No. 4598, 15.10.2012 **R.A.D. 399/2012**

THE OPEN ENDED UNDERTAKINGS FOR COLLECTIVE INVESTMENT (UCI) LAW OF 2012

Directive DI78-2012-13 of the Cyprus Securities and Exchange Commission on UCITS permitted investment limits

ORDER OF PARAGRAPHS

The Cyprus Securities and Exchange Commission exercising the power vested in it by section 40(5), section 41(5)(b) and (d), section 42(8) and section 44(3) of the Open Ended Undertakings in Collective Investment Law of 2012 and for the purpose of harmonisation with the European Union act entitled:

Official Journal of the EU: L79 of 20th March 2007, p. 11-19	"Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions";

Issues the following Directive:

Short title 1. This Directive shall be referred to as the UCITS permitted investment limits Directive of 2012.

Definition 2. For the application of this Directive, the following definitions apply:

78(I) of 2012 "Law" means the Open Ended Undertakings in Collective Investment Law of 2012.

"Directive" means this Directive.

Terms used in this Directive and are not defined otherwise have the same meaning as the Law.

Scope of application 3. The purpose of this Directive is to set out rules according to which particular categories of assets are considered as permitted investments by UCITS and to safeguard that the definition of terms used in the Law is consistent with its principles as are the principles governing the differentiation of risk and the limits of exposure to risk, the ability of a UCITS to redeem its units following an application by its unit holders and calculate the net asset value of its assets when units are issued or redeemed.

Transferable securities 4. (1) The reference in section 2 of the Law to transferable securities shall be understood as a reference to financial instruments which fulfill the following criteria:

(a) the potential loss which the UCITS may incur with respect to holding those instruments is limited to the amount paid for them;

Provided that a partly paid security must not expose a UCITS to a damage greater than the amount paid for it.

(b) their liquidity does not compromise the ability of the UCITS to comply with section 4(1)(c), section 6(d) and section 18 of the Law which refer to the obligation of a UCITS to redeem its units when requested by the unit holder.

(c) reliable valuation is available for them as follows:

(i) in the case of securities admitted to or dealt in on a regulated market as referred to in section 40(1)(a) to (d) of the Law, in the form of accurate, reliable and regular prices which are either market prices or prices made available by valuation systems independent from issuers;

(ii) in the case of other securities as referred to in paragraph (a) of subsection (2) of section 40 of the Law, in the form of a valuation on a periodic basis which is derived from information from the issuer of the security or from competent investment research;

(d) appropriate information is available for them as follows:

(i) in the case of securities admitted to or dealt in on a regulated market as referred to in section 40(1)(a) to (d) of the Law, in the form of regular, accurate and comprehensive information to the market on the security or, where relevant, on the portfolio of the security;

(ii) in the case of other securities as referred to in section 40(2)(a) of the Law, in the form of regular and accurate information to the UCITS on the security or, where relevant, on the portfolio of the security;

(e) they are negotiable;

(f) their acquisition is consistent with the investment objectives or the investment policy, or both, of the UCITS;

(g) their risks are adequately captured by the risk management process of the UCITS.

Provided that, the risks of the value and their contribution to the general risk profile of the UCITS portfolio must be evaluated on a continuous basis.

(2) For the purposes of subparagraphs (1)(b) and (1)(e), and unless there is information available to the UCITS that would lead to a different determination, financial instruments which are admitted or dealt in on a regulated market in accordance with section 40(1)(a) to (d) of the Law, shall be presumed not to compromise the ability of the UCITS to comply with section 4(1)(c), section 6(d) and section 18 of the Law and shall also be presumed to be negotiable.

(3)(a) In case there is information available to the UCITS or there should be information available that would lead the UCITS to a determination that a transferable security could compromise its ability to comply with section 4(1)(c), section 6(d) and section 18 of the Law that refer to the obligation of the UCITS to redeem its units when so requested by the unit holder, the UCITS should evaluate the risk for its liquidity.

(b) The risk of liquidity is a factor that the UCITS must take into consideration when investing in financial instruments in order to comply with the obligation regarding its portfolio liquidity in accordance with the provisions of section 4(1)(c), section 6(d) and section 18 of the Law, which refer to the obligation of the UCITS to redeem its units when so requested by its unit holder.

(c) The following are an indicative list of factors which the UCITS should take into consideration when evaluating liquidity risk:

(i) The volume and turnover of the transactions.

(ii) When the price is determined by the supply and demand of the market, the size of the issue and the proportion of the issue that the portfolio manager intends to buy, as well as evaluating the potential and the time frame to buy or sell;

(iii) Where necessary, the independent analysis of the market prices and selling in the long term may suggest the relative liquidity and marketability of the instrument, as may the comparison of available prices;

(iv) At the evaluation of the quality of the activity of the secondary market on a transferable security, the analysis of the quality and the number of intermediaries and market makers who execute transactions on the said transferable security should be considered.

(d) In case of transferable securities not listed on a regulated market, according to section 40(1)(a) to (d) of the Law, the liquidity is not granted and the UCITS should, where necessary, evaluate the liquidity of the said transferable securities, with the aim of safeguarding that the provisions of section 4(1)(c), section 6(d) and section 18 of the Law which refer to the obligation of the UCITS to redeem its units when so requested by a unit holder are complied with.

(e) In case the security is evaluated as having inadequate liquidity to fulfill the expected applications for redemption, the security should be redeemed or maintained in the UCITS portfolio only if there are enough other liquid securities who ensure that the provisions of section 4(1)(c), section 6(d) and section 18 of the Law, which refer to the obligation of the UCITS to redeem its units when so requested by a unit holder are complied with.

(4) In case of transferable securities not listed on a regulated market, in accordance with section 40(1)(a) to (d) of the Law, negotiability is not granted and the UCITS should evaluate the negotiability of the securities held in its portfolio, with the aim of safeguarding that the provisions of section 4(1)(c), section 6(d) and section 18 of the Law, which refer to the obligation of the UCITS to redeem its units when so requested by the unit holder are complied with.

(5) Transferable securities as referred to in section 2 of the Law shall be taken to include the following:

(a) Units in closed end funds constituted as investment companies or as unit trusts which fulfill the following criteria:

(i) they fulfill the criteria set out in subparagraphs (1) to (4);

(ii) they are subject to corporate governance mechanisms applied to companies;

(iii) where asset management activity is carried out by another entity on behalf of the closed end fund, that entity is subject to national regulation for the purpose of investor protection.

(b) units in closed end funds constituted under the law of contract which fulfill the following criteria:

(i) they fulfill the criteria set out in subparagraphs (1) to (4);

(ii) they are subject to corporate governance mechanisms equivalent to those applied to companies as referred to in subparagraph 5(a)(ii);

(iii) they are managed by an entity which is subject to national regulation for the purpose of investor protection;

(c) Financial instruments which fulfil the following criteria: financial instruments which fulfill the following criteria:

(i) they fulfill the criteria set out in subparagraphs (1) to (4);

(ii) they are backed by, or linked to the performance of, other assets, which may differ from those referred to in section 40(1) of the Law.

Provided that, a UCITS may not invest in closed ended funds with the aim of circumventing the investment limits provided in the Law.

(6) In order to evaluate whether the corporate governance mechanisms for closed ended funds incorporated in contractual form, are equivalent, according to the provisions of subparagraph 5(b)(ii), the following factors may be used by a UCITS, as guiding lines :

(a) Regarding unit holders rights, the contract on which the closed ended capital in based on must provide for the following:

(i) Voting rights of the unit holders in the substantive decision making procedure of the capital (including the appointment and termination of the Management Company, the amendment of the contract based on which the capital was incorporated, differentiation of the investment policy, merger, winding up ;
(ii) Right to control the investment policy of the capital through appropriate mechanisms.

(b) The assets of the said capital must be separate and distinct from the assets of the Management Company and the capital will be subject to winding up terms which adequately protect the interests of unit holders.

(7) Where a financial instrument covered by subparagraph 5(c) contains an embedded derivative component as referred to in paragraph 11, the requirements of section 41 of the Law shall apply to that component.

Money Market Instruments

5. (1) The reference in section 2 of the Law to money market instruments as instruments shall be understood as reference to the following:

(a) financial instruments which are admitted to trading or dealt in on a regulated market in accordance with section 40(1)(a) to (c) of the Law, and

(b) financial instruments which are not admitted to trading on a regulated market.

Provided, that there is no possibility of exposure in precious metals through investments in money market instruments.

Provided further that, section 50(3) of the Law forbids the uncovered sale of money market instruments by a UCITS.

(2) The reference in section 2 of the Law to money market instruments as instruments “normally dealt in on the money market”, shall be understood as a reference to financial instruments which fulfill one of the following criteria:

(a) they have a maturity at issuance of up to and including 397 days;

(b) they have a residual maturity of up to and including 397 days;

(c) they undergo regular yield adjustments in line with money market conditions at least every 397 days;

(d) their risk profile, including credit and interest rate risks, corresponds to that of financial instruments which have a maturity as referred to in subparagraphs 2(a) or 2(b), or are subject to a yield adjustment as referred to in point 2(c).

(3) Government and local authorities’ promissory notes, certificates of deposits, trading deeds and bills of exchange, usually fulfill the criteria “normally dealt in on the money market”.

(4) The reference in section 2 of the Law to money market instruments as instruments which are liquid shall be understood as a reference to financial instruments which can be sold at limited cost in an adequately short time frame, taking into account the obligation of the UCITS to repurchase or redeem its units at the request of any unit holder.

(5) For the evaluation of the adequacy of the liquidity of a money market instrument, the following factors must be considered cumulatively by the UCITS:

(a) As to the money market instrument:

(i) Frequency of transactions and price fixing for the particular instrument;

(ii) A number of market makers which are willing to buy and sell the instrument, willingness of the market makers to market make the particular instrument, nature of market transactions (time needed to sell the instrument, method of attracting bids and transfer techniques);

(iii) Size of issue / program;

(iv) Chances of buy-back, redemption or sale of the money market instrument in a short period of time (e.g. seven working days), with limited cost, with low commission and market prices / sale and with a very small delay in the settlement.

(b) As to the UCITS, the following relative factors must be considered in order to safeguard that a money market instrument by itself will not affect the liquidity of the UCITS:

(i) Characteristics and concentration of the UCITS unit holders

(ii) Purpose of the unit holders participation

(iii) Quality of information regarding the available liquid assets of the UCITS

(iv) Guidelines in the prospectus regarding limitations in the redemptions.

(c) The fact that some of the factors in subparagraphs (5)(a) and (5)(b) above are not met does not automatically imply that the financial instruments must be considered as illiquid.

(d) The elements of subparagraphs (5)(a) and (5)(b) above must safeguard that the UCITS will adequately organize the structure of its portfolio and forecast of cash flow with the purpose of matching the expected cash flow with the sale of appropriate liquid instruments in its portfolio to satisfy the demand for liquidity.

(6)(a) The reference in Section 2 of the Law to money market instruments as instruments which have a value which can be accurately determined at any time shall be understood as a reference to financial instruments for which accurate and reliable valuations systems, which fulfill the following criteria, are available:

(i) they enable the UCITS to calculate a net asset value in accordance with the value at which the financial instrument held in the portfolio could be exchanged between knowledgeable willing parties in an arm's length transaction;

(ii) they are based either on market data or on valuation models including systems based on amortised costs.

(b) In case the UCITS considers that an amortization method can be used for the evaluation of the value of the money market instrument, then it must safeguard, applying the procedures set by itself, that it will not result in the substantive divergence between the value of the money market instrument and the value calculated based on the amortization method. The following UCITS / money market instruments will usually comply with the following principle:

(i) Money market instruments with residual maturity of less than three months and without particular sensitivity in market parameters, including credit risk, or

(ii) UCITS who invest exclusively in high quality instruments and have, as a general rule, maturity or residual maturity up to 397 days or readjustment tactics regarding the performance according to maturities mentioned above and with weighted average maturity of 60 days. Adequate duty of care should be exhibited as to observing the credit risk and the instrument's final maturity.

(c) The principles of subparagraph (6)(b) together with adequate procedures determined by the UCITS, aim to avoid circumstances where the divergence between the value of the money market instrument as provided in the Directive and the value calculated according to the amortisation method, may prove substantive, either in the money market instrument level, or the UCITS level. Such procedures may include the updating of the credit spread of the issuer or the sale of the money market instrument.

(7) The criteria referred to in paragraphs 4(4) up to 4(6) shall be presumed to be fulfilled in the case of financial instruments which are normally dealt in on the money market for the purposes of section 2 of the Law and which are admitted to, or dealt in on, a regulated market in accordance with section 40(1)(a) up to (c) of the Law, unless there is information available to the UCITS that would lead to a different determination.

(8) When the UCITS cannot rely on the assumption of “liquidity” and “accurate valuation”, the money market instrument must be adequately evaluated by the UCITS.

(9) The money market instruments referred to in section 40(2)(a) of the Law are those instruments which fall within the meaning of money market instruments according to section 2 of the Law (which usually are subject to trading in the money market and fulfill the requirements of liquidity and accurate valuation), but do not fall in the categories of instruments determined in section 40(1)(a) up to (c) and (h) of the Law.

Instruments of which the issue or issuer is regulated for the purpose of protecting investors and savings

6. (1) The reference in section 40(1)(h) of the Law to “money market instruments, other than those dealt in on a regulated market, of which the issue or the issuer is itself regulated for the purpose of protecting investors and savings”, shall be understood as a reference to financial instruments which fulfill the following criteria:

(a) they fulfill one of the criteria set out in paragraph 5(2) and all the criteria set out in paragraphs 5(4) and 5(6);

(b) appropriate information is available for them, including information which allows an appropriate assessment of the credit risks related to the investment in such instruments, taking into account subparagraphs (2) to (4);

(c) they are freely transferable.

Provided that it remains a UCITS obligation to ensure whether a money market instrument which is not traded on a regulated market is a permissible investment for the UCITS.

(2) For money market instruments covered by section 40(1)(h)(ii) and (iv) of the Law, or for those which are issued by a local or regional authority of a Member State or by a public international body but are not guaranteed by a Member State or, in the case of a federal State which is a Member State, by one of the members making up the federation, appropriate information as referred to in subparagraph 1(b) shall consist in the following:

(a) information on both the issue or the issuance programme and the legal and financial situation of the issuer prior to the issue of the money market instrument;

(b) updates of the information referred to in subparagraph 2(a) on a regular basis and whenever a significant event occurs;

(c) the information referred to in subparagraph 2(a), verified by appropriately qualified third parties not subject to instructions from the issuer. Such third parties should be specialized in the verification of legal or financial documents and be composed of persons which fulfill professional levels of integrity;

(d) available and reliable statistics on the issue or the issuance programme.

(3) For money market instruments covered by section 40(1)(h)(iii) of the Law, appropriate information as referred to in subparagraph 1(b) shall consist in the following:

(a) information on the issue or the issuance programme or on the legal and financial situation of the issuer prior to the issue of the money market instrument;

(b) updates of the information referred to in subparagraph 3(a) on a regular basis and whenever a significant event occurs;

(c) available and reliable statistics on the issue or the issuance programme or other data enabling an appropriate assessment of the credit risks related to the investment in such instruments.

(4) For all money market instruments covered by the first indent of section 40(1)(h)(i) of the Law, except those referred to in subparagraph (2) above and those issued by the European Central Bank or by a central bank from a Member State, appropriate information as referred to in subparagraph 1(b), shall consist in information on the issue or the issuance programme or on the legal and financial situation of the issuer prior to the issue of the money market instrument.

Establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by the Republic

7. The reference in section 40(1)(h)(iii) of the Law to an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law shall be understood as a reference to an issuer which is subject to and complies with prudential rules and fulfils one of the following criteria:

(a) it is located in the European Economic Area;

(b) it is located in the OECD countries belonging to the Group of Ten;

(c) it has at least investment grade rating;

(d) it can be demonstrated on the basis of an in-depth analysis of the issuer that the prudential rules applicable to that issuer are at least as stringent as those laid down by Community law.

Securitisation vehicles which benefit from a banking liquidity line	8.	(1) The reference in the fourth indent of section 40(1)(h)(iv) of the Law to securitisation vehicles shall be understood as a reference to structures, whether in corporate, trust or contractual form, set up for the purpose of securitisation operations. (2) The reference in section 40(1)(h)(iv) of the way to banking liquidity lines shall be understood as a reference to banking facilities secured by a financial institution which itself complies with section 40(1)(h)(iii) of the Law.
Financial Derivative instruments	9.	(1) The reference in section 4(1)(a) of the Law to liquid financial assets shall be understood, with respect to financial derivative instruments, as a reference to financial derivative instruments which fulfill the following criteria: (a) their underlying securities consist in one or more of the following: (i) assets as listed in section 40(1) of the Law including financial instruments having one or several characteristics of those assets; (ii) interest rates; (iii) foreign exchange rates or currencies; (iv) financial indices; (b) in the case of OTC derivatives, they comply with the conditions set out in section 40(1)(g)(ii) and (iii) of the Law.

(2) Financial derivative instruments as referred to in section 40(1)(g) of the Law, shall be taken to include instruments which fulfill the following criteria:

(a) they allow the transfer of the credit risk of an asset as referred to in subparagraph (1)(a), independently from the other risks associated with that asset;

(b) they do not result in the delivery or in the transfer, including in the form of cash, of assets other than those referred to in section 40(1) and (2) of the Law;

(c) they comply with the criteria for OTC-derivatives laid down in the second and third indents of section 40(1)(g)(ii) and (iii) of the Law and in subparagraphs (3) and (4);

(d) their risks are adequately captured by the risk management process of the UCITS, and by its internal control mechanisms in the case of risks of asymmetry of information between the UCITS and the counterparty to the credit derivative resulting from potential access of the counterparty to non-public information on firms the assets of which are used as underlying securities by credit derivatives.

Provided, that the UCITS must conduct risk control with particular care when the derivative contracting party is a related person of the UCITS or the credit issuer.

(3) For the purposes of section 40(1)(g)(iii) of the Law, the reference to fair value shall be understood as a reference to the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

(4) For the purposes of section 40(1)(g)(iii) of the Law, the reference to reliable and verifiable valuation shall be understood as a reference to a valuation, by the UCITS, corresponding to the fair value as referred to in paragraph 3 of this Article, which does not rely only on market quotations by the counterparty and which fulfils the following criteria:

(a) the basis for the valuation is either a reliable up-to-date market value of the instrument, or, if such a value is not available, a pricing model using an adequate recognised methodology;

Provided that, for the purposes of section 41(1) of the Law in conjunction with section 40(1)(g)(iii) of the Law, the reference to procedures which allow the accurate and impartial valuation of OTC derivatives, means:

(i) Regarding the reliable valuation of the OTC derivative: a procedure which gives the ability to the UCITS, during the course of the derivative lifetime, to valuate the said investment with reasonable accuracy at fair value on a reliable basis which reflects an up to date market value;

(ii) Organization and means which allow the analysis of undertaken risks, by an independent section from trade or functional units and from the contracting party, or, in case such conditions are not attainable, by an independent third person. In the latter case, the UCITS remains responsible for the correct valuation of the OTC derivatives. Such type of UCITS organization, implies the need to set risk limits.

(iii) As to the procedures for accurate and impartial valuation of the OTC derivatives, paragraph 34 and Annex IV of Directive DI78-2012-03 must be considered.

(β) verification of the valuation is carried out by one of the following:

(i) an appropriate third party which is independent from the counterparty of the OTC-derivative, at an adequate frequency and in such a way that the UCITS is able to check it;

Provided that, the correct valuation of the OTC derivative remains the responsibility of the UCITS and must, among others, check that the independent third person, can valuate adequate the types of OTC derivatives in which the UCITS wishes to conclude.

(ii) a unit within the UCITS which is independent from the department in charge of managing the assets and which is adequately equipped for such purpose.

Provided that, for the purposes of this provision, the UCITS will use its own systems of valuation, which however may be provided by an independent third person. This does not include the use of valuation models which are available by a person connected to the UCITS, and which have not been checked by the UCITS. This also precludes the use of data which derive from a procedure which has not been approved by the UCITS.

(5) The reference in section 4(1)(a) of the Law to liquid financial assets and in section 40(1)(g) to derivative financial assets, shall be understood as excluding derivatives on commodities.

Provided that, the permissible investment limits by a UCITS do not include non-financial indices.

Financial Indices

10. (1) The reference in section 40(1)(g) of the Law to financial indices shall be understood as a reference to indices which fulfil the following criteria:

(a) they are sufficiently diversified, in that the following criteria are fulfilled:

(i) the index is composed in such a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index;

(ii) where the index is composed of assets referred to in section 40(1) of the Law, its composition is at least diversified in accordance with section 44(1) of the Law;

Provided that, if the composition of the index is not diversified at least according to the provisions of section 44(1) of the Law, its components must be combined with other elements of the UCITS assets according to the provisions of section 41(3) and (4), as well as section 42 of the Law, with the purpose to avoid unduly concentration.

(iii) where the index is composed of assets other than those referred to in section 40(1) of the Law, it is diversified in a way which is equivalent to that provided for in section 44 of the Law;

Provided that, in cases of derivatives on an index which consists of elements not permissible to invest for the UCITS and the derivatives are used to follow the index or to achieve a high exposure to the index, the index must be at least diversified as provided by the diversification ratios of section 44 of the Law.

Provided further that, in case the derivatives on a index are used for the purpose of diversification of risk, provided that the UCITS exposure to every index separately fulfills the ratio 5/10/40%, there is no need to check the elements of every index separately to ensure that the indices are adequately diversified.

(b) they represent an adequate benchmark for the market to which they refer, in that the following criteria are fulfilled:

(i) the index measures the performance of a representative group of underlyings in a relevant and appropriate way;

(ii) the index is revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available;

(iii) the underlyings are sufficiently liquid, which allows users to replicate the index, if necessary;

(c) they are published in an appropriate manner, in that the following criteria are fulfilled:

(i) their publication process relies on sound procedures to collect prices and to calculate and to subsequently publish the index value, including pricing procedures for components where a market price is not available;

(ii) material information on matters such as index calculation, rebalancing methodologies, index changes or any operational difficulties in providing timely or accurate information is provided on a wide and timely basis.

(2) The indices based in financial derivatives which have as subject commodities or indices in immovable property, may be a permissible investment for a UCITS as long as the criteria referring to financial indices are met.

(3) Where the composition of assets which are used as underlyings by financial derivatives in accordance with section 40(1) of the Law does not fulfill the criteria set out in subparagraph (1), those financial derivatives shall, where they comply with the criteria set out in paragraph 9(1), be regarded as financial derivatives on a combination of the assets referred to in points (i), (ii) and (iii) of paragraph 9(1)(a).

Transferable securities and money market instruments embedding derivatives

11. (1) The reference in section 41(4) of the Law to transferable securities embedding a derivative shall be understood as a reference to financial instruments which fulfill the criteria set out in paragraphs 4(1) up to and including 4(4), and which contain a component which fulfils the following criteria:

(a) by virtue of that component some or all of the cash flows that otherwise would be required by the transferable security which functions as host contract can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative;

(b) its economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract;

(c) it has a significant impact on the risk profile and pricing of the transferable security.

(2) Money market instruments which fulfill one of the criteria set out in Article 3(2) and all the criteria set out in paragraph 5(4) up to and including 5(6) and which contain a component which fulfils the criteria set out in subparagraph (1), shall be regarded as money market instruments embedding a derivative.

(3) A transferable security or a money market instrument shall not be regarded as embedding a derivative where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such a component shall be deemed to be a separate financial instrument.

(4) The following examples of structured financial instruments, may be considered by a UCITS to embody a derivative:

(a) Securities connected with credit facilities;

(b) Structured financial instruments whose performance is connected with the performance of a bond index;

(c) Structured financial instruments whose performance is connected with the performance of a group of securities with or without active management;

(d) Structured financial instruments with fully guaranteed nominal value whose performance is connected with the performance of a group of securities with or without active management;

(e) Convertible bonds; and

(f) Exchangeable bonds.

(5) Collateralised debt obligations-CDOs or asset backed securities with the use of derivatives, with or without active management, will not be considered in general to be structured financial instruments which embody derivatives, unless:

(a) They are leveraged, that is collateralised debt obligations-CDOs or asset backed securities are not limited recourse vehicles and the loss to investors may be greater than their original investment, or

(b) they are not adequately diversified.

(6) When a product is structured as an alternative of an OTC derivative, its treatment should be similar to that of the OTC derivative, in order to safeguard compliance with the provisions of the Law. Such products will be tailor-made hybrid instruments, like for example single tranche CDO structured in a way that satisfies that special needs of a UCITS, which legal wise should be considered to embody derivatives. Such a product offers an alternative solution to the use of OTC derivatives, for the same purpose as achieving a diversified exposure with set level of credit risk in a portfolio of entities.

(7) UCITS that use structured financial instruments and embody derivatives must comply with the principles of the Law which include the following:

(a) The incorporated derivatives should never be used in a way that contravenes the principles and rules of the Law.

(b) In order to comply with section 41(4) of the Law which provides that “when the transferable security or money market instrument incorporates a derivative, this derivative is considered when complying with the provisions of subsevtions (1) to (4)”, the Management Company for every UCITS it manages, or when not under external management, the Variable Capital Investment Company itself must:

(i) Use “procedures of risk management which allow it to control and assess every moment the risks of its positions and their contribution to the general risk profile of the UCITS portfolio” (section 41(1) of the Law);
(ii) Have total exposure in relation to derivatives which does not exceed the total net value of its portfolio;
(iii) Comply with all the investment limits provided in sections 42 and 44 of the Law in relation with section 41(4) of the Law.

In particular:

- UCITS which use structured financial instruments which incorporate derivatives must follow the rules of dispersion set in section 42 of the Law, taking into consideration the way with which the elements of the derivative financial instruments must be considered at the evaluation of the compliance of the risk limits provided in the particular section in accordance with the provisions of Part V of Directive DI78-2013-03 and

- In general, the incorporated derivatives will not be considered when calculating the limits of the contracting party, unless the said products give the issuer of the hybrid instrument the means to pass the risk of the contracting party of the derivatives in question to the UCITS.

(8) It is the responsibility of the UCITS to check that investments in hybrid means which incorporate derivatives comply with the above mentioned requirements. The nature, frequency and the aim of the checks accomplished will depend from the characteristics of the derivatives in question and the impact they have on the UCITS, considering its investment goals and its risk profile.

Provided that, where a UCITS considers that the said impact is not important, the checks may be formulated accordingly. In such cases, the UCITS may for example rely in prescribed investment limits in order to safeguard adherence of the abovementioned principles.

Techniques and instruments for the purpose of efficient portfolio management

12. (1) The reference in section 41(2) of the Law to techniques and instruments which relate to transferable securities and which are used for the purpose of efficient portfolio management shall be understood as a reference to techniques and instruments which fulfill the following criteria:

(a) they are economically appropriate in that they are realised in a cost-effective way;

(b) they are entered into for one or more of the following specific aims:

(i) reduction of risk;

(ii) reduction of cost;

(iii) generation of additional capital or income for the UCITS with a level of risk which is consistent with the risk profile of the UCITS and the risk diversification rules laid down in section 42 of the Law;

(c) their risks are adequately captured by the risk management process of the UCITS.

(2) Techniques and instruments which comply with the criteria set out in subparagraph (1) and which relate to money market instruments shall be regarded as techniques and instruments relating to money market instruments for the purpose of efficient portfolio management as referred to in section 41(2).

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(3) The instruments and techniques related with transferable securities and money market instruments include, but are not limited, to guarantees according to the provisions of the Agreements for the Provision of Investment Guarantees Law of 2004. The requirement for complying with the provisions of section 41 of the Law implies in particular that in case a UCITS is granted license to use repurchase agreements or loans for guaranteed securities to achieve leverage through the reinvestment of the guarantees, such actions must be considered when calculating of the total exposure of the UCITS to risk.

(4) In relation to section 40 and section 41(2) of the Law, in the present stage, only derivative financial instruments are subject to the provisions of both sections. Therefore, in accordance with the wording of section 41(2), the derivative financial instruments used in accordance with section 41(2), must comply simultaneously with the obligations of section 40. Despite the above, the derivative financial instruments according to section 40 are not automatically subject to the provision for "effective management of the portfolio" of section 41(2).

(5) Sections 56 and 57 of the Law, which define the obligations in relation to information which the unit holders must be supplied with by the UCITS, mean that the means and techniques connected with transferable securities and money market instruments cannot result in amending the stated investment policy of the UCITS or effectively add additional risks in relation to the general risk policy as described in official sale documents of the UCITS.

UCITS whose investment policy consists in the replication of a stock exchange index

13. (1) The reference in section 44(1) of the Law to replicating the composition of a stock or debt securities index shall be understood as a reference to replication of the composition of the underlying assets of the index, including the use of derivatives or other techniques and instruments as referred to in section 41(2) of the Law and paragraph 11 of this Directive.

(2) The reference in section 44(1)(a) of the Law to an index whose composition is sufficiently diversified shall be understood as a reference to an index which complies with the risk diversification rules of section 44(1) of the Law;

Provided that, a UCITS must provide adequate information for unit holders in the basic information for investors, in case the investment limit in shares and/or bonds issued by the same organization is increased by more than 20% and the maximum limit of 35% in the same issuer, in order to comply with section 44 of the Law, with the aim of justifying the particular conditions of the market.

(3) The reference in section 44(1)(b) of the Law to an index which represents an adequate benchmark shall be understood as a reference to an index whose provider uses a recognised methodology which generally does not result in the exclusion of a major issuer of the market to which it refers.

(4) The reference in section 44(1)(c) of the Law to an index which is published in an appropriate manner shall be understood as a reference to an index which fulfils the following criteria:

(a) it is accessible to the public;

(b) the index provider is independent from the index-replicating UCITS.

Provided that, it shall not be precluded for index providers and the UCITS forming part of the same economic group, provided that effective arrangements for the management of conflicts of interest are in place.

Other undertakings of collective investment

14. (1) For the evaluation by the Commission of whether un undertaking of collective investment is subject to regulation “equivalent to that laid down in Directive 2009/65/EC” as provided by section 40(1)(e)(i) of the Law, the Commission may consider, among others, the following:

(a) Memorandums of cooperation (bilateral or multilateral), participation in an international organization for competent authorities or other arrangements of cooperation (like exchange of letters) in order to safeguard a satisfactory level of cooperation between authorities;

(b) The Management Company of the undertaking for collective investment on which the proposed investment is aimed, its regulation and the choice of depositary have been approved by its competent authority;

(c) The license of the undertaking in collective investment from a member state of the Organization of Economic Co-operation and Development (OECD).

(2) For the evaluation by the Commission whether the level of investor protection is “equivalent to that provided for unit holders in a UCITS” as provided in section 40(1)(e)(ii) of the Law, the Commission may consider, among others, the following factors:

(a) Rules that guarantee the autonomy of management of the undertaking for collective investment as well as the management to the exclusive interest of the unit holders;

(b) The existence of an independent trustee / depositary with similar duties and responsibilities in relation to both the safeguarding of units and the regulation. Where the existence of an independent trustee / depositary, is not a requirement of the national legislation for undertakings of collective investment, the powerful structures of corporate governance may provide an appropriate alternative solution;

(c) Availability of information regarding the billing and the provisions for the submission of reports·

(d) Facilitation for redemptions and frequency;

(e) Restrictions in transactions by related persons;

(f) The level of separation of assets; and

(g) The national provisions for borrowing, lending and unsecured sales of transferable securities and money market instruments, which relate to the portfolio of the undertaking in collective investment.

Hedge funds indices

15. (1) For the purpose of section 40(1)(g) of the Law (derivative financial instruments), a hedge fund index:

(a) in order to fall into the category of “financial index” it must comply with the requirements in paragraph 10.

(b) will not fall into the category of “financial index”, unless the index methodology provides that the choice and reformation of the its elements is based on predetermined rules and objective criteria.

(c) will not fall in the category of “financial instruments”, unless the index provider accepts payments by possible elements of the index for the purpose of participating on the index.

(d) will not fall in the category of “financial index”, if the methodology of the index allows for backfilling.

(2) When the UCITS is exposed to a hedge funds index through an OTC derivative, it must fulfill the relevant provisions provided in the Law and the Directive, which include:

(a) Provisions regarding counterparties (section 40(1)(g) of the Law);

(b) Provisions regarding the valuation and the possibility of closing the positions (section 40(1)(g) of the Law and paragraph 9 of the Directive);

(c) Provisions regarding risk management and the valuation procedure (section 41(1) of the Law); and

(d) Provisions regarding the exposure to risk (section 42 of the Law).

(3) When exposed to a hedge fund index, a UCITS must conduct a due diligence inspection. This includes the attestation by the UCITS of the “quality” of the index. During the evaluation of the quality of the index, a UCITS must consider at least the following factors:

(a) the completeness of the methodology of the index, including the following elements:

- (i) Whether the methodology includes adequate explanation of subjects such as the calculation and categorization of the index elements (e.g. on the basis of the investment strategy of selected hedge funds) and the way of handling defunct components.

- (ii) Whether the index is an adequate benchmark of the types of hedge funds it refers to.

(b) the availability of information regarding the index, including the following elements:

- (i) Whether there is a clear description as to what the index is trying to reproduce;

- (ii) Whether the index is subject to an independent control and the purpose of such a control (e.g. that the methodology of the index has been followed, that the index has been calculated correctly);

- (iii) How often the index is published and whether something like that will influence the ability of the UCITS to calculate accurately its net asset value.

(c) Matters related to the handling of index elements, including:

(i) The procedures through which the index provider conducts due diligence on the procedures for the calculation of the index elements net asset value.

(ii) The degree of detail regarding the index elements and their net asset value, which are available (including whether they are open to new investments or not).

(iii) Whether the number of index elements achieves adequate diversification.

Provided that, the UCITS must maintain a record of the index evaluation.

(4) For the purpose of this paragraph, due diligence, means that the UCITS must conduct a complete evaluation of the quality of the particular hedge fund index based on the criteria determined above as well as any additional criteria which the UCITS considers appropriate.

Provided that, the UCITS is responsible for such a decision and in practice, it will have to be able to explain the evaluation it conducted.

Entry into force

16. The Directive enters into force from its publication in the Official Gazette of the Republic.