

## PUBLIC STATEMENT

### Actions to manage the impact of the Russian invasion of Ukraine on investment fund portfolios

The European Securities and Markets Authority (ESMA) is issuing this Public Statement to promote convergence in relation to actions taken to manage the impact of the Russian invasion of Ukraine on investment fund portfolios exposed to Russian, Belarusian and Ukrainian assets. It concerns in particular the obligations of the following fund managers:

- Authorised external Alternative Investment Fund Managers (AIFMs) and internally-managed Alternative Investment Funds (AIFs) subject to the AIFMD<sup>1</sup>,
- EuVECA managers subject to the EuVECA Regulation<sup>2</sup>,
- EuSEF managers subject to the EuSEF Regulation<sup>3</sup>, and
- UCITS management companies and self-managed UCITS investment companies (together 'UCITS managers') subject to the UCITSD<sup>4</sup>,

to manage investment funds in the best interest of investors, have adequate liquidity management systems in place and ensure fair valuation of assets.

More precisely, this Public Statement is aiming at recalling some general principles that can be derived from Union law that are of relevance to the management of the impact of the Russian invasion of Ukraine on investment fund portfolios. This includes appropriate actions to deal with valuation issues in case of exposures to Russian, Belarusian and Ukrainian assets, including where the use of liquidity management tools (LMTs), specifically side pockets, may be warranted.

ESMA is conscious of the fact that the use of LMTs is not yet fully harmonised in Union law and still largely subject to national law. In this context, the AIFMD review package put forward by the European Commission provides for proposed legislative amendments to the AIFMD and UCITSD with a view to harmonising the definitions and use of LMTs across Member States.<sup>5</sup>

ESMA also takes note that the asset valuation and fund accounting rules are not harmonised

<sup>1</sup> Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

<sup>2</sup> Regulation (EU) No 345/2013 of the European Parliament and of the Council of 17 April 2013 on European venture capital funds (OJ L 115, 25.4.2013, p. 1).

<sup>3</sup> Regulation (EU) No 346/2013 of the European Parliament and of the Council of 17 April 2013 on European social entrepreneurship funds (OJ L 115, 25.4.2013, p. 18).

<sup>4</sup> Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 302, 17.11.2009, p. 32).

<sup>5</sup> European Commission legislative proposals put forward in the context of the AIFMD/UCITSD review, COM(2021)721.

in Union law and are also largely subject to national law.

It is important to highlight that the selection of the most suitable LMTs as well as the valuation to be applied to affected assets falls under the responsibility of the fund manager which shall act in the best interest of all investors.

In accordance with Article 31(2) of the ESMA Regulation<sup>6</sup>, ESMA is issuing this Public Statement to promote convergence in the way market participants and national competent authorities (NCAs) respond to these adverse events and to provide clarity to fund managers.

## Background

ESMA is closely monitoring the impact of the Russian invasion of Ukraine on investment funds and facilitating the exchange of information among NCAs with a special focus on the use of LMTs.<sup>7</sup>

In this context, questions have been raised regarding the appropriate action in case of exposures to Russian, Belarusian and Ukrainian assets, in particular given the material valuation uncertainties and adverse impacts on the liquidity of these assets.

## General principles in case of material liquidity issues and valuation uncertainties

As a general principle, fund managers of investment funds with exposures to assets facing liquidity issues need to assess whether a fair value of these assets can still be determined and adapt the valuation without undue delay. Fund managers need to follow a consistent approach to the valuation of assets in line with the applicable policies and procedures and Union and national law. Fund managers should consequently refrain from following a one-size-fits-all approach whereby all assets facing liquidity issues are by default written down to zero without giving due consideration to the specificities of each individual asset.

Where fund managers of investment funds with material exposures to assets facing liquidity issues reach the conclusion that a fair value can no longer be determined, or that the subscription or redemption of shares or units at the current market price is not in the best interest of investors, consideration should be given to suspending temporarily both subscriptions and redemptions as an immediate measure aimed at mitigating the risks of dilution or arbitrage by incoming and outgoing investors.

Following this assessment, in the context of the Russian invasion of Ukraine, and in light of the material liquidity and related valuation issues referred to above, managers may consider whether other measures in some cases are preferable from an investor protection perspective compared to a prolonged temporary suspension that would not allow existing investors to

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<sup>6</sup> [Regulation \(EU\) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority \(European Securities and Markets Authority\), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC](#).

<sup>7</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-coordinates-regulatory-response-war-in-ukraine-and-its-impact-eu-financial>.

access liquidity.

These measures may include the total write off of the relevant assets, the liquidation of the fund or the segregation of the assets that have become illiquid or non-tradable as a consequence of the Russian invasion of Ukraine from the liquid assets in the investment fund portfolio. The concrete solution to be chosen depends on a case-by-case assessment taking into account, *inter alia*, the possible value that could be recovered, the amount of affected assets and their weight in the total portfolio, the cost of each measure and the tools available according to Union and national law.

### **Permissibility of side pockets**

In this context, a central question that has emerged is whether fund managers may consider using side pockets<sup>8</sup> or similar arrangements to segregate assets that have become illiquid or non-tradable.

#### General concept as well as potential benefits and risks of side pockets

The ESRB recommendations on liquidity and leverage risks in investment funds describe side pockets as a measure that allow illiquid assets to be separated from remaining liquid assets of the investment fund.<sup>9</sup> ESMA supports the view expressed by the ESRB that this approach has two advantages. First, investors needing liquidity can still cash in the liquid part of the investment fund's portfolio at, presumably, little liquidation cost. Second, the approach protects the interests of investors who wish to remain in the investment fund, since the fund manager is not forced to liquidate assets at or under market prices if faced with high redemption demand. The ESRB therefore viewed side pockets as especially suitable whenever a fund has diverging investor interests, i.e. when some investors wish to remain invested in the fund while others want to redeem their shares.

In the context of the Russian invasion of Ukraine, and in light of the material valuation issues referred to above, side pockets may in some cases be preferable from an investor protection perspective compared to a temporary suspension that would not allow existing investors to access liquidity.

In particular, the use of side pockets might prevent the need to suspend all subscriptions and redemptions<sup>10</sup> and provide initial investors with protection against potential dilution effects,

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<sup>8</sup> ESMA is conscious of the fact that the national law of Member States currently diverges on the question whether side pockets are restricted to exceptional circumstances. Moreover, in the context of the AIFMD/UCITS review, it is currently under discussion whether the use of UCITS side pockets in UCITS and open-ended retail AIFs should be limited to exceptional circumstances, as witnessed currently due to the implications of the Russian invasion of Ukraine on some UCITS portfolios, and should in no way be understood as a standard LMT for UCITS and open-ended retail AIFs, bearing in mind the paramount characteristics of UCITS (and open-ended retail AIFs) as liquid retail investment products.

<sup>9</sup> See the [ESRB recommendation of 7 December 2017 on liquidity and leverage risks in investment funds \(ESRB/2017/6\)](#). The [IOSCO Final Report on Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration](#) similarly describes side pockets as a mechanism by which a fund manager establishes a separate account for the sole purpose of segregating specific assets from the fund's overall portfolio. IOSCO also set out pros and cons of side pockets (see Table 5 of the aforementioned report).

<sup>10</sup> This refers to the suspension of subscriptions and redemption in the long period. It is acknowledged that the creation of side pockets requires a short temporary suspension of the fund for technical reasons.

especially where the illiquid assets are valued at zero or significantly lower prices.<sup>11</sup> Without side pockets, subscribing investors could benefit from investing in the illiquid assets for free or at a very low price, while these assets might gain some value in the future. Side pockets could be used to allow specifically the initial investors to benefit from potential future gains of these assets.

However, side pockets might also come with potential risks. Some NCAs are concerned about potential moral hazard problems.<sup>12</sup> Moreover, illiquid assets that are transferred to side pockets do not necessarily become liquid or gain value again in the future, meaning that in some cases writing off relevant assets from the outset might have saved investors the costs for the creation of side pockets. ESMA has also been made aware by NCAs and stakeholders of potential operational problems that some fund distribution platforms have with the creation of side pockets.

ESMA would like to highlight that the use of side pockets, including for UCITS, is subject to ongoing discussions in the context of the AIFMD/UCITS review.<sup>13</sup> Therefore, the clarifications provided in this Public Statement are provided in the context of the exceptional circumstances arising due to the impact of the Russian invasion of Ukraine and are without prejudice to any potential future legislative amendments adopted by the EU legislators in this respect.

### **Side pockets in AIFs**

While the AIFMD framework does not yet provide a legal definition of side pockets<sup>14</sup> or explicit operational requirements for their use, it includes specific investor disclosure and regulatory reporting requirements where side pockets are used.<sup>15</sup>

Consequently, side pockets are recognised and explicitly referred to in the AIFMD framework. Without prejudice to any possible additional or more restrictive requirements stemming from national law<sup>16</sup> or the constitutional documents of the relevant fund, authorised AIFMs may therefore consider using side pockets where this is in the best interest of investors.<sup>17</sup>

The same considerations should in principle apply to other AIFs such as EuVECA and EuSEF managed by registered EuVECA and EuSEF managers, although ESMA notes that this should be less relevant in practice given the closed-ended nature of these funds.

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<sup>11</sup> However, it should be noted that there are other LMTs and arrangements similar or equivalent to the side pocket arrangement described below that might achieve the same goal.

<sup>12</sup> In particular, side pockets should not be used by fund managers to correct errors in investment decisions or initial asset valuations.

<sup>13</sup> See footnote 5.

<sup>14</sup> Point 8 of Annex II and IV of the [Commission proposals put forward in the context of the AIFMD/UCITSD review](#) describe side pockets as follows: *Side pockets: side pockets allow illiquid investments to be separated from remaining liquid investments of the investment fund.* Under the Commission proposals, ESMA would be empowered to provide regulatory technical standards to define and specify the characteristics and provide criteria for the selection and use of suitable LMTs including side pockets.

<sup>15</sup> Article 108 and Annex IV of Commission Delegated Regulation (EU) No 231/2013.

<sup>16</sup> Noting in particular that Member States may allow the marketing of AIFs to retail investors in their jurisdiction and in that case impose stricter requirements, see Article 43 of the AIFMD.

<sup>17</sup> Stricter national rules may apply in particular to cases where AIFs are marketed to retail investors, see footnote 15.

## Side pockets in UCITS

Conversely, the UCITS framework does not make any reference to side pockets.

Without prejudice to national law and any future guidance that the European Commission may provide on this topic, ESMA is of the view, in consultation with the European Commission, that for the purpose of managing the impact of the Russian invasion of Ukraine on the portfolio of the fund, side pockets in UCITS could be permissible where the liquid and illiquid assets are segregated by way of transferring the liquid assets to a new UCITS<sup>18</sup> or to a new compartment of the initial UCITS. After such segregation, the existing investors will receive shares or units of the new UCITS, or new compartment in the same proportion as their investment in the initial UCITS, whereas new investors will only subscribe to the new UCITS or new compartment thereof holding the liquid assets. The use of the side pocket arrangement should be in the best interest of investors and cannot result in a transformation of the UCITS into a non-UCITS in contravention of Article 1(5) UCITSD.

The scenario above is not exhaustive, meaning that this does not exclude that other side pocket arrangements may be permissible.

In relation to disclosure to investors, ESMA is of the view that the general business conduct rules<sup>19</sup> and disclosure requirements<sup>20</sup> set out in the UCITSD require UCITS managers to inform both investors and home NCAs in a timely, clear and comprehensive manner of the envisaged use of side pockets. It is equally important that investors are informed on a regular basis both of the illiquid and the liquid part of the original UCITS portfolio.

## Comprehensive analysis

It is important to note that it remains under the responsibility of the fund manager to perform a comprehensive analysis to ascertain, whether and which of the permissible side pocket arrangements could be implemented in the relevant case and under what circumstances and conditions, carefully weighing the advantages and disadvantages for all investors wishing to subscribe, redeem or remain invested in the fund. For UCITS, the analysis should demonstrate that the liquid part of the UCITS portfolio is sufficiently diversified to operate in accordance with the UCITS risk diversification requirements. In case the risk profile or the constitutional documents of the UCITS need to be changed, these changes should be reflected in the prospectus of the UCITS accordingly.

The comprehensive analysis should also take into account all other relevant regulatory requirements including restrictions linked to the evolving EU sanctions regime and potential adverse tax implications under the applicable national rules. In this context, special consideration will need to be given also to the legal effects and contagion risk of any segregation method used under the applicable national rules, bearing in mind that there is no

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<sup>18</sup> This transfer of liquid assets to a new UCITS is not permissible to self-managed UCITS investment companies without requesting a new authorisation status as a UCITS management company since a self-managed UCITS investment company is not permitted to manage other UCITS.

<sup>19</sup> In particular Article 14(1)(a) of the UCITSD.

<sup>20</sup> Chapter IX of the UCITSD.

legal segregation of assets between different UCITS share classes and ESMA is aware that even the legal segregation between different UCITS compartments might be uncertain in some Member States<sup>21</sup>, meaning that there could be risks of future liability arising in one compartment to impact the assets and investors in other compartments of the fund.<sup>22</sup>

## Next steps

ESMA will continue to closely monitor the situation and take or recommend any measures necessary to mitigate the impact of the Russian invasion of Ukraine on investment funds. ESMA will, where necessary, reassess any potential need to supplement the guidance provided in this Public Statement or provide additional guidance on other issues arising from this crisis.

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<sup>21</sup> See [ESMA Opinion on UCITS Share Classes \(ESMA34-43-296\)](#), paragraphs 4 and 5. It should be noted that while asset segregation between sub-funds is not legally required in some jurisdictions, ESMA has expressed the view in paragraph 4 of this Opinion that the UCITSD should be interpreted in such a way that it requires the segregation of assets between compartments.

<sup>22</sup> Noting the level of contagion risks will depend on the specificities of the case including the individual assets in the relevant portfolio, e.g. side-pockets with derivative instruments with future liabilities might pose contagion risks. Fund managers will therefore have to carefully evaluate all potential liabilities that could arise from the side pocket arrangements and assets included therein as well as the related contagion risks on a case-by-case basis.