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FINAL SUMMER INTERNSHIP PROJECT REPORT

*on*

# *“Study of UCITS Regulations in the European Union”*

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# ACKNOWLEDGEMENT

I wish to express my deepest gratitude towards the organization - JPMorgan Chase & Co for providing me the good fortune to be a part of its team of interns. Despite of the global upheaval that we are presently facing, the firm has walked the extra mile to just to ensure that we get a holistic internship experience, albeit a virtual one.

Nevertheless, I would also like to thank my Manager, who has been a constant source of wisdom and guidance throughout the tenure of my internship without his valuable insights, feedbacks and direction, this project could not have been able to see the light of the day. This project allotted by him proved as a deep source of leaming for me and helped me in gaining significant knowledge about UCITS and the European fund industry. I am grateful to him for sparing time from his busy schedule to hear, guide and keep me on the correct path throughout the tenure of my internship at this esteemed organization.

I am also thankful to my Institute, and my faculty mentor - Prof. Mayank Bhatia for their support and encouragement for enabling me to take up such a wonderful opportunity.

I perceive this opportunity as a big milestone in my career development. I will strive to use the gained skills and knowledge in the best possible way, and I will continue to work towards their improvement, in order to attain my desired career objectives.

# EXECUTIVE SUMMARY

The Undertakings for Transferable Securities Collective Investments (UCITS) is the European Commission's regulatory framework for the establishment of a harmonized system of management and sales of mutual funds throughout Europe. UCITS funds may be registered in Europe and sold through unified regulatory and investment protection requirements to investors around the world. The providers of UCITS funds that meet the standards in the individual European countries are exempt from national regulations.

A UCITS is a European Union-based mutual fund in general terms. UCITS funds, which in Europe, South America and Asia are perceived as secure and well-regulated investment, are popular among investors who prefer not to invest in a single public limited company but among diverse unit trust spread across the European Union.

Due to their high safety and regulatory perception, UCITS funds are highly popular investments. They represent about 75% of all collective investments of small investors in Europe, according to the European Commission. As part of their marketing campaign multiple mutual funds companies use the word "UCITS-compliant." While the funding is regulated throughout Europe, UCITS funds can be invested by purchasers all over the world.

This project was allotted to me by my organizational Manger to enable me develop a better understanding of the regulatory bodies, regulatory frameworks, and regulations which govern the operation of Mutual Funds in the European Union. This study was undertaken by me in order to develop a better understanding of compliances and its significance in the fund management industry. JPMorgan Chase & Co. is a financial institution having operations throughout the world, whose history dates back to the year 1799. A team of its Corporate and Investment Banking line of business overlooks the monitoring of regulatory compliances for its European mutual funds. I happened to work with this particular team during the tenure of this internship.

*(302 WORDS)*

## INDEX

| PART 1 | EU MARKET AND ITS FUND INDUSTRY OVERVIEW |
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The European Union (EU) is a political and economic union containing 27 member states that are primarily based in Europe. Its members have a total area of 4,233,255.3 $km^2$ (1,634,469.0 sq. mi) and an estimated overall population of about 447 million people. The EU has established a single internal market through a common legal framework that applies to such matters in all Member States, except only those matters where members have agreed to act as one. EU policies aim at ensuring the free flow of citizens, products, services and resources within the internal market, enacting justice and home affairs regulations and retaining existing trade, agricultural, fisheries and regional growth policies.

The passport controls have been abolished for travel within the Schengen Region. A monetary union was formed in 1999, entering full force in 2002, and is made up of 19 EU member states using the euro currency.

By the accession of new Member States and in government, the Communities and their successors have increased in size with the addition of policy areas to their remit. The most recent major change to the EU's constitutional framework, the Lisbon Treaty, came into force in 2009.

Britain was the first member state ever to leave the EU in January 2020. The UK stated its intention to leave following a 2016 referendum, and signed a withdrawal deal. The UK remains under EU law and part of the EU Single Market and Customs Union in a transitional period until at least 31 December 2020.

Before that, the EU or its predecessors had left three territories of member states, namely French Algeria (in 1962, on independence), Greenland (in 1985, after a referendum) and Saint Barthélemy (in 2012).

With some 5.8 percent of the world's population in 2020, the EU created a nominal gross domestic product (GDP) of around US$ 20 trillion in 2017 (including the United Kingdom), which represents roughly 25 percent of the global nominal GDP. Additionally, according to the United Nations Development Plan all EU countries have a very high Human Development Index. The EU received the Nobel Peace Prize in 2012.

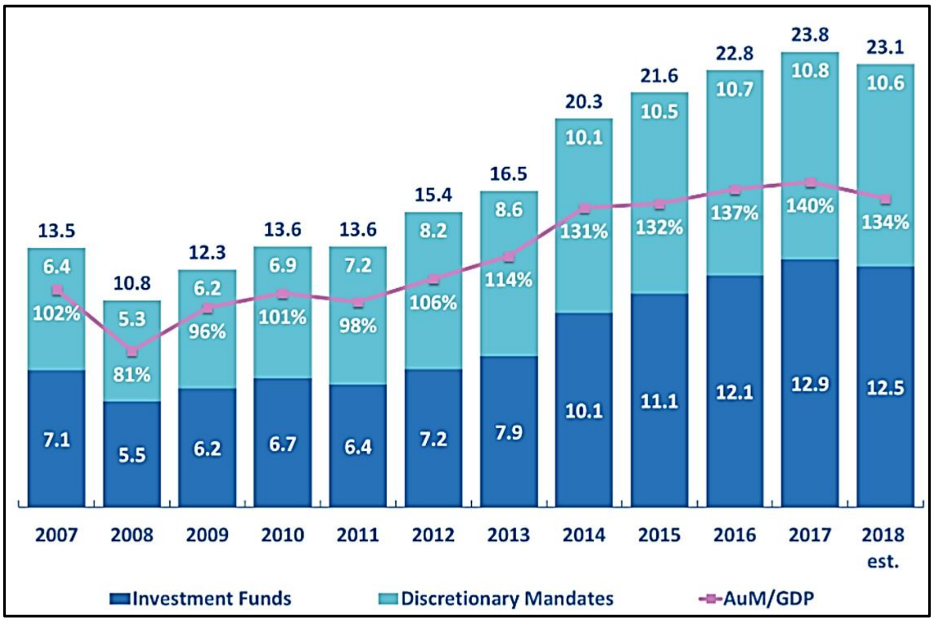
The EU has established a role in international affairs and defence, through the Common Foreign and Security Policy. The union maintains permanent diplomatic missions worldwide and is represented at the United Nations, the World Trade Organization, the G7 and the G20. The European Union has been described as an emerging powerhouse, because of its global reach.

## ❖ European Assets Under Management

- **Evolution of European AuM**

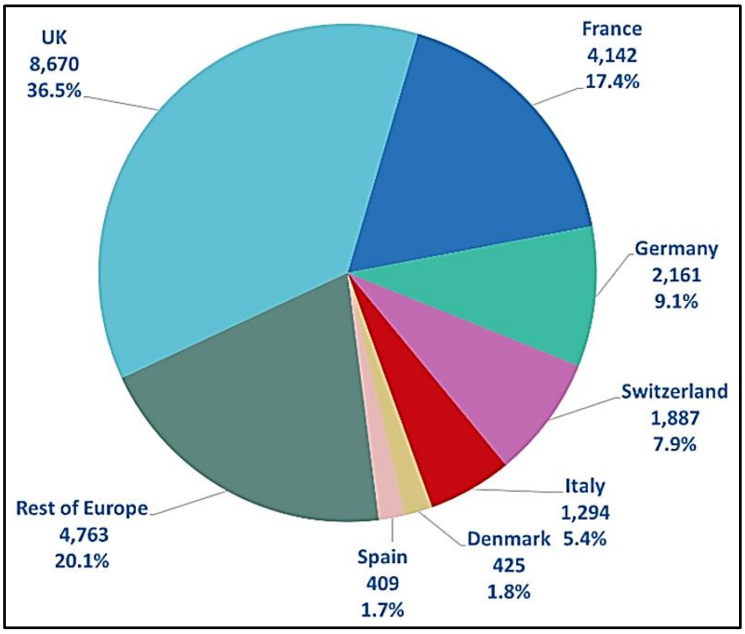
  In 2018, assets managed within Europe stood at EUR 23.1 trillion, a rise of 71 per cent since the end of 2007. This strong growth in assets stems from good stock and bond results, particularly during the 2012-2017 period. Fresh capital flows into pension funds and spending policies led to that development as well. In terms of European GDP, assets under management (AuM) grew from 102 per cent at the end of 2007 to 134 per cent at the end of 2018. At the end of the year, the downturn in AuM in 2018 was triggered by the sharp decline in world financial markets.

*Fig. 1.1: European Assets Under Management (EUR trillion and percent)*



More than 76 per cent of overall AuM in Europe is handled by five nations. The UK is the main market in asset management led by France, Germany, Switzerland and Italy. This dense concentration reflects the scale of these nations, their financial services expertise and the savings pool they have built over the years.

*Fig. 1.2: European Assets Under Management at end of 2017*
*(Euro billion and percentage of total AuM)*




- **Clients of the European Asset Management Industry**

Retail clients – mainly families but also high net worth individuals (HNWI) – and institutional clients are two of the wealth management industry's largest customer categories. Institutional customers include mutual funds, brokerage companies, insurers, and other institutions such as foundations, hospitals, and major businesses. At the end of 2017, their share in the overall European AuM reached 70 percent, with 28 percent and 25 percent respectively of pension funds and insurance firms. These high shares are attributed to pension funds and insurance firms who own vast sums of financial reserves and sometimes outsource to foreign wealth managers the management of all or part of their reserves.

Fig. 1.3: Breakdown of Clients by AuM at End 2017

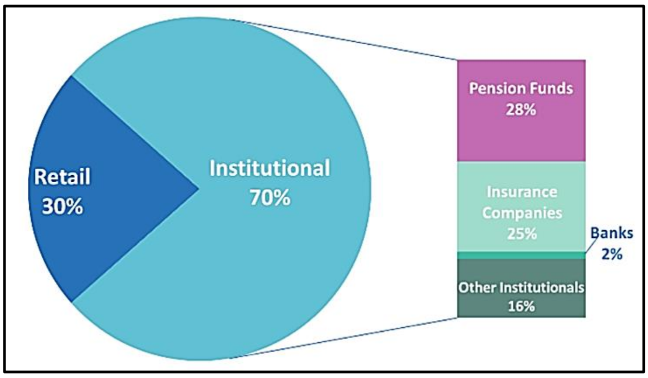
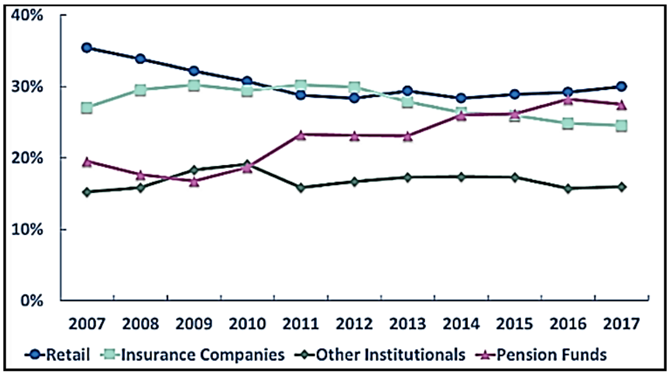



Fig. 1.4: Evolution of Breakdown between Clients
(% of total AuM)




Two observations may be made regarding the progression of the shares of the different categories of customers in the overall AuM handled in Europe. First, retail customers' share has risen in recent years, most likely due to the ultra-low interest rates on bank deposits and the restoration of consumer trust in stock market instruments. The share of institutional investors, however, remained smaller than prior to the global financial crisis. Second, the shares of pension funds and insurance firms have moved in the same direction, with a gradual fall in the share of pension funds and the share of insurance companies.

Pension funds have gained even more from the good success of the stock market as their stock positions in asset management are higher than those of insurance firms who are subject to Solvency II rules. The rising share of pension funds is also motivated by the fast growth of the UK pension fund market, which has benefited since 2012 from a compulsory enrolment program in occupational pension schemes. Insurance insurers' share has also decreased as some firms have opted to re-internalize the administration of their government bonds with pure vanilla to cut costs.

In 2017 about 4,400 wealth management companies were operating in Europe. Table 1A below shows the number of firms per country.

*Table: 1A*

| No. of AMCs in EU Countries - 2017 | | | |
|---|---|---|---|
| Austria | 24 | Slovakia | 10 |
| Luxembourg | 304 | France | 630 |
| Belgium | 64 | Slovenia | 7 |
| Malta | 127 | Germany | 380 |
| Bulgaria | 31 | Spain | 109 |
| Netherlands | 236 | Greece | 50 |
| Croatia | 21 | Sweden | 105 |
| Norway | 31 | Hungary | 24 |
| Cyprus | 125 | Switzerland | 210 |
| Poland | 41 | Ireland | 253 |
| Czech Republic | 23 | Turkey | 49 |
| Portugal | 66 | Italy | 256 |
| Denmark | 53 | United Kingdom | 1100 |
| Romania | 22 | Liechtenstein | 16 |
| Finland | 26 | **Europe** | **1194** |

The UK, France and Germany have the highest number of asset management firms, reflecting the relative importance of London, Paris and Frankfurt as asset management centres and the role that independent and specialized asset managers, such as private equity fund management firms, play in those markets. The high number of asset management firms working in Ireland and Luxembourg is the product of their role in cross-border UCITS and AIF delivery.

# PART 2 FINANCIAL REGULATORS IN EUROPE

## ❖ European Central Bank

The European Central Bank (ECB) is the euro's central bank and administers monetary policy within the Eurozone that includes 19 European Union member states and is one of the world's largest monetary areas. Created by the Treaty of Amsterdam, the ECB is one of the most powerful central banks in the world and it acts as one of the seven European Union institutions enshrined in the Treaty on European Integration. The 27 central banks of each EU member state own the bank's capital assets.

The ECB's primary goal, prescribed in Article 2 of the ECB Law, is to preserve market stability within the Eurozone. Its main duties, as set out in Article 3 of the Law, are the development and execution of monetary policy for the Eurozone, the conduct of foreign exchange operations, the management of foreign reserves of the European System of Central Banks and the operation of financial market infrastructure under the TARGET2 payment mechanism and the technical framework (currently being developed) for securitisation settlement. The ECB has the sole right to approve the issuing of euro banknotes under Article 16 of its Legislation. Member States may issue euro coins, but the amount must be approved in advance by the ECB.

## ❖ European Banking Authority

The European Banking Authority (EBA) is a European Union regulatory body with headquarters in Paris. Its operations include performing stress checks on European banks to improve European financial sector transparency and finding vulnerabilities in the capital frameworks of banks. The EBA was founded on 1 January 2011, on which date it assumed all the duties and obligations of the European Banking Supervisors Committee (CEBS). The department has moved to Paris following UK exit from the European Union referendum.

## ❖ European Securities and Markets Authority (ESMA)

The European Securities and Markets Authority (ESMA) is a financial regulation body of the European Union and a European Supervisory Authority, headquartered in Paris.

ESMA works to improve the functioning of financial markets in Europe in the field of securities legislation and regulation, strengthening investor protection and cooperation between the competent national authorities.

The concept behind ESMA is to establish an "EU-wide watchdog on financial markets" One of its principal tasks is regulating credit rating agencies. Credit rating companies were blamed in 2010 for lack of consistency in their ratings and for a perceived conflict of interest. At the same time, the effect of the issued ratings on companies and banks but also on states became important.

## ❖ European Insurance and Occupational Pensions Authority (EIOPA)

The European Insurance and Occupational Pensions Authority (EIOPA) is a financial regulatory body of the European Union, which succeeded the European Insurance and Occupational Pensions Supervisors Committee (CEIOPS). It is developed in compliance with EU Regulation No 1094/2010.

EIOPA is one of the three European Supervisory Authorities responsible for micro prudential regulation at European Union level, and is part of the European Financial Supervisory Framework.

## ❖ European Systemic Risk Board (ESRB)

In response to the continuing financial crisis the European Systemic Risk Board (ESRB) was created on 16 December 2010. To contribute to the avoidance or reduction of structural threats to financial stability in the EU, it is charged with the macro-prudential regulation of the financial sector within the European Union. It should contribute to the smooth running of the domestic economy and thereby ensure that the financial sector contributes sustainably to economic development.

The ESRB is an autonomous EU agency that is part of the European Financial Supervisory Structure (ESFS), aimed at providing oversight of the EU financial sector. The European Central Bank houses and sponsors the ESRB. It comprises members from the ECB, national central banks and EU member state supervisory bodies, and the European Commission.

## ❖ Region wise list of Financial Regulators

| Region | Financial Market Regulator |
|---|---|
| Luxemburg | Commission de Surveillance du Secteur Financier (CSSF) |
| UK | Financial Conduct Authority (FCA) |
| Ireland | Irish Financial Services Regulatory Authority |
| Switzerland | Financial Market Supervisory Authority (FINMA) |
| Sweden | Financial Supervisory Authority *(Swedish: Finansinspektionen, FI)* |
| Norway | Financial Supervisory Authority of Norway *(Norwegian: Finanstilsynet)* |
| Denmark | Danish Financial Supervisory Authority |
| Germany | Federal Financial Supervisory Authority *(German: Bundesanstalt für Finanzdienstleistungsaufsicht - BaFin)* |
| Belgium | Financial Services and Markets Authority |
| Guernsey | Guernsey Financial Services Commission |
| Finland | Finnish Financial Supervisory Authority *(Finnish: Finanssivalvonta; FIN-FSA)* |
| Netherlands | Netherlands Authority for the Financial Markets *(Dutch: Autoriteit Financiële Markten)* |
| Jersey | Jersey Financial Services Commission (JFSC) |

# PART 3 INTRODUCTION TO UCITS REGULATIONS

## ❖ About UCITS

The Undertakings for Collective Investment in Transferable Securities (UCITS) is a European Commission regulatory framework creating a harmonized regime for the management and sale of mutual funds throughout Europe. Unified regulatory and investor security standards allow UCITS funds to be listed in Europe and marketed to investors around the world. In individual European countries, UCITS fund providers that follow the requirements are exempted from regional regulations.

In regular usage a UCITS is a European Union-based mutual fund. UCITS funds are viewed as secure and well-regulated investments and are common among investors in Europe, South America and Asia who choose not to invest in a single public limited entity but instead across diversified unit trusts distributed across the European Union.

## ❖ Evolution of UCITS

The first UCITS Guideline was adopted on 20 Dec. 1985 with a specific goal to promote cross-border mutual fund offers to institutional investors. Proposals for amending the Directive were made in the early 1990s but never entirely implemented. As such, there is no UCITS II. However, two new directives were introduced in 2002, after consultations among member countries. Directives 2001/107 / EC and 2001/108 / EC, collectively known as UCITS III, broadened the investing scope of UCITS funds and eased certain index fund constraints.

UCITS IV, or Directive 2009/65 / EC, introduced additional legal changes and was adopted in July 2011. Finally, UCITS V, or Directive 2014/91/EU, which came into effect in March 2016, aligns the roles and obligations of depository funds and the remuneration conditions of investment managers with those set out in the Alternative Investment Fund Managers Directive (AIFMD).

UCITS funds are very common investments, since they are seen as very secure and well-regulated. They account for around 75 per cent of all joint contributions by small investors in Europe, according to the European Commission. Often mutual fund companies use a term as part of their marketing campaign, such as "UCITS-compliant". Although the funds are regulated in Europe, investors can invest in UCITS funds from around the world.

## ❖ Management Directive

Management Directive 2001/107/EC aims to provide management firms with a "European passport" to work across the EU, and expands the practices that they are permitted to perform. It also implements the idea of a simplified prospectus which aims to provide more open and detailed information in a simpler format to support UCITS cross-border marketing across Europe.

## ❖ Product Directive

The primary aim of Product Directive 2001/108/EC is to eliminate barriers to cross-border selling of pooled investment fund units by enabling funds to participate in a broader variety of financial instruments (including derivatives), which in each Member State subject the same legislation. All UCITS funds have to follow the same investment constraints.

To permit EU-wide marketing, a collective investment fund can apply for a UCITS status. The aim is to establish an EU-wide single fund market. The goal is for economies of scale to reduce savings for fund managers that can be passed on to customers in a wider market.

## ❖ UCITS IV

The proposal of UCITS IV Directive was approved by the European Parliament on 13 January 2009 and also by the Council of the European Union as the Directive 2009/65/EC, to be implemented on 1 July 2011. This updated the UCITS III Directives by introducing the following changes: -

- Notification Procedure

- Key Investor Information Document
- Adapted Framework for Mergers
- Master-feeder Structures
- Cooperation between Member State Supervisory Authorities
- Management Company Passport

## ❖ UCITS V

On 23 July 2014 the European Union adopted Directive 2014/91/EU ("UCITS V") on the arrangement of rules, legislation and administrative requirements relating to collective investment undertakings in transferable securities with respect to depositary functions, remuneration policies and sanctions.

UCITS V can be related to the Alternative Investment Fund Managers Directive ('AIFMD') (European Union Directive 2011/61/EU), which is a similar policy on hedge funds and alternative investments.

UCITS V proposes new rules for depositories of UCITS, such as the organizations qualified to assume this position, their duties, delegation arrangements and the liability of depositors, as well as general principles of remuneration applicable to fund manager.

The depositary as a special feature under UCITS (rather than under AIFMD) legislation. The depository can delegate its safekeeping functions to a third-party custodian (but not other depositary functions).

## ❖ UCITS VI

The initiatives apply to areas other than those discussed by UCITS V. In summary, these are the issues that have been raised: -

**1. Eligible assets and the use of derivatives** – whether the reach of qualified derivatives including those traded on multilateral platforms and approved by a central counterparty should be limited

**2. Effective portfolio management strategies –** if the existing requirements (for example, on qualifications, liquidity and diversification) require a change

**3. Over-the-counter derivatives ('OTC') –** how to deal with OTC derivative trades while determining counterparty UCITS limits

**4. Extraordinary liquidity management rules –** whether, in extraordinary situations, a common mechanism for dealing with liquidity bottlenecks is required or not

**5. Depositary passport –** whether and how the depositary passport would work in practice

**6. Money market funds –** whether they are a source of systemic risk and/or require harmonized EU regulation

**7. Long-term investments –** (a) how retail investors can be reached and how this can be applied and regulated; (b) what portion of the portfolio of a fund should be allocated to these assets; and (c) if diversification rules are appropriate to ensure sufficient liquidity

**8. Improvements to the UCITS IV framework –** for example Article 64(1) of the UCITS Directive requires UCITS to provide investors with information in the following two cases: (i) where the ordinary UCITS is converted into a feeder UCITS; and (ii) where the master UCITS changes. This does not, as it stands, cover a third possible example, namely that a feeder UCITS turns into an ordinary UCITS. These conversions can lead to a major shift in investment strategy.

## ❖ Asset Allocation

As of 2019, the law of 5/10/40 specifies that funds should only invest up to 10 per cent in a single issuer, and that concentrated assets above 5 per cent must not exceed 40 per cent of the overall portfolio, with certain exceptions.

In 2003, UCITS III allowed funds to invest their assets in illiquid investments up to 10 per cent.

| PART 4 | PRE AND POST TRADE COMPLIANCES |
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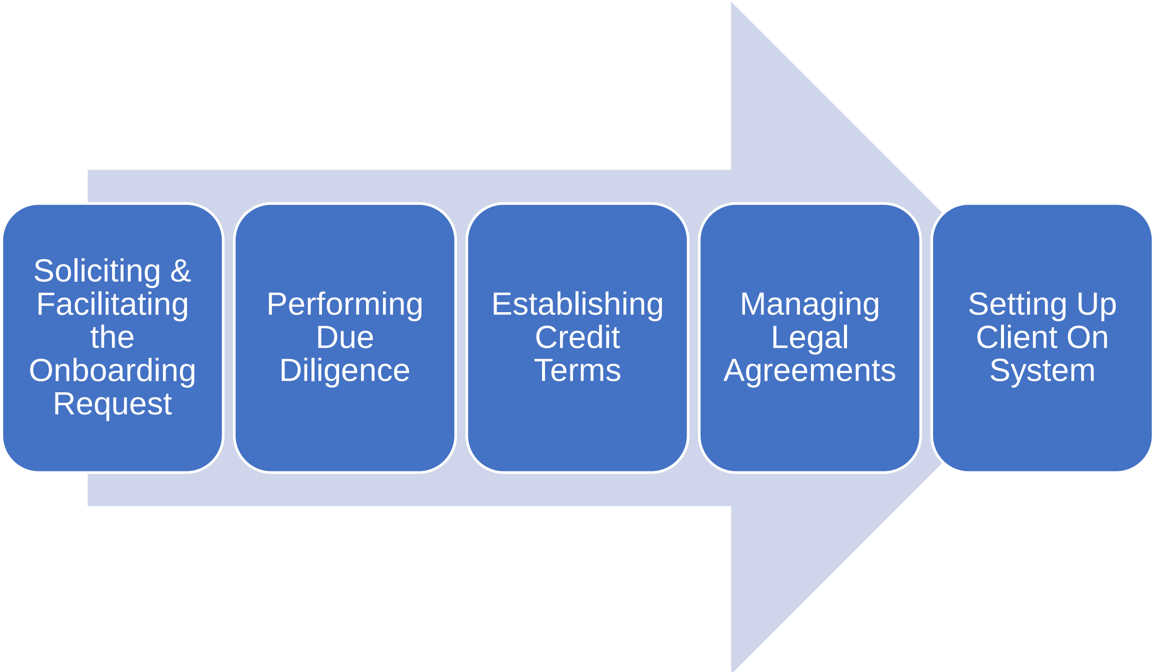
## ❖ PRE-TRADE COMPLIANCE




### i. Client onboarding – KYC

Client onboarding refers to the process through which a bank, investment firm, or other trading institution establishes a relationship with a new client or customer. Well-implemented client onboarding can be an effective tool through which an institution can develop strong client relationships, minimize its risks, and satisfy regulatory requirements. Poorly-implemented client onboarding has the opposite effect as it can lead to client attrition, expose the institution to risk, and result in significant compliance issues.

### ii. Performance Due Diligence

Once an onboarding request has been made, the institution then performs client/customer due diligence. This is the process of gathering information and investigating the potential client to ensure suitability. Through performing due diligence, the institution aims to:

- Identify whether it is willing and legally permitted to retain the client

- Ensure that any products and services that may be made available to the client are appropriate given the client's profile

As part of its due diligence, the institution gathers the client's details and must:

- Identify the documentation that is required to perform due diligence
- Request this documentation from the client
- Check the documentation

Since a key element of due diligence is to identify client suitability for specific products and services, documentation related to those products and services may be required. Later in the tutorial, we will discuss an important element of client due diligence related to anti-money laundering (AML) and combating the financing of terrorism (CFT).

### iii. Establishing Credit Terms

After the institution satisfies itself that the client relationship is suitable and legally acceptable, the next step is to establish the credit terms. This defines the credit exposure that the institution will face due to the client relationship.

Clients engage in a number of activities that expose institutions to credit risk. For example:

- A client may borrow funds from the investment firm to purchase securities, exposing the institution to the risk that the client may not repay the borrowed funds.
- A client may enter into a derivatives contract that contractually obligates them to engage in certain transactions in the future, exposing the institution to the risk that the client may not satisfy these contractual obligations.

An institution must first determine the client's creditworthiness and capacity to assume financial obligations. Once the credit due diligence is performed, it must decide whether it is willing to extend credit to the client at all. If it is willing to extend credit, the institution must then establish how much credit it is willing to extend. Based on this, credit limits are set.

The institution must also determine what collateral, margin, and/or capital the client must provide when entering into products or strategies that have such requirements. In addition, the institution must establish how credit limits, collateral, margin, and capital terms will change as the client's creditworthiness and capacity changes over time.

#### iv. Managing Legal Agreements

Having established the credit terms with the client, an institution must then be prepared to negotiate and execute legal agreements.

Legal agreements include the service level agreement (SLA), which is the formal agreement that defines the relationship between the client and the institution. Management of legal agreements also includes negotiating the terms of other legal agreements besides the SLA. Two notable examples that may be required for clients entering into OTC derivatives contracts are the ISDA Master Agreement and the Credit Support Annex (CSA).

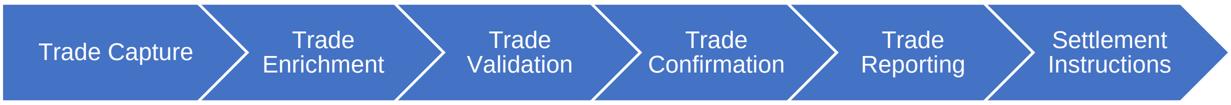
#### v. Setting up Client On System

Once the legal agreements have been negotiated and executed, the final step is to set the client up in the institution's system. Once this has been done, the client can engage in trading and access the services provided by the institution. Furthermore, the system is able to capture all relevant data that is required throughout the trade lifecycle, including data and information required for compliance, auditing, and reporting purposes.

## ❖ POST-TRADE COMPLIANCE

#### i. Trade Clearing

Trade Clearing refers to the activities that take place post-trade execution and pre-settlement. Before settlement can take place, the counterparties to the trade and their agents must determine and verify the exact details of the transaction and prepare for settlement. The main steps involved are: -



- **Trade Capture:** Once the front office executes a trade, it records data related to the trade – a process known as trade capture – and submits this as a "trade ticket" or "deal ticket" to the operations (back office) unit. Alternatively, trade details may be fed automatically from the electronic execution/trading platform into the trade capture system. Ultimately, the trade ticket will include all details related to the trade. Timely and accurate booking and capturing of trades is a fundamental processing step and key control because:
    - A record of all newly-executed trades must be created and reconciled in the books and records in order to understand exposure
    - Information related to captured trades flows downstream to other systems for processing, monitoring, and reporting
    - Traders cannot start managing the risk on new trades until they are reflected in their position
    - Operations staff cannot start processing trades until the data flows through to the confirmations and settlements system

  Trade capture systems should provide reliable and real-time information to enable credit risk, market risk, and position management, as well as supporting trade processing.

  Accuracy is vital. Any errors need to be spotted and resolved as soon as possible to prevent the risk of errors downstream.

- **Trade Enrichment:** The front office may submit just basic trade details. Operations then engage in trade enrichment, which is the process of applying additional information to a trade that is necessary for downstream processing. Trade details are also enriched with various "identifiers", such as International Securities Identification Numbers (ISINs) and ISO currency codes that are used for identification and standardization. The aftermath of the financial crisis resulted in the introduction of several other fields, such as Legal Entity Identifier (LEI) and Unique Transaction Identifier (UTI), that trade capture systems need to accommodate for regulatory reporting purposes.

Trade enrichment may take place manually, or automatically using **straight through processing (STP)**. If automatic, trade enrichment makes use of static data that is stored in a static data repository.

- **Trade Validation:** Following enrichment, and before communicating with other entities in relation to a trade, it is prudent to perform a final check of the details. This process is known as trade validation and its purpose is to:
  - Check whether the gathered information in relation to any trades is complete and accurate
  - Implement protocols, known as exception handling, through which to address those trades that have been flagged as potentially problematic

Examples of issues that trade validation will flag include:

- A trade date in the future or a value date in the past
- A value date that is not a business day in the settlement location
- A security identifier that is not in the appropriate format
- The omission of a call schedule for a security that is callable

The trade validation process also considers whether a trade is "acceptable." For example, a trade may be flagged for further investigation if:

- The trading price is outside of a predetermined acceptable range
- The size of the trade is above a predetermined maximum
- The client/counterparty is not authorized to engage in the given trade

Hence, trade validation is intended to ensure completeness, reduce the likelihood that any information is inaccurate, and ensure that trades are acceptable before communication takes place with other entities. Trade validation can take place either automatically using STP or manually. If automatic, then rigorous protocols are required to automate trade validation and trigger exceptions. If manual, staff must work diligently to ensure that trade validation is rigorous and error free.

- **Trade Confirmation and Affirmation:**

Trade validation ensures that the trade details are complete and accurate, and that the trade is deemed to be acceptable. However, this validation is only internal. The next step is to engage in a process to verify that the participants in the trade are in agreement with its terms.

When an institution executes a trade for a client, the institution is a direct participant in the trade and the client is an indirect participant. Hence, the verification process has to take place at two levels:

- **Trade Confirmation:** This is the process through which trade details are verified between the direct participants to the trade.
- **Trade Affirmation:** This is the process through which trade details are verified between the direct participants and indirect participants to the trade.

- **Trade Reporting:** Trade reporting refers to the reporting of transactions using an approved reporting mechanism. Reporting may take place automatically once a trade is executed on an exchange or may be a requirement that participants in the trade must satisfy.
  Trade reporting is important for financial regulators, and was a major element of regulations such as EMIR (European Market Infrastructure Regulation) and the Dodd-Frank Act in the US that were introduced following the financial crisis.
  Financial regulators can use the reported information to determine whether there are any issues associated with a given trade or a given trader, such as violation of trading rules, insider trading, or other abnormal trading. Regulators can also use the reported information to understand market volatility and liquidity, as well as the exposures faced by individual counterparties and the financial system as a whole.

- **Settlement Instructions:** Once a trade has been captured, enriched, validated, agreed, and reported, the final step before settlement is the preparation of settlement instructions. Settlement instructions are instructions that are sent to the relevant clearinghouse or CCP stipulating how trade settlement should take place. Once the clearinghouse or CCP receives the instructions, it will engage in:
  - Settlement instruction validation, which checks whether the information in the instructions is complete and accurate.
  - Settlement instruction matching, which involves matching the settlement instruction received from both counterparties to a given transaction, and addressing any unmatched instructions.

Settlement instructions are typically transmitted using an electronic mechanism, a prominent example is provided by SWIFT (Society for Worldwide Interbank Financial Telecommunication). SWIFT exchanges millions of standardized financial messages, including settlement instructions, every day on behalf of almost 11,000 banks and other institutions in more than 200 countries.

Settlement instructions must be relayed in a timely manner to facilitate settlement. Specific markets and products adhere to different settlement cycles (T+1, T+2, and so on) and deadlines for receipt of instructions. The operations area is responsible for advising clients of the deadlines applicable to a transaction. Deadlines depend on the value date of a transaction, but may also be affected by the method of transmitting settlement instructions (for example, if an instruction is not transmitted in a standardized electronic format such as SWIFT and requires any manual authentication as a result).

### ii. Trade Settlement:

As defined earlier, settlement refers to the completion of the agreed-upon transaction. Two methods through which settlement can take place are:

- **Delivery vs Payment (DVP):** DVP refers to settlement whereby securities are only delivered if payment is made and payment is only made if securities are delivered. In other words, the transfer of securities and payment for those securities occurs simultaneously.
- **Free of Payment (FOP):** FOP refers to settlement whereby the delivery of the securities and payment of funds take place separately. It requires one or both counterparties to a trade to release securities/payment before confirmation of receipt.

DVP removes principal risk, while FOP does not. Principal risk is the risk that a party to a transaction that has fulfilled its obligations may not receive promised funds or securities from the counterparty. Because DVP removes principal risk, regulators recommend DVP settlement.

Once a trade reaches its value date, settlement should occur. A settlement fail occurs when a trade does not settle on the date that it was contractually scheduled to take place. Hence, settlement failure occurs if:

- The buyer fails to receive securities (securities fail), and/or
- The seller fails to receive payment (cash fail)

### iii. Custody and Asset Servicing:

Clearing of a trade typically takes place through a clearing system, which implements clearing procedures at a single entity known as a clearinghouse. Hence, a clearinghouse represents a central processing mechanism through which the exchange of securities and funds is facilitated using the rules set by the clearinghouse.

It is important to distinguish between a clearinghouse and a central counterparty clearinghouse, known as a CCP. The key difference between the two is that a CCP assumes counterparty risk while a clearing house does not. Under the CCP model, the CCP is substituted as a counterparty to each of the original counterparties through a process known as novation. When an initial bilateral transaction is novated, the CCP becomes the seller counterparty to the original buyer counterparty and the buyer counterparty to the original seller counterparty.


Because a CCP takes on the role of counterparty to each trade, it is exposed to significant counterparty exposure. As such, CCPs engage in extensive risk management, such as demanding margin from counterparties and forming a reserve fund, among other risk management techniques.

An investor's relationship with a CSD can take several forms:

- The investor may have an account directly with the CSD, whereby the securities are directly registered in the investor's name. However, many CSDs do not allow investors to have direct accounts.
- Alternatively, the investor's agent (such as a bank, broker, or investment firm) may have an account with the CSD, and the securities are registered in the

agent's name rather than the investor's name. The investor is the beneficial owner of the securities and therefore receives all benefits associated with the securities, such as dividends and voting rights. In the US, such registration is known as "street name" registration. If the investor uses multiple agents, each agent will have its own account with the CSD.

- Another alternative is for the investor to form a relationship with a custodian, whereby all of the investor's securities are registered in the custodian's name rather than the investor's or the agent's name. Once again, the investor is the beneficial owner of the security.

A custodian is typically a bank. Before the creation of CSDs, custodian banks engaged in safekeeping of physical securities. Since then, their focus is more on the administering of securities and the provision of services. These will be described shortly.

Custodian banks may be:

- Local custodian banks that focus on a specific market.
- Global custodian banks that provide services to clients across multiple markets (global custodians have a network of sub-custodians, which it appoints, and these sub-custodians may or may not be affiliates of the global custodian).

# PART 5 INVESTMENT RESTRICTIONS UNDER UCITS

## ❖ Investments in Transferable Securities and Money Market Instruments

A UCITS fund cannot invest more than 10 per cent of its own assets in transferable securities and money market instruments, and no more than 5 per cent in transferable securities and money market instruments issued by the same body. This limit of 5 percent does not apply to deposits and OTC-derivative transactions with financial institutions under prudential supervision and may be increased:

- 10% if the value of shares owned in the same company is less than 40% of the assets of the UCITS fund;
- to 20% of investment in equity and/or debt securities of an equal entity, subject to approval, to 35% of the investment strategy of the UCITS company, as defined in the prospectus, to replicate the composition of a certain index of stock or debt securities; -
- a 25% for bonds issued by a bank having its registered office in a Member State and subject, by legislation, to special public surveillance designed to protect bond holders;
- 35 per cent if a Member State or its local authorities' issue or guarantee transferable securities and monetary market instruments

The aforementioned limitation shall be, without prejudice, the discretion of the financial regulator of the country to authorize UCITS to make investments in transferable securities and money market instruments to a maximum of 100% of the UCITS fund, as long as such securities or instruments are issued or guaranteed by a Member State or by local authorities or by a non-Member State. Moreover, the Financial Regulator of the country must be satisfied that UCITS fund unit holders have the same protection as those of unit holders of the UCITS fund, which respect the above-mentioned limits.

The UCITS fund must meet the following conditions, if the financial regulator of the country authorizes this increase:

- Subject to securities of at least six distinguishes issues and do not constitute more than 30% of their overall assets through securities of each issue;
- The names of the nations, municipal governments or public external bodies selling or guaranteeing securities that it plans to spend more than 35 percent of its assets must be explicitly disclosed to the prospectus and to any advertising material in the UCITS Portfolio.

## ❖ Bank Deposits

A fund of UCITS cannot deposit with any bank more than 20% of its reserves. If the risk spreading principle is observed, however, during the first 6 months following its launch a UCITS fund may exceed its limit.

## ❖ Trading in Derivatives

An OTC and traded derivatives fund may be traded under OCITS for as long as:

- the capital assets that are based on are financial indices, interest rates, currencies or foreign exchange rate, as defined in the prospectus or the instruments of incorporation, and are in conformity with its investment objective;
- OTC's counterparties are institutions subject to prudential supervision and approved by the Financial Regulator of the country;
- OTC derivatives are subject to reliable and verifiable daily valuation and can be sold, liquidated or closed at any time at their fair value and on the initiative of the UCITS fund itself, through an offsetting transaction.
- The maximum possible loss incurred by the counterparty in the case of a counterparty defaults is not more than 5% of the value of its total assets for one counterparty in an OTC derivative transaction. This limit may be increased to 10 percent for OTC derivative transactions in banks registered in a Member State that are repayable on demand or can be withdrawn within no more than 12 months, as long as such banks are subject to prudential rules which are considered in the country's registered offices. Such restrictions shall not extend in the first six months following launch if the UCITS Fund follows the risk-sharing concept.

## ❖ Uncovered Sales

A UCITS Fund shall ensure that its total overall net value for its derivatives does not exceed (taking into account the present underlying value of the asset; the counterparty risk; future market movements; and the time available to liquidate position) and its total risk exposure shall not exceed 200 per cent of its Net Asset Value ( NAV) of the Fund.

Only direct investments in derivatives or efficient portfolio management / hedging with counterparties may be entered into by a UCITS fund.

- FIN is not the UCITS fund trustee or custodian;
- belong to a group that has its registered, registered or established head office or parent company in the country of domicile of the Fund, the EEA or any OECD member under prudential control equal to that provided for in Community legislation and
- iv have a credit rate, which is acceptable to the financial regulator of the country, of at least A (Standard & Poor) or A2 (Moody's).

A UCITS fund is not entitled to "uncovered sales" of transferable securities, monetary market instruments, units or derivatives of other UCITS funds. 'Uncovered selling' applies to any activities that expose the UCITS fund to the possibility of purchasing the stock, which is a loss and of not being willing to settle the underlying assets at a better price than the price at which the securities were sold.

## ❖ Single Issuer Exposures

A UCITS Fund cannot aggregate more than 20 percent of its assets on transactions in a single entity distributed in transferable securities and money market instruments. This 20% limit also applies to both deposits with the same bank and counterparty and other OTC transactions deriving from the same corporation. In the first six months of its launching, a UCITS fund may derogate from this 20% limit if it follows the risk spreading principle.

## ❖ Investments in other UCITS Funds or Collective Investment Schemes

Up to 20% of its own funds can be invested in units of one UCITS Fund or other mutual investment schemes from a UCITS company. The total UCITS Fund investment, in contrast, may not exceed 30 percent of its own assets in other collective investment schemes' units (not UCITS funds). Where the UCITS fund invests a substantial share of its assets in other UCITS funding or collective investment schemes, the prospectus and its annual report should contain all management fees (i.e. fees charged for both UCITS and the UCITS funds charging for the other collective investment schemes in which it invests).

A UCITS Fund does not own more than 10% or 25% of any unit of any particular UCITS funds or of any other joint scheme for the non-voting share of debt securities or money market instruments of any particular issuing entity. Moreover, a UCITS fund or its management manager is not authorized to acquire any of the voting shares of another UCITS fund or collective investment scheme which would allow the UCITS fund or its management manager to have an important influence on its management. However, this second ban and the thresholds of 10% and 25% can be violated in case of:

- The securities and money market instruments transferable provided or pledged by a Member State or its local governments;
- shares and money market products transferable to non-member countries guaranteed;
- transferable securities and financial market instruments issued by international public bodies one or more Member States of which are members;
- take the UCITS fund shares owned by a corporation established in a third country which is invested primarily in the securities of issuing bodies with their registered offices in that non-Member State and given that is the only manner in which a UCITS fund can legitimately invest in those securities and that the investment stays within EU issuing bodies' limits (as mentioned above);

## ❖ Borrowing Limits

A UCITS fund is also restricted by borrowing because it can only borrow from it:

- to a maximum of 10% of its assets, if established as an investment firm or a limited partnership, without borrowing from UCITS to acquire immovable properties which are essential for the direct pursuit of its business and can borrow up to 115% of its assets;
- a maximum value of 10% when established as a unit's trust or as a common fund.

The bonding shall be temporary and shall not exceed 200 percent of the overall risk exposure of the UCITS fund. These funding restrictions do not preclude a UCITS fund from raising foreign currency in a back-to - back loan, as long as the offsetting investment is denominated in the UCITS fund's base currency and the foreign currency debt amount is not greater.

## ❖ Repurchase/Reverse Repurchase and Stock borrowing/Stock lending Agreements

A UCITS Fund is authorized to conclude a repurchased / return buy and stock loan / stock borrowing agreement only when that is in the interests of their investors and implies an acceptable level of risk. A minimum credit rating of A (Standard & Poor's) or A2 (Moody's) or other rating acceptable to the financial regulatory authority of the country must also be obtained by the counterparty to any such agreement. Any collateral acquired by way of the repurchase agreement or the stock credit arrangement must be liquid and comprise:

- Cash;
- Governance or other government securities;
- deposit certificates from EEA, Swiss, Canadian, Japan-US, Jersey, Guernsey, Man island, Australia or New Zealand certified banks ("relevant institutions");
- bonds / business paper issued by institutions concerned;
- Letters of credit given unconditionally and irrevocably by appropriate entities with 3 or fewer remaining maturity;

Furthermore, Foreign Securities are traded in EEA, Canada, Japan, Guernsey, Isle of Man, Australia and New Zealand on a stock exchange.

- Any collateral obtained by such an agreement must also be:
- Fisheries marked daily to market;
- no less than the value of the investment or loaned securities;
- the transferred to or agent of the custodian;
- Available without warning to the UCITS Fund

Further limitations attach based on whether or not the collateral is currency. Only in the following cash collateral:

- deposits issued by the relevant institutions or certificates of deposit;
- Government or other government securities;
- Letters of credit of 3 months or lower residual maturity issued unconditionally and irrevocably by the relevant institutions;
- Agreements to pay back;
- Every-day trading in qualified cash market funds that have a AAA or comparable minimum credit ranking.

No cash collateral, however, cannot be sold or committed; must be held by a counterparty at credit risk, and must be issued by a non-cash entity.

| PART 6 | RISKS MITIGATED BY UCITS RESTRICTIONS |
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| Sr. No. | Rule Details | Guidelines | Types of Risk Mitigated |
|---|---|---|---|
| 1 | 5%/40% Restriction - Article 52.1 & 2 | The aggregated value of issuers of 5% of NAV should not exceed 40% of the NAV | Concentration Risk |
| 2 | 10% Restriction - Article 52.1 & 2 | The value of single user should not exceed 10% of NAV | Concentration Risk |
| 3 | 5% Unapproved OTC CP - Article 52.1(b) | The risk exposure of a counterparty in a UCITS in an OTC derivative transaction may not exceed 5% of its assets or unapproved counterparties | Counterparty Risk |
| 4 | 10% Unapproved OTC CP - Article 52.1(b) | The risk exposure of a counterparty in a UCITS in an OTC derivative transaction may not exceed 5% of its assets or unapproved counterparties | Counterparty Risk |
| 5 | Deposit Issue - Article 52.1(b) | The fund will not invest greater than 20% in one issuer of deposit | Counterparty Risk |
| 6 | 20% Issuer Restriction - Article 52.2 | The value of single user should not exceed 20% of NAV | Concentration Risk |
| 7 | 35% Restriction - Article 52 & 54 | Rule to identify if greater than 35% is held in one government issuer | Interest Rate Risk and Concentration Risk |
| 8 | 30% Restriction - Article 52 & 54 | Rule to identify if greater than 30% is held in one government issue | Interest Rate Risk and Concentration Risk |
| 9 | Government 6 issue restriction - Article 52 and Article 54 | Rule to identify if less than 6 issues of Government Bonds are held | Liquidity Risk |
| 10 | Government Conditional | This is a conditional rule that combines rules related to UCITS Government Bond Issuers limits | Liquidity Risk |
| 11 | Approved Government Issuer - Article 52 & Article 54 | Rule to identify if Government issuers 35% are approved issuers | Counterparty Risk |
| 12 | 100% Restriction - Article 54 | Rule to identify if greater than 100% is held in a single government body | Concentration Risk |
| 13 | 10% Issued Debt Restriction - Article 56.2 (b) | The fund will not invest greater than 10% of the total issued debt of an issuer | Concentration Risk |

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| 14 | Money Market Instrument Rule - Article 56.2 (d) | The fund will not acquire greater 10% of the issued Money Market Instruments | Concentration Risk |
| 15 | Uncovered Sale - Article 89 | Exposure to short sales should not exceed 90% of NAV | Systemic Risk |
| 16 | Short Sales - Article 89 | The fund will not engage in Physical Short Sales | Systemic Risk |
| 17 | 10% Non-Voting Shares Restriction Article 48.2 | A UCITS may acquire no more than 10% of the non-voting shares of the same issuer | Concentration Risk |
| 18 | Eligible Assets - Article 50 | The fund will not invest in ineligible assets | Operational Risk |
| 19 | 10% Non-Transferable Securities Restriction - Article 50.2 (a) | The fund will not invest greater than 10% of NAV in Non-Transferable Securities | Liquidity Risk |
| 20 | Precious Metal - Article 50.2 (b) | The fund will not invest in precious metals | NA |
| 21 | Global Exposure - Net - Article 51.3 | A UCITS shall ensure that its global exposure relating to derivative instruments does not exceed 100% NAV | Financial Leverage Risk and Systemic Risk Contribution |
| 22 | 5%/80% Covered Bond Restriction - Article 52.4 | The aggregated value of a Covered Bond Issuer exceeding 5% of NAV should not exceed 80% of NAV | Interest Rate Risk and Concentration Risk |
| 23 | 25% Covered Bond Restriction - Article 52.4 | The value of a single issuer of Covered Bond should not exceed 25% of NAV | Interest Rate Risk and Concentration Risk |
| 24 | 35% Issuer Restriction - Article 52.5 | The value of a single issuer of Issuer should not exceed 35% of NAV | Concentration Risk |
| 25 | 20% CIS Restriction - Article 55.1 | The fund will not invest greater than 20% in one CIS | Concentration Risk |
| 26 | 30% Non UCITS Restriction - Article 55.2 | The fund will not invest greater than 30% of NAV in Non UCITS CIS | Operational Risk |
| 27 | Significant Influence Restriction - Article 56 | The fund will not acquire greater than 10% of the total shares carrying voting rights which would enable it to exercise significant influence over the management of an issuing body | Operational Risk |
| 28 | 10% Borrowing - Article 83.2 | The fund will not invest by borrowing greater than 10% | Financial Leverage Risk and Systemic Risk Contribution |
| 29 | Closed Ended Governance - EAD Article 2 | Closed Ended Funds from countries outside of EU must have sufficient corporate governance mechanisms | Operational Risk |
| 30 | 49% Ancillary Cash Restriction - Article 50.2 | The fund must not hold in excess of 49% of NAV in ancillary cash | Reinvestment Risk |

## PART 7 COMPARISION OF UCITS AND NON UCITS FUNDS

- **Key Issue #1: Europe or Global Distribution Required?**

Only a UCITS fund is eligible, when EU distribution is required, for an EU retail passport, meaning that the Fund can be sold in other Member States without additional authorisation once authorised in one EU member country. If, as with many private equity vehicles, private placement is planned, a non-UCITS fund should be considered, then. Both vehicles may be listed and migrated to the London Stock Exchange at domestic stocks. No investment qualifications or minimum investment criteria are in place for investment in UCITS, while non-UCITS are generally available at least €100 000 of non-UCITS investment funds per investor for certified 'professional investors.'

- **Key Issue #2: What is a more suitable Legal Structure?**

The variable capital investment companies are usually created for UCITS as well as non-UCITS funds, but there may be circumstances that can provide a better suitability to a unit trust or common contractual fund. Both kinds of funds make the arrangements of the umbrella. The use of subsidiaries by UCITS does not generally allow. Non-UCITS funds may be used to improve their access to Double Taxation Agreements by underlying subsidiaries.

- **Key Issue #3: What is the intended Investment the Fund?**

Non-UCITS funds have very little investment policy constraint in general (and therefore are as popular around the world as private equity vehicles). In general, UCITS is restricted to transferable securities or monetary market instruments exchanged within the specified limits in controlled markets, currency, currencies, certain UCITS and exchanged or off-market derivatives. Many non-UCITS funds have not only invested in UCITS-approved investments, but also in derivatives, unregulated funds, property, movable assets, valuables and other classes of assets.

- **Key Issue #4: Determining the Intended Liquidity Needs of the Fund?**

The main difference is that a liquidity is a crucial prerequisite of a UCITS Portfolio, while non-UCITS will provide for a wide spectrum of choices, from liquid, to semi-liquid and to illiquid and not requiring redemption at least once every two weeks.

- **Key Issue #5: Degree of Borrowing/ Leverage is Needed by the Fund?**

There is no borrower limit for non-UCITS funds, whilst UCITS can only borrow up to 10 per cent, but only on a temporary basis. There is a debt cap for non-UCITS, while global exposure cannot, commonly speaking, surpass the Net Asset Value of a UCITS portfolio.

- **Key Issue #6: What Governance Criterion deems fit to UCITS and non-UCITS?**

For UCITS and common non-UCITS funds, the choice of the following parties requires pre-approval by the Regulator (Central Bank). The following parties are required:

- Promotor with a verifiable track record in the marketing of funds in charge of at least € 635,000 in shareholder funds
- Managers
- Discretionary manager for investment, to be recognized in EU competence
- Customer / administrator / trustee (must be permitted to operate in Ireland)

Furthermore, the Fund must be appointed to legal advisors and registered auditors.

| PART 8 | IMPACT OF BREXIT ON UCITS REGULATIONS AND MARKETS |
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## ❖ KEY AREAS OF IMPACT FOR ASSET MANAGERS

### I. Passporting Rights loss in EU

One of the major consequences of Brexit is that UK companies will lose their management and marketing rights in the EU under current regulations. In order to further the single market, the passports have been widely utilized, and have shaped the way that many asset managers conduct their business, for instance enabling funds to be focused in centers like Luxembourg and Dublin, or in the case of non-EU managers, for example, from the USA or Switzerland, to establish a hub in London from which to 'pass' to other EU Member States. Brexit reportedly suggests that UK companies would no longer be qualified for an EU passport under new EU laws, which will have an effect on certain asset managers that depend on passports, for example, for selling and exporting their assets into the EU, or offering cross-border managing accounts and client advisory services to EU cl. In contrast, asset managers who are not passport dependents, e.g. if they administer assets from the United Kingdom and do not market their funds in the EU, or do not provide EU clients with separate portfolio or investment advice services. They are not likely to be significantly affected.

### II. Changes Affecting Managing and Marketing of UCITS

EU domiciles and the management of EU management undertakings should be a UCITS fund. Following Brexit, UCITS-funded funds in the UK would not be protected by the UCITS Directive, and would therefore not be entitled to use the passport provisions which permit the management and marketing of UCITS funding developed in one Member State in another. As a result, wealth managers for whom passports form part of their corporate strategies would have to adjust the way their funds are handled and sold. Whether it tends to operate in the UK, the regulator in the United Kingdom is likely to find the UK Regulatory Fund as a sort of retail non-UCITS fund, known as an AIFMD 'alternative investment base.' The EU will similarly view the Uk Fund like an AIF. Which ensures the UK EU entry UCITS will adhere to AIFMD and should only be commercialized in the EU for selling by qualified companies, under the regional AIFMD Regional Bullet Placement Regimes. AIFs are limited to institutional buyers (and are not at all allowed in certain EU jurisdictions) in marketing. In certain EU Member States, such as Italy, the privately held AIFMD regime is not in place. In others, such as in Germany, AIFMD regimes have very restrictive conditions. Similarly, unless the UK alters its regulations it will be possible to sell EU OCITS in the UK under the British domestic privately held system. This would require compliance with financial promotion restrictions in the UK and limit retail investment marketing.

### III. Changes to the Provision of Portfolio Management and Investment Advisory Services

Brexit would improve the trans-border supply, both through UK and EU companies, of Fund Management and Investment Consulting Services.

A number of management providers, under permission of the MiFID, are providing asset management services such as the transfer of (always or alone) portfolio administration for a fund to an investment firm, the provision of advice to the UCITS manager or AIFM or separate advisory / discretionary accounts.

Under its current arrangement, Brexit would result in loss for UK investment firms of the MiFID investment services passport and would not enable such managers to deliver services across the EU on a cross-border basis (or on a branch level).

The procurement and selling of these facilities will be subject to national laws of each EU Member State.

UK investment firms might still be able to reverse-request (and management activity is likely in the UK) to provide discretionary management services to existing EU clients that would be helpful for existing structures and mandates. Nevertheless, services such as investment consulting should be represented as being carried out within the EU customer's expertise and local regulatory laws would be followed. In fact, EU investment undertakings will forfeit the UK visa for their investment companies, thus impacting the distribution (and marketing) of UK clients' services. In fact, EU companies are in the same position as non-EU companies with regard to the provision of investment services in the United Kingdom at the moment. European companies will also have to acknowledge, at least if the clients are qualified consumers, the provision of exemption from UK licensing standards, such as exemptions for outermost citizens.

## IV. Change of Domicile and Delegation

Losses of management and passport marketing can lead to changes in domicile in some funds. For eg, UK management firms may no longer serve as the managing boards of EU OICTS, and EU management bodies may no longer function as UK OICTS administrators, and could choose to set up separate EU and UK management bodies for that reason (or find some sort of a re-organizing body in another EU jurisdiction where established EU affiliates exist).

Losses of management and passport marketing can lead to changes in domicile in some funds. For e.g., UK management firms may no longer serve as the managing boards of EU OICTS, and EU management bodies may no longer function as UK OICTS administrators, and could choose to set up separate EU and UK management bodies for that reason (or find some sort of a re-organizing body in another EU jurisdiction where established EU affiliates exist).

Finally, it might also be necessary for EU companies providing portfolio management by a UK-owned manager to consider any additional requirements to be fulfilled by the manager of the UK in relation to a delegation and the otherwise in relation to the Non-EU manager.

## V. Changes to investment mandates and parameters

UCITS may investment in non-UCITS collective investment schemes no more than 30 per cent of its assets. This will entail reassessment of expenditure requirements in order to take into consideration that Great Britain is not in the EU. Indeed, asset managers (both UK and European Union) must more broadly than UCITS take into account any associated EU investment parameters for investment in the EU (except for the United Kingdom) and the UK. Managers may need to revise and update investment management agreements and fund documentation.

Fund investors also have to review their internal procedures and investment guidelines as well as other constrains, both contract and regulatory. Investors in the Funds may also have similar restrictions.

From the documentation point of view for current and potential frameworks, Fund managers may need to expand the concept of "investments" in order to insure it is as broad as practicable (so that the connection of the UK to the EU is not restricted), and to have adequate stability to guarantee transition arrangements in the case of future restructuring.

It will be necessary to review agreements with any service providers to decide if adverse change provisions may be caused, particularly with banking documents. It is also important to discuss with service providers with a cross-EU platform, such as retailers delegating to or from the UK, whether their service provision is affected.

## VI. Can the Existing Legislative Framework Help Manage the Impact?

The Government is likely to try alternative mechanism for future EU cooperation, via the United Kingdom, for example by entering the EEA or negotiating a specific free-trade arrangement, that could retain some of the advantages of the single market in financial services. In addition to these alternatives, current financial services regulation has frameworks that may assist in the control of the consequences of Brexit, in particular by utilizing "third-country regimes," a characteristic in other main items, like MiFID2 / Mi FIR and EMIR, in the Financial services Law.

In particular, the Directive and Regulation on EU markets for Financial Instruments, (MiFID2/MiFIR, due into force from January 2018) provides for a new arrangement that would permit the provision of cross-border investment services to professional and eligible European clients by non-EU firms with equivalent jurisprudence under a so-called 'Third Country Passport Entity'

Nevertheless, it should be noted that not all facilities and events are provided by the programs. Of instance, while the third country regulation under AIFMD is in force of the EU promotion of non-EU AIFMs, there is no Third Country Regulation under UCITS, although there must also be 'conversion' to.

| PART 9 | WHAT IF UCITS FUND FAILS TO MEET THE REGULATIONS? |
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## 1) INVESCO PERPETUAL

– *Non-compliance of Key Investor Information Document (KIID)*

The fine for a range of compliance violations, including failing to ensure that its KIIDs were prepared in accordance with the requirements applied, amounting to over EUR 18 million was levied on a Fonds manager by the UK regulatory authority (the FCA). The following exposition examines general regulatory requirements with regard to KIID, the facts of this specific case, and the possible steps to be taken in order to ensure that the results of the case are complied with.

- **Obligations Concerning KIIDs**

A short two-page (or three-page) summary document is a "Key Investor Information Documents" or "KIIDs" that all UCITS should produce. This paper was included in the UCITS IV1 amendments which came into force in 2012. The KIID replaced the "simplified prospectus" required by UCITS III.2 to address some deficiencies in a simplified prospectus.

The KIID is designed to support potential investors by providing essential information in a harmonized short format that allows for the comparison of relevant product features, including expenditure and risk profile .

The creation of this paper and its delivery in advance of a subscription is mandatory for all UCITS. UCITS IV has given the European Commission authority to take steps detailing extensive and systematic material, type and delivery of the KIID with a view to ensuring the highest degree of harmonization in the arrangements of KIIDs, and this information is contained in the supplementary law ("law").

## ➢ The Invesco Case

Invesco Asset Management Limited and Invesco Fund Managers Limited ('IFML') (total Invesco Perpetual') manage some of the UK's most important retail funds, which totaled more than £70 billion before December 2013. Their assets are under management. IFML was the management company for the UCITS concerned, and IAML was appointed as the portfolio manager with discretionary investment activity powers. Despite the delegation for investment activity, IFML retained its regulatory responsibilities to the funds in question.

In April 2012, the FCA announced its application to Invesco Perpetual for several deemed infringements, as set out in the Final Notice of 24th April 2014 ("Notice"), to the tender for the fine of 18,643,000 dollars (reducted from over 26 million dollars by the Executive Settlement Procedures (FCA). In addition to the decision of vulnerabilities in KIIDs, other justification for the FCA to enforce the fines included infringements of appropriate investment limitations and shortcomings in order to ensure correct assessment of all funds and a reasonable distribution of all transactions between funds. The Notice also provides details on each of the reasons for the fine.

## ➢ Disclosures and Risk

KIIDs have a special responsibility to define the key types of qualifying financial instruments to which the investment strategy is applicable. However, the "key aspects" of OCCITS should also be defined, and this should provide definitions in basic terms of the performance variables required to evaluate the usage of such risk management strategies, such as hedging, arbitration and leveraging.

The divulgation used as stated above was deceptive and vague, as it emphasized just the possible benefits of the usage of derivatives and not all the downside risks. In particular, the FCA expressed concern that this communication did not reflect the real impact of leveraging by the use of derivatives, which meant that the NAV would probably vary from net asset to value, including the amount of losses.

In this scenario, just 5 percent of the NAV at its peak point (though that may have been up to 20 percent according to the prospectus) was leveraged through the related funds currently launched.

- **Synthetic Risk and Reward Indicator (“SRRI”)**

A SSRI consisting of a variety of numerical divisions from 1 to 7 must be included in KIID's. A narrative explanation of all risks that are substantially important to a fund and that the SRRI does not appropriately identify is also required. The SRRI of the funds in question was set at 6 out of 7 and indicates a strong variability. However, even this extra detail had not been found adequate to render things transparent and not deceptive for KIID 's disclosures. It is worth noting that the Law allows the descriptions of the risks involved with the use of derivatives in every content to be narrated explicitly.

- **Key Lessons**

The FCA assessment as outlined in the Notice gives an overview of the applicable law and clarifies the UK's approach in evaluating KIID compliance. It also provides guidance on ways to deal with the like by other European regulators. For that reason, it gives valuable insights into all UCITS, including those within Ireland's and Luxembourg 's dominant cross-border jurisdictions.

In particular it provides proof that:

- inclusion of specific technical references or instruments alone is not sufficient for compliance;
- full divulgation of both positive and negative consequences of relevant asset management techniques is required;
- There is no requirement for defined materiality; a leverage amount of 5% may be deemed important or material;
- The reflection of a risk in the SRRI cannot replace clear narrative communication concerning the effects of techniques such as the use of derivative contracts.

If any of these paragraphs are not complied with, the risk of a UCITS being exposed to a clear and not misleading breach of the general requirement is therefore both civil liability as well as a regulatory penalty or other penalty. It should also be remembered that, given the fact that the FCA considered that Invesco Perpetual's offenses were not "reckless or intentional," the penalty was imposed in this situation.

- **Recommendations**

Given the guidance in the Notice, UCITS and its management companies should review all KIIDs to check that they comply with the Guideline. In this regard, it is recommended. By their nature KIIDs are evolving documents and they are generally required to be revised and updated at least annually. These points should therefore be taken into consideration at least at the next formal KIID review. However, it would be advisable for Boards to consider whether the findings in the present case require a review, immediately, of any circulating kids in light of negative publicity and financial expense inherent in regulatory censorship such as that contained in this notice

## 2) WOODFORD FUND

– *Liquidity Crunch and Liquidation of the Fund*

In October 2019, after halting the redeems in June, the Woodford Equity Income Fund (WEIF) was liquidated. Neil Woodford, investment manager who received the widely recognized status of "star" after a successful career in the City, has managed the fund since its inception in 2014. WEIF had at its height about £ 10 billion in management funds..

- **Portfolio illiquidity and asset sell-off**

WEIF was designed as an enterprise for the UCITS, a retail-friendly, European controlled investment company available and specifically needed to provide for the regular liquidity of investors by the regulatory regime. Notice the two words: daily liquidity. Woodford and his creditors will torment him. The regulatory framework requires UCIT managers to render long-term wagering on liquid stocks. But Woodford's investors had a surprise soon.

- **WEIF Suspension & Liquidation**

Woodford had been trapped by any fund manager in a vicious cycle of nightmares. When WEIF redemptions is halted, the vortex was briefly trapped in June 2019. This meant that investors could not withdraw their investments effectively trapped in the Fund. In October 2019 the administrator and corporate director of WEIF decided to withdraw Woodford as its manager and to wind down the fund with the assistance of two investments advisors designated to this effect after a significant outcry from the mainstream and social media, both from its investors and the industry commentators.

In January 2020, the trustee was willing to liquidate and allocate £ 2.1 billion to WEIF creditors. The March 2020 pay-out is estimated to be about EUR 142 million (march 2020), and accounts for around 20 percent of the outstanding funds of £575 million.

- **Liquidity Structure of WEIF**

The WEIF was a United Kingdom dependent UCITS and was subject to FCA, the UK financial agency, administrative supervision. UCITS are European investment products for retail investors that offer "daily liquidity" which means investors can withdraw on any working day. Why therefore could WEIF investors not redeem from the fund? Why did the FCA allow this? Investors wanting to redeem from WEIF faced two problems: one of Woodford 's production and the other of the collective investment vehicle investments:

I. Woodford 's investing choices lead to a risky misbalance of the Fund's assets, with unlisted firms holding illiquid roles. The assets was small-cap. As the securities of these businesses remained unlisted, no reliable judgments existed for them and Woodford did not have the demand for the selling of the stock. He had a ready purchaser. Yet when these firms gave notices of losses and other many issues, there was no investor to be found. In short, this project trapped Woodford. So, because he did not get them disposed of, he could not collect funds to satisfy demands raised by concerned WEIF creditors.

II. Investors receive a prospectus from all investment funds, such as UCITS. The prospectus is simply a deal between creditors and the company; on the financial front there is an investment arrangement with the manager of the company. Such contracts require the Fund to cancel claims for compensation under the specified conditions — that is, to discontinue repayment demands. The management, not investors, is always favored by this provision. A typical catch is that "if the best interests of investors want to do so, the fund can suspend payments." This allows the fund 's management to lock investor funds into the fund.

The Woodford investors were both characterized by this dynamic. Due to the fund's panic, the loss of confidence in its manager and the resulting fire sales of assets that were continuously caused by the pressure of withdrawing investors, WEIF suspended redemptions in June 2019. We were trapped in, as the decline in the redemption of Woodford's obligation to sell portfolio securities, which implies (at least in theory) that it would take longer, and that the values might be better: and so it was "in the best interests of the creditors."

The suspension of the WEIF investors was (on their face) imposed in the appropriate way, therefore, just as unfortunate as the suspension was. However, there was far from adequate liquidity in the fund's portfolio, which initially led investors to leave. Woodford was subject to strict rules of UCITS requiring him to maintain a fixed percentage of the investment portfolio in liquid positions that can be sold to supplies daily liquidity to investors: i.e. they must have the ability to redeem their investment in UCITS at any working day. In stocks that he knew were illiquid, Woodford invested in exceeding this value limitation.

When the FCA, the regulator responsible for enforcement, came alive to such infringements, it was too late: WEIF outflows had hit peak rates already and Woodford could not divest the unliquid assets soon enough.

- **Gating versus Suspending**

What makes the WEIF portfolio, which has been investing illegally into illiquid positions, significant is the extent of its inherent illiquidity and Woodford has not taken the fund as an initial measure. Their percentage value is significant. A "gate" can be imposed by the manager, which is strictly provisional, on the total value of redemption requests received on every day.

Woodford should have purchased some time and room for liquid investing and leverage over outflows from WEIF up to the full 10% regulatory interest of the redemption demands. However, there was no such interim action that Woodford was already under enormous pressure from WEIF 's largest investors (including Jupiter Asset Management, which invested £ 1 billion in the fund), and immediately required to suspend the reimbursement entirely.

## 3) LINDSELL TRAIN FUNDS

– *Concentration Violation of UCITS Regulations*

Links on portfolio concentration several times in 2019 were violated by extremely popular investment managed from Lindsell Train, the British stock picker, which caused a dismay for investors who felt uninformed. The manager's British capital fund and £4.9bn global capital fund have been dropped last summer over their Hargreaves Lansdown equity stakes from the influential Hargreaves Lansdown Wealth 50 best buy list. Due in December to capacity concerns, the UK fund was also downgraded by Morningstar, the data company. The foreign investor and the Japanese venture investor for the company were found to be breaking European UCITS regulations on the number of significant stakes in the business. The UK fund managed by one of British leading managers of Nick Train does not obey the same rules of UCITS, but has breached certain UK caps on individual companies which make up not more than 10% of the fund's assets.

After Neil Woodford's investment company failed over its flagship fund's exposure of unquoted securities, the question of how tightly funds obey laws of safeguard final creditors has been illuminated. The Financial Conduct Authority has faced a fence of criticism about its handling of the case and has stepped up supervision of investment funds and has been demanding additional information on troubled funds.

The limitations of UCITS Regulation (5/10/40), which states that fund investments comprised more than 5 percent of the portfolio shall not exceed 40 percent of the Fund's assets, were violated by the global and Japanese funds of Lindsell Train. No holding will constitute over 10% of the fund's assets. At least six times earlier, in October, the global fund – co-managed by Mr Train, Michael Lindsell and James Bullock – broke the law, with more than half the assets containing the most concentrating securities.

Last year at least five instances, the Japan Fund — managed by Mr. Lindsell — violated the rule. Its most recent fact sheet shows the largest investments

In Kao, a chemical company, over half of the portfolio at the end of February accounted for 10.1%.

In recent months, Lindsell Train, one of Britain's most popular fund managers, has suffered from outflows. His global fund controls GBP 9 billion and the United Kingdom fund handled GBP 7.4 billion in August last year.

## 4) MADOFF SCANDAL

*– UCITS Investor Rights and Depository Liabilities*

An investment scandal struck the headlines on 11 December 2008, when the asset management enterprise of former NASDAQ chairman, Bernard Madoff, revealed itself as an immense Ponzi scheme and is supposed to be the biggest fraud in investors ever committed. Massive sums accumulated in Bernard Madoff Investment Securities LLC also vanished. The inevitable problem about who accounts for Madoff 's debts is not limited to the European financial sector.

Luxembourg, a fund center within the European Union and the location of the 'Match Alpha' Portfolio, which triggered a loss of around 1,4 billion euros because of Madoff's investment, became especially challenging.

In the event of Luxalpha, the Swiss bank UBS has explicitly addressed the obligation of depositary banks. Despite being relatively comprehensive EU legislation, European investment funds are subject to different provisions concerning the role of the fund depositing companies, according to their Member States of residency, in accordance with the UCITS directive 85/611/EEC ('UCITS Directive') co-ordination of laws, regulations and administrative provisions (OJ L 375, 31.12, 1985, p3).

- **Background**

The International Fund ("Thema") is an Irish regulated investment company subject to the legislation of Irish companies. It has appointed the Depositary Officer ('HSBC') for its Assets, (known as the "trustee," in accordance with the UCITS Regulations of 2003). One fundamental provision of the UCITS system is that a security depository be entrusted with fund funds, and such funds must then be kept segregated from their own properties, so that their responsibility is usually unaffected when delegating protection to a sub-custodian.

The topic of HSBC litigation resulting from Madoff bribery started in December 2008 and claims numerous wrongs perpetrated against HSBC and its employees, including breaches of the 2003 UCITS laws, breaches of contracts, infringements of fiduciary responsibilities and coercive offenses. Finally, HSBC solved the problem.

The complainants (Mr Shmuel Harlap and Alico Life International Ltd.) launched a lawsuit against Thema and HSBC in 2009. In reply, Thema and HSBC submitted that, where the claimants were not unit holders in the Fund, they owed no actionable obligations to the claimants.

- **Key Takeaways**

  a) A 'unit holder' means a shareholder in a UCITS company and thus investors which hold UCITS units via a nominee are not unit holders. Investors in a UCITS investment company It is your responsibility to make sure that the applicant does not indirectly offer the appropriate benefits and protections under the Directive, if they choose not to become unit owners but to invest through a nominee or other intermediary.

  b) In accordance with Article 16 of the Directive, a unit owner of an investment company UCITS did not have the right to take direct actions against the depositary / trustee.

  c) The practice of a unit holder for the recuperation of their stock in an investment firm is typically exempt by both the Foss v Harbottle law and the reflective failure law.

- **Depositary Liability after UCITS V**

As already stated, while Article 16 imposed responsibility upon the Depositary, the Court held that the unit holders were not given a direct case of action. In this context, it should be remembered that there is a distinction between unit trusts / contractual funds and investment firms in the Directive and 2003 UCITS Regulations.

In accordance with the laws of its home Member State, both provided that the depositary is liable to the Fund and unit holders for loss suffering as a result of violation of the regulated liability standard, but there is a further statement that 'liability to unit holders can be invoked directly or indirectly through the management company,' In accordance with the legislation of its home Member State, The legislature agreed intentionally that this difference would be eliminated by amending the UCITS law for "UCITS V." Unit holders in the UCITS are now entitled to invoke the liability of the depositor directly or indirectly by the management or investment firm, as long as it does not lead to a duplication or unequal treatment of unit holders, according to Article 24(5) of Directive 2009/65 / EC (emphasis added). Unit holders in all UCITS funds can now have the right directly to sue the depositary, independently of legal form, since UCITS V is in force

The only qualification is that claims by unit holders should not remedy or treat unit holders unequally.

# PART 10 TRASH ISSUES WITH UCITS

After a variety of concerns at GAM, Woodford, and H2O Wealth Management, a previously undisclosed aspect of EU fund law was brought to investors' notice.

Both of these funds are subject to the laws of UCITS. The directive is planned, as has already been addressed, to make it possible for daily liquid funds to be allocated to investors in Europe and worldwide other than the US. The securities in which they will participate include common stocks or bonds.

However, in one of the directives, funds can be invested in other, lower liquid assets as well. It helps executives, with a 'trash ratio' in the sector, to keep up to 10% of their capital in reserves that may in turn be difficult to sell.

- **Why is this a problem?**

It's not in the good times.

If customers placed capital on a fund, the manager can effectively monitor the trash rate by utilizing inputs to purchase more volatile assets or hold them as currency, keeping them from reaching the 10 percent cap. The trash ratio then decelerates as a percentage of the fund if no more illiquid assets are purchased by the manager.

Much of the last decade has been like that. After the financial crisis, the UCITS industry has risen to almost €9.3 tons in reserves. As compared to a decline in business revenue in last year, every calendar year since 2008 has been rising in scale.

- **What happens if investors start to withdraw?**

It can be difficult here. Typically, these funds deliver regular withdrawals. If customers want their cash, for whatever reason, they tend to have assets easier to sell, like big-cap equities or major government bonds easier to price.

If, though, a fund has a loss ratio of up to 10 percent, otherwise reimbursements may easily result in a greater proportion than the fund share.

In this case, the manager is not obliged to immediately correct such an infringement of the rules. The manager will, however, easily get into a complicated position whereby creditors who have left have their cash back, while customers who stay in the fund have a more challenging share of money. These assets may be not as valuable, or just take a long time to sell, as the manager thought. Investors who have left the fund could be disadvantaged either way.

## PART 11 OPERATIONAL CHALLENGES IN UCITS COMPLIANCE

The Regulation on UCITS funds, intentionally aligned with the Alternative Investment Fund Manager Directive (AIFMD), implies strict transparency, risk management and the liquidity requirements of the UCITS funds, with tight leverage and limiting levels and with highly diversifying funds. Limits to ensure their diverse nature imposed on UCITS funds include but are not limited to:

i. A single EU debtor portfolio equivalent to 35% of the assets of the company.
ii. A single company issuer holding limited to 10%-or 20% including derivatives.
iii. Single investment fund holdings are limited to 20% of assets.
iv. Illiquid asset holdings are limited to 10% of assets.
v. Fund deposits of one entity (custodian) are limited to 20 percent.

UCITS fund managers tend to hire a number of other external bodies, including suitable custodians, depositors, managers, administrators, marketers and distributors, many of which have very specific positions.

Managers will require a particular document of the UCITS fund, known as the Key Investor Document (KIID), as well as the risk management strategy, to define guidelines, limits and procedures for all threats of the UCITS fund.

- **Daily NAV Calculation:**

The need for intra-month liquidity (i.e. the willingness of buyers to sell or redemption in a month regardless of the usual monthly rounds in traditional hedge funds), which may be as normal as daily liquidity, is one of the main obstacles that investment managers encounter with UCITS financing. This means that the Official NAV Fund must be computed and verified daily.

- **Daily Liquidity Requirements:**

Many problems raised by the UCITS liquidity criteria involve the need for this to continuously re-equilibrate asset distribution through the portfolio, which is why the sustainability of the funds invested in the fund should be borne in mind.

Investment managers operationally need efficient cash flow management to manage the availability of funds in an attentive manner, ensuring they can always meet the needs of investors.

- **Pre-Trade and Post-Trade Compliance:**

The enforcement with the different visibility, liquidity, leverage and concentration restrictions is a major challenge as UCITS funds are tightly controlled investment vehicles. Investment managers should ideally use both pre-trade and post-trade compliance checks.

Many execution management (EMS) and order management (OMS) systems offer pre-trade conformity checking systems with pre-trade compliance.

Specific types of Enforcement Alerts, from pre-execution alert to trade-prevention without the consent of senior enforcement managers.

The last defense against possible violations is post-trade compliance and usually carried out on a T+1 basis. Investment management should control this mechanism themselves, either using the resources provided by portfolio administration (PMS) programs or through a third-party contractor like an accountant. the task may be outsourced. Even with regard to the latter situation, it is critical that investment managers have established a reconciliation or review process to verify the findings of a third-party provider as stipulated in the regulation that the investment manager is ultimately responsible for compliance.

Investment managers require adequate resources and procedures in place for the continuous tracking of risks, allocation, collateral, counterparty and monetary trading restrictions placed on UCITS funds as well as sector through transaction preliminary and post-execution surveillance.

## PART 12 KEY LEARNING OUTCOMES OF THIS PROJECT

This project provided me a deep insight into the financial regulatory frameworks prevalent in Europe and elsewhere in the world AIFMD, and Act 1940 (US). It also gave me a high-level overview of the European fund industry and the significance as well as the relevance of various regulatory bodies, regulatory frameworks and regulations prevalent there.

The role of compliance and adherence to regulations was also made understandable to me by the way of exploring various cases where funds have run into violations or non-compliance. The far-reaching implications of global events such as Brexit and its consequent impact has also been referred to. Shortcomings and challenges faced by industry players gave me a high-level overview of operational side of compliance.

All in all, working on this project has proven to me as a deeply enriching experience and has broadened my horizon of understanding pertaining to UCITS, I shall cherish the steep learning curve that this project and the firm offered me for the times to come.

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