ESMA Proposes Look-Through for UCITS Investments

ESMA, the EU securities regulator, has recommended to the European Commission that a look-through approach should be applied to all proposed UCITS investments to determine the eligibility of the relevant assets. ESMA has also proposed that UCITS should be permitted to gain indirect exposures of up to 10% to alternative assets.

The list of eligible assets for undertakings for collective investment in transferable securities ("**UCITS**") is set out in the Level 1 UCITS Directive. The UCITS Eligible Assets Directive ("**EAD**") was adopted in 2007 to assist national competent authorities ("**NCAs**") and market participants to develop a common understanding of the eligibility of assets under the UCITS framework. In June 2023, the European Commission ("**Commission**") issued a formal request to the European Securities and Markets Authority ("**ESMA**") to provide technical advice on the review of the EAD with a view to ensuring that the eligibility requirements are implemented in a uniform manner in all EU member states, while taking into account market and regulatory developments that have occurred since the adoption of the EAD.

Following a call for evidence published in May 2024, ESMA has now published its final report, which sets out ESMA's policy assessments, summarises stakeholders' feedback, provides an overview of NCA positions on the UCITS eligibility of relevant asset classes[1] and sets out proposed amendments to the legal texts to reflect the policy recommendations.

The Commission will now consider ESMA's advice and it is expected that it will publish its own consultation in the coming months. Legislative change is therefore likely to be some way off. ESMA has also recognised the need for an orderly transition and has recommended sufficiently long transitional periods to allow relevant UCITS management companies to modify their portfolios, where required. In the meantime, NCAs will be cognisant of ESMA's advice and may be influenced by ESMA's views. However, it should be borne in mind that current exposures in UCITS portfolios are permitted under the currently applicable legislation and provide important diversification opportunities and access to uncorrelated asset classes.

Look-through Approach

ESMA advocates a look-through approach to determine the UCITS eligibility of assets for at least 90% of the UCITS portfolio. In ESMA's opinion, this approach *"ensures a high level of investor protection and transparency"* and is *"therefore best placed to protect the reputation and trust in the UCITS brand"*.

ESMA's view is that not applying a look-through would risk allowing UCITS to gain significant exposures to alternative assets, blurring the lines between UCITS and AIFs. ESMA has invited the Commission to clarify the applicability of the look-through approach in light of divergent approaches in EU member states. ESMA's draft proposals would mean that asset classes should not be backed by, or linked to the performance of, other assets which may differ from those referred to in Article 50(1) UCITS Directive. To avoid any circumventions, ESMA expects that the look-through approach is performed to the level of the final underlying of the investment.

Investing in Alternative Assets

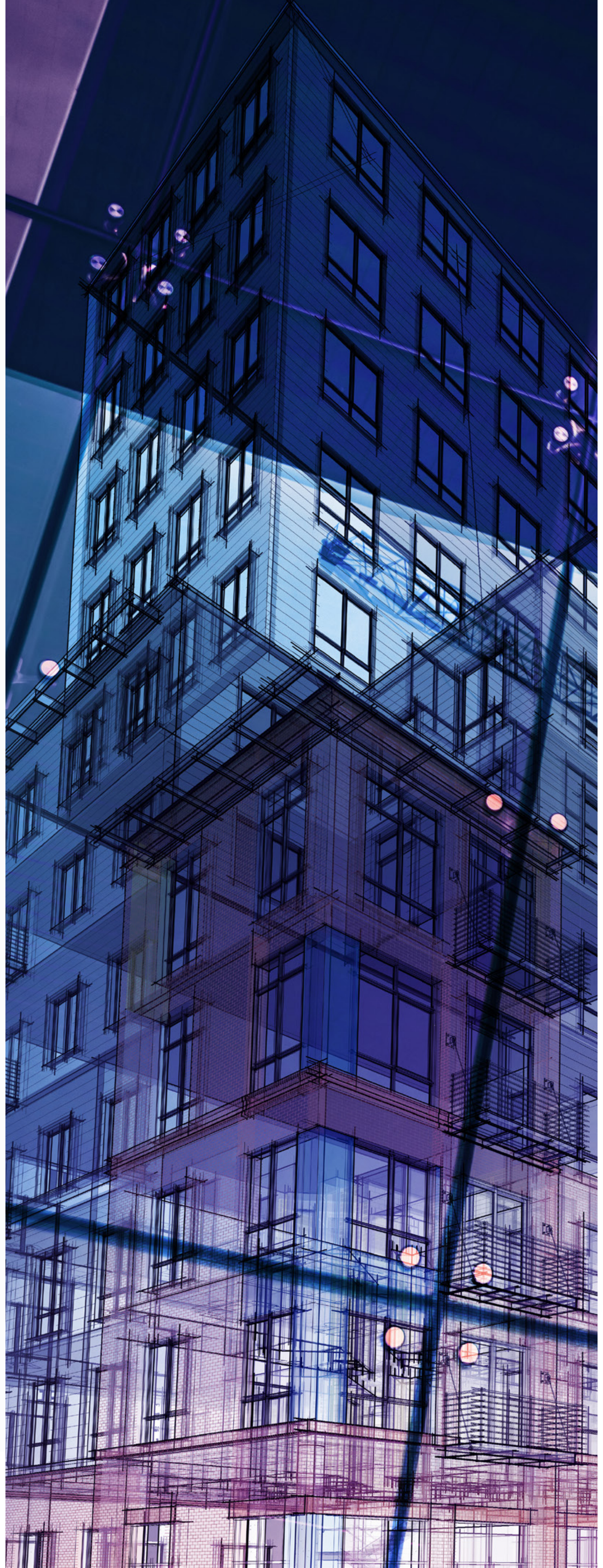
There has been growing interest in the retail investor community in gaining exposure to alternative assets, in the pursuit of risk diversification and investment return from uncorrelated asset classes. The UCITS Directive currently includes a 10% limit for UCITS investments in transferable securities and money market instruments other than those listed as eligible assets the directive, commonly referred to as the "trash bucket". ESMA sees merit in allowing some level of flexibility to gain limited indirect exposures - up to 10% - to alternative assets, subject to compliance with other regulatory safeguards (eg, liquidity and valuation). The wording of the relevant legislative provision (Article 50(2)(a) UCITS Directive) should therefore be amended to extend the 10% limit to all eligible asset classes listed in the UCITS Directive, including financial derivative instruments and units or shares of open-ended AIFs.

ESMA observes that the well-established framework under the Alternative Investment Fund Managers Directive ("**AIFMD**"), including the product specific regulations - European Venture Capital Funds ("**EuVECAs**"), European Social Entrepreneurship Funds ("**EUSEFs**") and European Long Term Investment Funds ("**ELTIFs**") - might provide more suitable vehicles for collective investment in alternative assets. ESMA acknowledges that many market participants prefer the UCITS label as it provides for a retail marketing passport, whereas the rules on marketing alternative investment funds ("**AIFs**") to retail investors are not harmonised at EU level. ESMA notes that the ELTIF Regulation provides for a retail passport, while the EuVECA and EuSEF Regulations allow for marketing to certain categories of high-net worth individuals.

ESMA recommends that consideration could be given to an EU harmonisation of the retail distribution rules for certain AIFs and investment strategies. Another option would be the creation of a new EU harmonised AIF product, next to the existing products, dedicated to investments in those asset classes that would be deemed not eligible under the proposed revised UCITS framework. Such a product might address investor demand for a "semi-liquid" product situated between the UCITS and ELTIF and could assist in advancing the policy objectives under the EU's Saving and Investments Union, which aims to encourage more retail participation in capital markets.

ESMA's Views on Eligibility of Specific Asset Classes

The final report includes a table providing a simplified overview of the expected implications of the look-through approach on relevant asset classes. ESMA emphasises that, to avoid any circumventions, a case-by-case analysis of the relevant financial instrument will always be required, following a substance-over-form approach. The table provides a high-level overview of the likely implications of the look-through approach and does not consider the other conditions and criteria prescribed for the UCITS eligibility of assets (eg, assessment of liquidity, valuation, risk management etc). The ESMA table is summarised below.



Asset Class	Potential eligibility under Article 50(1) following a look-through approach	Potential eligibility of certain exposures within the 10% limit set out in Article 50(2)(a) (without look-through)
Loans	✗	✓
Catastrophe Bonds (Cat bonds)	✗	✓
Contingent Convertible Bonds (CoCo bonds)	✓	✓
Unrated bonds	✓	✓
Distressed securities	✓	✓
Unlisted equities	✓	✓
Crypto-assets	✗	✓
Commodities and precious metals	✗	✓
Exchange traded commodities (ETCs)	✗	✓
Real estate	✗	✓
Special Purpose Acquisition Companies (SPACs)	~	✓
EU AIFs	~	✓
Non-EU AIFs	~	✓
Emission Allowances	✗	✓
Delta-one Instruments	~	✓
Exchange traded notes (ETNs)	~	✓

~ In the case of SPACs, the underlying is usually equity but the other eligibility criteria (eg, liquidity and valuation) need to be particularly carefully assessed. In the other cases, the assessment of the impact of the look-through will depend on the asset classes in which the AIF invests, or the asset classes which the delta-one instrument or ETN is backed by or linked to.

Other Points of Note

ESMA also makes the following points of note in the final report:

- the Commission is invited to give consideration to using directly applicable EU regulations in the area of UCITS, as done in other areas of EU financial law;
- there may be merit in providing additional clarifications on the criteria to be taken into account by UCITS management companies when assessing the liquidity of assets, following a principles-based approach;
- the legal text should be amended to clarify the distinction between the liquidity assessment to determine the eligibility of an individual asset and the broader liquidity risk management at portfolio level;
- the liquidity and negotiability of assets cannot be presumed but should always be assessed ex ante and on an ongoing basis – a presumption of liquidity should not apply to listed securities;
- the EAD valuation-related criteria should be clarified by specifying that the valuation assessment must be supported by adequate liquidity of the market and adequate sources of information;
- the application of the look-through approach should include financial indices;
- the legal text should clarify that the 20% counterparty limit for deposits made with the same body applies also to ancillary liquid assets, without prescribing a maximum amount of ancillary liquid assets that a UCITS may hold;
- ESMA is of the view that holding foreign currencies as ancillary liquid assets is permissible and that UCITS investments in foreign currencies are allowed (no amendment to the EAD is suggested in this regard); and
- ESMA sees merit in assessing the opportunity to amend the UCITS Directive to allow for the deployment of “other collateral arrangements” (ie, collateral arrangements that do not provide for title transfer), provided that certain conditions are met to mitigate relevant risks.

Next Steps

As noted above, the Commission is expected to issue its own consultation on the review of the EAD in the coming months. The Commission is not bound to accept ESMA’s recommendations. It is therefore likely to be some time before there is clarity with regard to any proposed changes to the UCITS Directive and the EAD. ESMA has noted that, in the event of legislative change, long transitional periods should be provided for to allow UCITS to adapt their portfolios, where needed.

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