

Eligible Assets for UCITS: the directive is out!

dated 30 March 2007

On March 19, 2007 more than two years after the EU Commission mandated the Committee of European Securities Regulators ("CESR") to assist in clarifying the definitions of Eligible Assets for UCITS, the Commission adopted its Directive 2007/16/EC on Eligible Assets for UCITS.

Following the publication of CESR's technical advice on eligible assets in January 2006 (CESR/06-005), the Commission published its draft rules in March 2006 in the form of a regulation. Surprisingly, the Commission changed its mind in September 2006 when it published its second draft document in the form of a directive thus providing member states the freedom to transpose the measures into their national laws in an appropriate manner for them.

This Directive adopted on March 19, 2007 aims at ensuring uniform application of Directive 85/611/EEC, as amended by reducing uncertainties in determining whether certain categories of financial instruments fall within the scope of the definitions provided by Directive 85/611/EEC. According to its objective, "the clarifications provided by this Directive do not of themselves give rise to any new behavioural or operational obligation for competent authorities or market participants" but helps them to better assess whether or not financial instruments could be eligible.

The following key developments can be highlighted:

- Closed-end funds (whatever their nature) become transferable securities provided that they are subject to certain corporate governance mechanisms; their asset management activities are carried out by an entity subject to national regulation for the purpose of investor protection; and they fulfil the eligibility criteria applicable to transferable securities.
- It is now clear that the "look-through approach" should be applied to financial instruments backed or linked to the performance of other assets (SFI) only when the linkage to these other assets meets the criteria for being considered as an embedded derivative in which case the underlying assets must be in line with the UCITS requirements.
- Credit derivatives are considered as eligible assets for a UCITS fund provided that they comply with the criteria applicable to OTC derivatives; that they do not result in the delivery of non permissible assets for UCITS; and that their specific risks are adequately captured by the UCITS' risk management process.
- Derivatives on a single commodity still remain forbidden.
- Financial indices, whether or not composed of eligible assets or not could be considered as eligible financial indices provided that they are sufficiently diversified; that they represent an adequate benchmark for the market to which they refer; and that they are published in an appropriate manner.

Member States have now twelve months following the date of entry into force of this Directive to adopt and publish the regulations and administrative provisions necessary to comply with this Directive and four months following March 23, 2008 to bring their national provisions into force.

To complement this Directive, on the same date CESR published its final guidelines on eligible assets which, without constituting binding rules, aim to assist market participants and regulators in their interpretation of the new directive.

The completion of this process has been long and difficult but has been ultimately worthwhile in that we now have a firm basis for a harmonised application of these rules going forward.

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