples of how differing interpretations of the restrictions have been applied across the jurisdictions:

- In terms of VaR and global exposure, regulation in Ireland and Luxembourg provide for the use of either absolute or relative VaR. In Luxembourg, the absolute VaR threshold is 20 per cent of the NAV and the limit for the relative VaR is “two times the VaR of a reference portfolio of the same market value as the UCITS” with a holding period of one month. In Ireland, it is 20 per cent with a holding period of 20 days. Other limits and holdings will be considered/ approved by the Financial Regulator on a case-by-case basis. In the UK, neither the threshold nor the type of VaR used is detailed in the regulation or associated guidance; however, it should be agreed between the authorised fund manager and the depositary and detailed in the funds prospectus.
- The minimum holding period in Luxembourg and the UK for the VaR model employed is one month.⁵ In Ireland, it is up to 20 days. Longer or shorter holding periods with a corresponding increase or reduction in VaR percentage limits will be considered by the Financial Regulator on a case by case basis.
- For counterparty exposure calculations, the methodology in Luxembourg and the UK is to multiply the notional value of the underlying or reference item to an OTC derivative by an add-on percentage determined by the contract type and number of years to maturity. This figure is then added to the positive market value of the contract. In Ireland, the add-on percentage is multiplied by the value of the contract rather than the value of the underlying, which is considerably less restrictive than in the UK and Luxembourg. This effect is reduced, however, in the UK and

Luxembourg by the application of a weighting factor of up to 20 per cent for counterparties who meet certain criteria (for example, EU credit institutions). A 50 per cent weighting factor is also used in Luxembourg for non-EU credit institutions.

- More generally, the commitment approach for non-sophisticated UCITS is considered in Ireland and Luxembourg regulation and in UK guidance. Calculation methodologies are also prescribed in Ireland and Luxembourg and, in general, refer to the value of the underlying asset or reference item of the derivative contract. UK market guidelines tend to be less restrictive in this regard and refer to unrealised gain/loss for certain derivative contract types.

Other cost and considerations

Before setting up a 130/30 strategy under a UCITS structure, there are a number of other considerations that should be evaluated.

In terms of cost, the restrictions for applying FDIs, in a UCITS framework are extensive. It is costly to employ personnel who understand them and can measure them accurately. While systems have been developed for VaR measurement, software can be expensive to service an umbrella UCITS fund that uses derivatives extensively. Fund accounting data on existing platforms may also have to be enriched to feed risk platforms at significant IT cost. Regardless of sophistication, the commitment approach must be used for other derivative restrictions, such as liquidity cover requirements, which is often a manual and time-consuming process.

Responsibility under the UCITS regime to monitor risk and compliance with restrictions rests with the management company or the investment company. While the assessment of compliance can be delegated to investment managers, it

is often viewed as a conflict of interest to do so. In Ireland, dedicated consultants are often therefore required at additional cost to the UCITS.

Where OTC derivatives are used, independent valuations must also be acquired, which, again, can be costly. Service provider fees can also increase in line with the sophistication of investments and the difficulty of valuation. This, in turn, raises the question as to whether an administrator who specialises in hedge funds, or one that specialises in traditional funds, is the better fit for the 130/30. The general experience is that neither model fits without significant investment, particularly for any retail UCITS that intend to charge performance fees.

Conclusion

The success of 130/30 UCITS will remain an open question until more providers add product to the market and that product builds up a performance record. Where UCITS are the structures of choice, consideration must be given to differing interpretations across domiciles and the extensive restrictions that must be adhered to. Costs should also be considered, but perhaps more importantly whether such costs could be put to better use in enhancing the performance and distribution of existing strategies.

Notes

¹ Deputy Director-General, DG Internal Market and Services, European Commission, in a letter entitled, “Physical short-selling in the context of the UCITS Directive - March 2007 CESR guidelines on eligible assets”, addressed to the Chairman of CESR (ref. MARKT/G4/dm/D(2008) 4056).

² CESR’s guidelines concerning eligible assets for investment by UCITS (CESR/07-044, March 2007).

³ Financial Regulator, Collective Investment Schemes - Policy Changes and Related Matters, “UCITS - Covered Short Sales” (Ireland: Financial Institutions and Funds Authorisation, October 2007).

⁴ CESR’s guidelines concerning eligible assets for investment by UCITS (CESR/07-44b, March 2007; updated September 2008).

⁵ Circular 07/308 refers to a holding period equivalent to one month (20 days).

CSSF Circular 08/356: taking advantage of new opportunities

On 4 June 2008, the Commission de Surveillance du Secteur Financier (CSSF) published its long-awaited Circular 08/356 on rules applicable to undertakings for collective investment when they employ certain techniques and instruments relating to transferable securities and money market instruments. Changes introduced are indeed innovative.

Provisions of article 42 (2) of the law of 20 December 2002 relating to undertakings for collective investment state that "A UCITS is also authorized to employ techniques and instruments relating to transferable securities and money market instruments under the conditions and limits laid down by the CSSF provided that such techniques and instruments are used for the purpose of efficient portfolio management".

Until 4 June 2008, the use of techniques such as securities lending, operations carried out under repurchase agreements¹ or "à réméré"² were governed by the rules set out under Chapter H of circular IML 91/75. The new Circular repeals and replaces the provisions of Chapter H and is applicable to all UCITS and UCIs.

Efficient portfolio management

Although the concept of "efficient portfolio management" was already the condition under which these techniques were authorised to UCITS under the previous law, this notion had never been further clarified until now. This grey area is now somewhat clearer. Pursuant to the provisions of Article 11 of the Grand Ducal Regulation on eligible assets of 8 February 2008, the Circular 08/356 (hereafter "the Circular") defines the notion of "efficient portfolio management" as follows:

- "They must be economically appropriate in that they are realized in a cost-effective way;
- They must be entered into for one or more of the following specific aims:
 - Reduction of risks
 - Reduction of cost
 - Generation of additional capital or income for the UCITS with a level of risk which is consistent with the risk profile of the UCITS and the risk diversification rules applicable to it;
- Their risks are adequately captured by the risk management process of the UCITS".

In transposing this definition into the Circular, the CSSF shows once again that it fully endorses the recommendations made by the CESR in view of harmonising the world of coordinated UCITS within the European Member States.

Quality of the counterparty

Without clearly defining the type of eligible counterparties, the Circular foresees that they must, in all cases, be subject to prudential rules considered by the CSSF as equivalent to those prescribed by Community law.

By analogy to what is written in Article 6 of the Grand Ducal Regulation of 8 February 2008, we can presume that a counterparty subject to prudential rules and located either in the European Economic Area or in G10 countries (including USA, Canada, Japan and Switzerland) could meet this requirement. Similarly, counterparties having at least an investment grade rating, or for which it can be demonstrated based on an in-depth risk assessment that the prudential rules are at least as stringent as those laid down by Community law, could be eligible counterparties.

The new Circular finally gives to UCITS the opportunity to generate additional income by reinvesting cash collateral received in the framework of securities lending transactions.

Periodical information of the public

The Circular 08/356 reiterates the requirement of disclosing separate information on those transactions in the financial reports of UCITS either under the form of the global valuation of securities lent in the case of securities lending transactions or the total amount of open transactions in the case of transactions made under a repurchase agreement or a "réméré agreement" on the date of reference of the reports.

Further key changes compared to the provisions of Chapter H of IML Circular 91/75 are:

No more quantitative limits for securities lending

Although the previous limits relating to lending transactions have been removed (namely that securities lent could not represent more than 50% of the total market value of the securities in a portfolio and the lending period was limited to a maximum of 30 days), the Circular strongly insists on the fact that the volume of securities lent must remain at an appropriate level allowing the UCITS to redeem the shares/units of its shareholders at their request. The latter remark is also applicable in the case of securities purchased under a repurchase agreement or purchased "à réméré".

Diversification and counterparty rules for securities purchased under a repurchase agreement or “à réméré”

The Circular foresees that securities purchased under a repurchase agreement or securities purchased “à réméré” shall comply with the usual diversification rules applicable to all securities in a portfolio. Moreover, any potential counterparty risk linked to transactions made under securities lending agreements, repurchase or “réméré” agreements must be monitored and must comply with the relevant counterparty limit.

Reinvestment of cash collateral on securities lending

This change is unquestionably the most expected one by the whole industry! Actually, the new Circular finally gives to UCITS the opportunity to generate additional income by reinvesting cash collateral received in the framework of securities lending transactions. With this aim in view, the new Circular clarifies the type of securities in which cash collateral can be reinvested, clearly stating that reinvestment of cash collateral has no impact on the diversification of the portfolio. UCITS must however avoid excessive concentration both at issuers and/or instruments level. This latter requirement is not applicable when cash collateral is reinvested either in shares or units of AAA money market funds calculating a daily net asset value or in short-term bonds issued or guaranteed by certain states or supranational entities. This should represent a huge opportunity for promoters with money market funds in their product range.

Conclusion

Funds managers and promoters will probably review their organisational process linked to collateral management in order to take advantage of all opportunities given by this quite innovative Circular.

In addition, as it does not completely close the door to UCITS wishing to sell securities purchased under a repurchase agreement, this possibility could certainly be of some interest for certain market participants, notably those using alternative strategies.

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Notes

- ¹ Under a “repurchase agreement”, the seller has, at maturity date, the obligation to repurchase the securities sold and the buyer has the obligation to return them to the seller.
- ² When securities are purchased under a “réméré agreement”, the seller has, at maturity date, the right to repurchase the securities sold while the buyer has the obligation to return them if it is asked to do so.

The CSSF defines rules for prime brokers selection

On 5 September 2008 the Commission de Surveillance du Secteur Financier has issued Circular 08/372 in which it sets the conditions applicable to a depositary bank of an investment fund adopting alternative investment strategies, in the instance that the fund uses the services of a prime broker.¹ In the context of the regulatory framework of the Grand Duchy of Luxembourg, funds using alternative investment strategies are generally referred to as SIFs, the special investment funds vehicles.²

The role of the prime broker

The role of a prime broker, according to CSSF's guidance, consists primarily in the following:

- Safekeeping of the assets of the SIF;
- Execution of transactions and netting operations on behalf of the SIF;
- Margining operations;
- Establishment of credit lines to finance overdrafts; and
- Involvement in securities lending, securities borrowing and repurchase transactions.

Depending on its legal form (contractual or corporate) the SIF's choice of the prime broker falls under the responsibilities of either the management company or the fund itself; still, from a legal perspective, the SIF law prescribes that the safekeeping of a SIF's assets should be entrusted to a depositary, whose liability would remain unaffected by the fact it has entrusted all or some of the assets in sub-custody to a third party.

This is only an apparent contradiction. The concept of "safekeeping" according to the CSSF should be interpreted as "supervision of the assets". In this context, the supervision requirement is met as long as the depositary accepts the selection of the prime broker, and puts in place adequate operational

arrangements to ensure it can supervise the assets held by the prime broker.

Establishing selection criteria and organising the prime brokerage relationship

The depositary must accept the choice of the prime broker; in doing so, it must ensure that the prime broker meets two eligibility criteria defined by the CSSF:

1. The prime broker must be a financial institution subject to regulatory supervision in a jurisdiction whose standards are equivalent to those provided by EU legislation; and
2. The prime broker must be a recognised financial institution specialised in the prime brokerage business.

Once these two criteria are met, the depositary must organise its relationship with the prime broker in a way to ensure it can carry out its supervisory tasks, by focusing on the right of information and the right of intervention.

The former is the right to obtain, at any time, all necessary information from the prime broker, in terms of composition and location of the assets, in order to fulfil its supervisory obligation.

The latter refers to the right of the depositary bank to intervene in the case where it feels it cannot any longer exercise its supervisory duty.

Both rights can be either defined in the framework of a prime broker agreement between the fund and the prime broker or in the framework of a direct contractual relationship between the prime broker and the depositary bank.

Circular 08/372 also provides, in the case of SIFs established in contractual form (fonds commun de placement) that the depositary may contractually entrust the prime broker with any other operation in respect of the day-to-day administration of the securities and liquid assets of

the fund (e.g. collection of interests and dividends, exercise of options and so on) that according to the SIF law are under the responsibility of the depositary.

Extremely practical approach

Circular 08/372 mirrors the contents of other similar pieces of legislation in other European countries, and from this point of view, provides little space for original interpretations of the role of the depositary and the prime broker.

Although aspects such as credit-solvability assessment, review of technical and organisational infrastructure of the prime broker or reference to guidelines produced by the Alternative Investment Management Association (AIMA) have been debated by the industry as possible examples of criteria to be used by a depositary to assess the adequacy of the prime broker, these requirements have not found their way into the text of Circular 08/372.

Conclusion

Circular 08/372 contributes substantially in defining the Luxembourg regulatory regime for alternative investments. In combination with the SIF law, a modern and flexible regulatory framework has been established, enabling the Grand-Duchy of Luxembourg to become one of the key centres for alternative investment products.

Although the responsibilities of the depositary remains untested in the case of a prime broker appointment, mainly due to the fact that the regulatory regime is still in its infancy, we believe that the CSSF's approach is a sensible one.

Notes

¹ Circulaire CSSF 08/382 sur les lignes de conduite applicables au dépositaire d'un fonds d'investissement spécialisé adoptant des stratégies d'investissement alternatives, dans le cas où ce fonds a recours aux services d'un prime broker.

² Regulatory regime established with the SIF law of 13 February 2007 (loi du 13 février 2007 relative aux fonds d'investissement spécialisés).

Glossary

CESR Commission of European Securities Regulators

CIF Collective Investment Fund

CIS Collective Investment Scheme

CSSF Commission de Surveillance du Secteur Financier (Luxembourg financial regulator)

EC European Commission

ECJ European Court of Justice

EFAMA European Fund and Asset Management Association

EU European Union

Financial Regulator Irish Financial Regulator

FIS Fonds d'investissement spécialisé (Specialised Investment Fund)

FDIs Financial derivative instruments

FSA Financial Services Authority (UK financial regulator)

IFIA Irish Funds Industry Association

MCP Management Company Passport

MS Member State

NAV Net Asset Value

OTC Over the counter

RMP Risk Management Process

SICAV Société d'Investissement à Capital Variable

SICAR Société d'Investissement en Capital à Risque (Risk Capital Investment Copmpany)

SIF Special Investment Fund

SPVs Special purpose vehicles

UCITS Undertaking for Collective Investments in Transferable Securities

VaR Value at Risk

VAT Value-added tax

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