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## ESMA Rules that UCITS May Not Invest In Unregulated Hedge Funds

In a further indication of policy orientation at European level that is seeking to limit the instruments that UCITS funds may invest in, on 20 November 2012, the European Securities and Markets Authority ("ESMA") published a formal opinion on its interpretation of Article 50(2)(a) of the UCITS Directive (Directive 2009/65/EC) (the so-called "trash ratio") which permits UCITS to invest up to 10% of its net assets in transferable securities and money market instruments, other than those eligible assets referred to in Article 50(1).

The Opinion arises from the fact that "questions have emerged about the correct interpretation of this Article and, in particular, whether the derogation...applies to units or shares of collective investment undertakings."

A number of national regulators, including the Central Bank of Ireland and the CSSF in Luxembourg, have interpreted Article 50(2)(a) as permitting UCITS to invest in unregulated investment funds, including hedge funds, provided the investment complies with the eligibility criteria for UCITS, which is understood as meaning hedge funds that redeem units at the request of unitholders and operate on the principle of risk spreading.

In its Opinion, ESMA states that Article 50(2)(a) refers only to investments in transferable securities and money market instruments and that it does not refer to units or shares of collective investment undertakings.

As a result, ESMA considers that UCITS may only invest in collective investment undertakings that fall within the meaning of Article 50(1)(e), meaning other UCITS, or alternatively, funds that are subject to equivalent supervision as UCITS and which provide an equivalent level of investor protection as UCITS.

In order to comply with the Opinion, UCITS that have investments in hedge funds will be expected to redeem such holdings "taking into account the best interests of investors and at the latest by 31 December 2013". It will be interesting to see whether national regulators look for earlier compliance than the 31 December 2013 deadline.

Following the entering into force of the revised Lamfalussy process, the role of ESMA is to achieve greater consistency in day to day application of EU legislation in the security markets field and it is expected to play an active role in building a common EU supervisory culture and consistent supervisory practice, including by providing opinions to competent authorities and issuing guidelines and recommendations.

Although technically these opinions, guidelines and recommendations are considered to be "soft law" and, therefore, not binding; ESMA's opinions are a central reference for the work of national regulators. Accordingly, the Opinion should be treated on a comply-or-explain basis by national regulators.

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