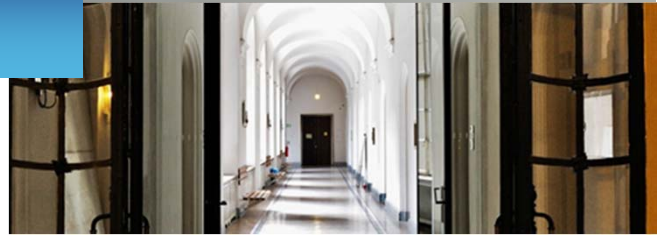


The rise of UCITS III



Background

In simple terms, a UCITS is a mutual fund based in the European Union. UCITS stands for “**Undertakings for Collective Investment in Transferable Securities**” and UCITS funds can be sold to any investor within the European Union under a harmonised regulatory regime. They have a strong brand identity across Europe, Asia and South America and are distributed for sale in over fifty countries as they have transparent, tried and tested regulation.

The original Directive introducing the concept of a standard fund structure, “**UCITS I**”¹, was adopted in 1985. However, due to differing cross border marketing restrictions in member states and the restricted range of asset classes permitted, the original Directive prevented UCITS from benefiting from the increasing range of investments that were available in the market. A second draft directive – UCITS II – was developed to rectify these issues, however extended political arguing between EU countries caused it to be abandoned.

UCITS III – development for change

It was not until 2003 that UCITS I was amended by a new Directive, UCITS III, which was itself made up of two directives: the Product Directive² and the Management Directive³.

- ▶ The **Product Directive** expanded the type and range of investments that a UCITS could hold;
- ▶ The **Management Directive** sought to give a European passport to management companies of a UCITS fund to enable them to operate throughout the EU as well as tightening up risk management frameworks and increasing managers' capitalisation requirements.
- ▶ The combined Directive was intended to widen consumer choice and consumer protection.

It is this combined UCITS III Directive that fund managers now refer to when they talk about “**UCITS-III-compliant**” or “**Newcits**” funds. In general, they mean the fund is taking advantage of the wider investment powers. But there is a good deal more going on behind the scenes.

One of the key benefits of the UCITS III Product Directive was the **broadening of the investment powers** available to mutual funds. This included derivatives for specific investment purposes and it has taken some years for the industry to realise that this enhanced breadth presents managers with the ability to offer a much fuller range of investment products than had previously been the case.

The Management Directive developed the existing concept of the “**product passport**”, on which BlackRock's European Retail distribution model is based. Under the passport, a UCITS fund in one member state can be freely marketed to investors in another EU⁴ country, subject to a processing period of up to two months by the regulator in the other country.

The Management Directive also introduced new prospectus requirements as well as demanding that all UCITS funds use a “**Simplified Prospectus**” as a marketing document throughout the EEA. Permissions to allow managers to operate funds domiciled in other countries (the “**management passport**”) was not however a complete success and the new UCITS IV Directive, which will come into force in 2011, in part aims to rectify this.

BlackRock in the UK was one of the first firms to see the possibilities for UCITS III, with the launch in 2005 of UK Absolute Alpha. Since then, we have launched other funds and now offer a wide range of UCITS-III-compliant funds as well as seven “Newcits” funds to UK and European investors, investing in equity, fixed income and foreign exchange. Most of these Newcits funds sit within the BlackRock Strategic Funds (BSF) umbrella:

- ▶ BlackRock UK Absolute Alpha (registered for sale in the UK only)
- ▶ BlackRock European Absolute Alpha (registered for sale in the UK only)
- ▶ BSF European Absolute Return
- ▶ BSF European Opportunities Extension Strategies
- ▶ BSF European Opportunities Absolute Return
- ▶ BSF European Diversified Equity Absolute Return
- ▶ BSF Global Currency Absolute Return

Regulatory change is constant, now more so than ever, but since UCITS III, further EU Directives, rules and guidance have been published, building on its base. This includes the Eligible Assets Directive⁵ which formally widened and clarified the scope of UCITS' investments, the European Commission Recommendation for the use of financial derivative instruments for UCITS⁶ which introduced additional aspects and demands in risk monitoring and additional guidance by CESR⁷ on an assortment of matters.

Main Features of a UCITS

A UCITS can only invest in eligible assets. The original UCITS directive was restrictive in scope and effectively allowed only equity and bond funds.

UCITS III expanded the range of available investments to include derivatives for investment purposes, other UCITS and cash. This dramatically increased investor choice, allowing for cash funds, funds of fund, mixed asset funds and as we now see, "Newcits" funds.

UCITS must operate on a principle of risk spreading, which means that restrictions apply which limit the spread of investments, leverage and exposure. UCITS III, however, re-defined how derivative exposure can be measured.

A UCITS must be open-ended i.e. shares or units in the fund may be redeemed on demand by investors.

A UCITS must be liquid, that is, its underlying investments must be liquid enough to support redemptions in the fund on at least a fortnightly basis. In practice of course, the vast majority of UCITS funds are daily dealing.

Assets must be entrusted to an independent custodian or depositary and held in a ring-fenced account on behalf of investors.

The development of investment powers

Eligible Assets

As part of UCITS III then, the Product Directive expanded the type of available investments to allow a UCITS to invest in derivatives not only for efficient portfolio management "EPM" or hedging purposes but for investment purposes as well.

This has allowed a number of hedge fund strategies to be accommodated within the UCITS format such as equity long/short, relative value, etc. Some strategies, however, will not easily fit within a UCITS framework because the underlying asset class is not permissible (e.g. individual commodities or bank loans) or because of the lack of liquidity (e.g. distressed debt).

The eligible assets that a UCITS can invest in include:

- ▶ **Transferable securities** – effectively, publicly traded equities or bonds, listed on mainstream stock exchanges. Broadly, this was the range of assets allowed under UCITS I. Under UCITS III, choice has become wider after 2003.
- ▶ **Deposits and Money Market instruments (MMIs)** – Cash deposits with "credit institutions" (i.e. banks) can now be held as investment assets, together with MMIs. These might include treasury and local authority bills, certificates of deposit or commercial paper. Thus pure cash funds can now be UCITS.

▶ **Other mutual funds** – UCITS have always been able to invest in other funds, although this was tightly restricted. UCITS III relaxed this restriction, with further ability to invest in other open-ended mutual funds where those are other UCITS or non-UCITS funds with UCITS-like traits. This has allowed the development of UCITS funds of funds.

▶ **Financial Derivative Instruments** – under UCITS I, derivatives could only be used for hedging and EPM (i.e. to reduce risk or cost, or to replicate a position that could otherwise be achieved through investing in the underlying asset). With the advent of UCITS III, UCITS are able to use derivatives for investment purposes, using exchange-traded or over-the-counter ("OTC") instruments, with some limitations. The underlying of a derivative must be:

- an eligible asset of the type mentioned above
- interest rates
- foreign exchange rates and currencies
- financial indices (e.g. S&P 500).

Physical short selling is not permitted. However, the same economic effect can be achieved and is allowed through the use of derivatives such as Contracts for Difference ("CFDs").

Firms must have systems and controls in place that can measure the derivative risk and provide an appropriate level of cover, which can mean that on the opposite side of the exposure there must be cash, a similar asset or balancing derivative giving an opposite exposure to a similar underlying asset to cover the original derivative exposure. It can also mean that some UCITS III funds may have high levels of gross exposure.

Ineligible assets – certain assets remains out of scope:

- ▶ Real estate
- ▶ Bank loans
- ▶ Physical metals such as gold (although certain securities based on metals are permitted)
- ▶ Commodities (although derivatives on financial indices such as commodity indices are eligible)

Risk spreading and concentration rules

A UCITS must be properly diversified. There are a number of different limits, all of them in place since UCITS I, but the best known is the 5/10/40 Rule. This states that a UCITS cannot invest more than 5% of its assets in securities issued by a single issuer. However, this limit can be increased up to 10% provided that where the 5% limit is exceeded, the exposure to these issuers, when added together, does not exceed 40% of the fund's assets. There are also rules around the proportion of a company that a UCITS may hold in that it might gain significant influence over its management. Rules exist too regarding the amount of a company's debt or non-voting shares that can be held.

The Risk Management Process – monitoring derivative risk

Whether funds use derivatives for investment purposes or for EPM, the exposure those contracts introduce has to be constantly reviewed. UCITS III more formally introduced the concept of having appropriate risk monitoring of the “global exposure” created by derivatives, although the Directive itself goes into less detail than one might expect.

A UCITS must have risk management systems in place which are explained in the **risk management process (“RMP”)**. The RMP sets out how the risks of a UCITS’ positions/investments (including risks arising out of its use of derivatives) will be measured and monitored.

Long-only funds with EPM, or UCITS III funds making a simplistic use of derivatives, are considered to be “**non-sophisticated**” and may use the “**Commitment Approach**” to establish risk levels. This essentially considers the gross exposure of the fund. “**Sophisticated**” funds – such as BSF European Diversified Equity Absolute Return or BlackRock UK Absolute Alpha – are examples of funds making use of derivatives in a more complex way. These funds have to use “**Value at Risk**” (VaR) to estimate risk. In theory, the “**unsophisticated**” funds of BGF could use the Commitment Approach whilst the more expansive BSF funds would use VaR. In practice though, with a few exceptions, almost all of the BlackRock funds, whether sophisticated or not, use the VaR risk measure. We take the view that VaR is a more insightful and informative measure in the vast majority of scenarios. Limits are coded to ensure that funds do not take more derivative risk than appropriate.

The Commitment Approach

This essentially aggregates the underlying notional value of stock and derivatives to determine the degree of gross exposure (called “global exposure” in the Directive). Under this measure, the leverage limit generated by using financial derivatives is limited to 100% of the UCITS’ net asset value. With the 10% short term overdraft facility that all funds are permitted, **this means the total gross exposure of the fund cannot exceed 210%** of the net asset value of the fund.

Value at Risk

VaR represents a more helpful means of showing how exposed a portfolio is and it is this measure that is used for sophisticated UCITS. Gross exposures can be quite high in funds taking this approach (e.g. BSF EDEAR) and thus sophisticated funds may go beyond the 210% limit of the Commitment Approach; but the VaR measure estimates the potential for loss that is likely to be experienced in a given time period.

VaR is derived from the historical returns of the underlying asset. For UCITS purposes, it is calculated on a monthly basis to a confidence interval of 99%. So if a UCITS has a

monthly 99% VaR of say 8%, we would expect, 99 times in a hundred, the NAV to fall no more than 8% in any single month.

Relative return UCITS (e.g. a “130/30” fund such as BSF European Opportunities Extension Strategies) must limit their 1-month 99% VaR to twice that of the benchmark index. In this example, the benchmark Citigroup Europe BMI Index has a measure of 15.7%, and therefore the UCITS limit would be 31.4%. The fund in fact currently has a 1-month 99% VaR of 12.2%.

Absolute return funds must stand within the limit of 20%. This is in our view a very high amount for a fund attempting to manage volatility to a low level and thus our absolute return funds tend to operate well away from this limit. For example, European Diversified Equity Absolute Return stands at 3.4% (31.08.10, source BlackRock).

Many competitors use the Commitment Approach for their absolute return funds because they promote relatively simple strategies or are willing to restrict themselves to a gross exposure of 210%. However we use the VaR methodology for almost all our BlackRock Global Funds, BSF and BlackRock Fund Managers funds (not just our Newcits funds) as we believe it is a more reliable and helpful measure. It does not cover every eventuality of outcome (the so-called “fat tails” that sit outside of the 99% confidence interval), but it is clear and simple for investors to understand and managers to operate.

Conclusion

UCITS III has taken some time to be fully utilised by the investment management industry that it was designed to assist. But we are now seeing some of the greatest innovation as investors’ (both professional and end-client) imaginations have been captured. The growth in hedge fund strategies in “Newcits” funds (BSF EDEAR, UK Absolute Alpha), following on from the development of funds of funds and multi-asset funds (BGF Flexible Multi-Asset Fund), as well as cash funds (ICS) testifies to this. Consumer choice has been enhanced, together with better consumer protection by virtue of additional measures to ensure risk is properly understood.

The passporting of funds cross-border within Europe took a massive step forward with UCITS III but retains some difficulties; UCITS IV is intended to further aid consumer choice by making passporting easier and encouraging further cross-border distribution of strong and imaginative products.

¹ EU Directive 85/611/EC

² EU Directive 2001/108/EC of 21 January 2002

³ EU Directive 2001/107/EC of 21 January 2002

⁴ Or EEA

⁵ EU Directive 2007/16/EC

⁶ EC document reference 2004/383/EC

⁷ The Committee of European Securities Regulators, which publishes rules and guidance for implementation across the EU much of which now governs UCITS and other mutual funds.

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