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Regulation should not penalise share performance of successful companies

Evaluation of UCITS diversification rules is necessary

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Reconsider the 10-percent-investment limit

According to data provided by ESMA, funds regulated by the UCITS-Directive (Undertakings for Collective Investments in Transferable Securities) represent the largest retail investment instrument in the EU, with € 5.5 trillion in assets held by retail investors in 2022.[1]

Equity funds are the most popular funds category under UCITS, accounting for 44 percent of total assets. Therefore, UCITS-funds are an important vehicle for retail investors aiming at attractive returns for long-term wealth building und retirement provisions. Additionally, UCITS can and do provide capital to support the European economy to finance challenges such as the digitalisation and energy transition, which is a key objective of the EU Savings and Investments Union.

In this context, Art. 52 UCITS, commonly referred to as the 5/10/40 rule[2], comes into play. The rule prohibits active asset managers from investing more than 10 percent of their assets in one single issuer. In contrast, a 75/5/10 rule applies in the US. Accordingly, asset managers are allowed to invest 25 percent of their assets in securities of one issuer. A limit of 5 percent per issuer applies to the remaining 75 per cent.[3]

The UCITS diversification limit can be problematic for equity fund managers with a focus on companies in a European country using the main stock index as benchmark and orientation. This holds especially true in times where stock performance is more and more driven by a few, outperforming companies.[4] In the US, stock markets are dominated by Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla, which contributed 60 percent of the S&P 500 increase in the first half of 2024. In Germany, seven companies accounted even for 92 percent of the DAX40-performance in the same period (SAP, Munich Re, Allianz, Rheinmetall, Deutsche Telekom, Siemens and Siemens Energy).

Due to the large number of companies constituting the S&P 500, even the biggest companies like Apple or Amazon make up only 6.9 or 4.5 percent of the total market capitalisation. In Europe, situation is completely different. Take for example the German market, the recent outstanding stock performance of SAP lead to an index weight of 16.5 per cent.[5]

1 ESMA: Market Report Costs and Performance of EU Retail Investment Products 2023, Paris (here).
2 All investments of more than 5 percent may not add up to more than 40 per cent of a fund's portfolio.
3 In addition, asset managers are not allowed to hold more than 10 percent of the voting securities of one issuer (here).
4 See calculations conducted by HQ Trust (here).
5 Source: www.boerse.de (16.1.2025).

So far, active fund managers are not able to participate on the stock performance of these companies, as they are forced to sell the shares when crossing the UCITS 10 per cent limit. Negative impacts on the stock market performance of the affected companies are the result, leading to two severe consequences:

- Equity funds with a focus on national European markets where returns of highly successful companies are artificially capped by UCITS investment limits will lose investors, as they will look for higher returns in funds with a broader regional focus. As a result, active investment funds using the respective indices as a benchmark run into underperformance "by definition" due to strong performances of companies crossing the limit.

- Affected companies will face increasing difficulties to get money for new business opportunities. In extreme, they will leave domestic markets and re-list in the US, where deep capital markets, many stock-listed companies and more flexible investment limits reduce the above-described risks. [6]

As both would further weaken European equity markets and undermine the legislator's goal to make capital markets stronger, various initiatives have already been adopted to overcome the above-mentioned problem:

- Different rules apply for passive investors: Art. 53 sets the limit for funds replicating the composition of a certain stock or debt securities index to 20 percent, with a maximum of 35 percent allowed under exceptional market conditions.

- Although there is a broad range of capping limits in different jurisdictions[7], providers of stock indices have implemented more generous diversification rules which better reflect market realities. For example, index regulations of the French CAC40 index family and the Italian FTSE MIB set a cap of 15 percent. In contrast, no such cap is required for the US S&P 500 and the FTSE 100 in the UK.

  In Germany, the main stock index DAX40 had a capping limit of 10 percent, which was increased to 15 percent in March 2024. The index provider had previously consulted the market on the proposed rule change, which was welcomed by most market participants. However, some investors raised concerns that increasing the capping limit would contradict the 5/10/40 UCITS rule.[8]

6 See e.g. „Stock market heavyweight SAP: Too fat for the DAX?" (here).
7 In this regard, consideration could be given to harmonising the index capping limits in the EU, which would make investment decisions easier.
8 See the results of the market consultation published by STOXX Ltd. in November 2023 (here).

In our view the legislator should ensure more consistency between the investment limits for passive investors, the rules of index providers and the limits for active investors. Active investors should have more leeway to prevent forced share selling to the detriment of investors and issuers.

Therefore, we suggest a better alignment with the rules for passive asset managers, in particular for shares. In this regard, active funds should be allowed to invest up to 20 percent of their assets in shares of a single issuer. At least, also following the rules for passive investors, a temporary exemption is necessary. Under exceptional market circumstances active investors could increase the limit up to 20 per cent. An indicator for this exception could be the companies' market capitalisation over a short period which lead to the crossing of the 10-percent-limit.

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