

ESMA's Proposals on UCITS— Potential Fallout for German Insurers, Pension Funds and Their Captive Special Funds

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Background. German insurance and pension investors (the “Insurance Investors”) often invest in closed-ended funds through a captive German open-ended fund, the so-called special fund with fixed investment terms in accordance with Sec. 284 KAGB (the “Special Fund”).¹ This offers various tax, accounting and asset allocation advantages. Closed-ended target funds are generally eligible investment assets for such Special Funds, since the German Capital Investment Act (KAGB) Special Funds permits investments in unlisted undertakings or securities. However, for German tax reasons,² such Special Funds would typically only invest in target funds if their interests can be qualified as “securities”.

German Regulator's (BaFin's) Practice and Impact of ESMA UCITS Proposal. While Special Funds are a different product category than UCITS and may adopt widely more flexible investment policies, BaFin has clarified in their Capital Investment Circular³ (applicable to pension funds and applied also by many insurance companies) that pension funds investing through Special Funds may only invest in securities if the latter qualify as “transferable securities” in accordance with UCITS rules (secs. 193, 198 KAGB). Therefore, Insurance Investors that invest in closed-ended alternative investment funds through a Special Fund must qualify the target fund interests as “transferable securities”.

ESMA's recent technical advice to the European Commission on the review of the UCITS Eligible Assets Directive (the “UCITS EAD”) of 26 June 2025 may result in such investors no longer being able to invest in non-EU closed-ended funds and/or funds of funds.

¹ The concerns voiced herein do not apply to special funds in accordance with sec. 282 KAGB.

² *Spezial-Investmentfonds* in accordance with sec. 25 et seq. of the German Investment Tax Act (InvStG).

³ Circular 11/2017 (VA), cf. para. B.4.13.

“Transferable Securities”. The proposal suggests redefining the criteria to be met for purposes of qualifying closed-ended funds as transferable securities. For now, this is only a proposal to the Commission, but if the proposal does eventually end up being implemented, the current practice regarding investments by Special Funds in closed-ended funds has to be reassessed and, in particular, investments in funds of funds and non-EU funds will be problematic.

The key aspects of ESMA’s suggested changes:

- The target fund interests must be liquid as assessed under normal and stressed market conditions. The requirement to assess whether the Special Fund’s assets are liquid enough to meet the redemption requests is not new, but ESMA’s proposal emphasises that only looking at the overall portfolio is not sufficient, and the fund interest must be scrutinised at an individual level as well. The relevant asset-level criteria for the assessment are:
 - (impending) listing on regulated market or MFT (if any);
 - volume, turnover, and number of trades per day;
 - bid and offer prices, and the relative size and spread;
 - issuance size, including the portion that the Special Fund intends to buy, also relative to the size of the Special Fund, and the opportunity and time frame to buy or sell;
 - **quality and number of intermediaries and market makers dealing in the fund interest on the secondary market (we would think that this criterium could be convincingly made here);**
 - characteristics of the issue and the issuer, such as the rating, the sector, or country of issuing, time since issuance and time to maturity, where relevant the currency of the issue, and issuer size;
 - transaction costs;
 - operational features of transaction, to measure the legal or procedural barriers; where relevant, collateral arrangements; and volatility of fund interest over time.
- Reliable valuation of fund interest is available at the same frequency of the subscriptions and redemptions of the Special Fund. Currently, quarterly valuations or sufficient financial information in quarterly reports are widely considered

sufficient. In the future, this may depend on the redemption frequency of the Insurance Investor's Special Fund.

- Problematic seems to be the following requirement: according to ESMA, the target fund must be authorised or registered under laws that provide supervision considered by BaFin to be equivalent to EU law, and cooperation between BaFin and the target fund's competent authority must be sufficiently ensured. Unless there is information available to the contrary, this is presumed for closed-ended EU AIFs managed by authorised EU AIFMs.

This would be a serious step up from the current requirement that the fund is subject to a home supervision for purposes of investor protection. In particular, despite mentioning "authorised and registered", the presumption for EU AIFs managed by authorised EU AIFMs implies that the yardstick is the authorised AIFM and comparability with registered sub-threshold AIFMs is insufficient. This would create considerable uncertainty for all non-EU target funds.

- Another problematic requirement is that the target fund may not invest more than 10% of its assets in aggregate in other UCITS or AIFs. This would preclude investments in funds with a (partial) fund-of-funds strategy.

Next Steps. The EU Commission will take ESMA's technical advice into account when reviewing the UCITS EAD. Once the Commission has published any draft amendments to the UCITS EAD, the draft would enter the trilogue between the Commission, the EU Parliament and Council. Any effective changes can probably not be expected before 2027.

We will monitor the developments and update you in due course. It should be kept in mind that, even if the UCITS EAD is adapted according to ESMA's proposal, BaFin or national German law may still ease the alignment of Special Funds and UCITS rules for Insurance Investors.

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Please do not hesitate to contact us with any questions.



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