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European Fund and Asset Management Association

**EFAMA REPLY TO THE EC CONSULTATION DOCUMENT
ON UCITS PRODUCT RULES, LIQUIDITY MANAGEMENT, DEPOSITARY,
MONEY MARKET FUNDS AND LONG-TERM INVESTMENTS**

EFAMA[1] welcomes the opportunity to comment on the eight areas covered in the Consultation Document of the European Commission on UCITS.

We fully agree with the Commission's view that UCITS has created a safe and transparent environment which has lead the UCITS brand to be considered by both professional and retail investors to represent one of the highest standards in the asset management industry.

We therefore fully support the Commission's work towards further improvements of the already robust UCITS framework and welcome the opportunity to bring our contribution to this work.

Reply to questions in Box 1 – Eligible Assets

(1) Do you consider there is a need to review the scope of assets and exposures that are deemed eligible for a UCITS fund?

Directive 2001/108/EC ("UCITS III") which expanded the list of eligible assets from listed shares and bonds to allow investments in bank deposits, money market fund instruments, financial derivative instruments and units of other collective investment schemes has undoubtedly been a major contributor to the worldwide success of the UCITS brand.

The **flexibility** offered by UCITS III in terms of permitted investments is highly valued by promoters and investors alike as it has indeed presented UCITS managers with tools enabling them to launch innovative products and investment strategies in order to better serve the investors needs without compromising the high quality standards of the UCITS framework.

This flexibility has always been accompanied by a **comprehensive set of investment restrictions** designed to protect investors by ensuring that there are robust controls in place to monitor risk exposure (including market risk, counterparty risk and issuer concentration risk),

[1] EFAMA is the representative association for the European investment management industry. EFAMA represents through its 27 member associations and 59 corporate members about EUR 14 trillion in assets under management of which EUR 8.4 trillion managed by 54,000 investment funds at end June 2012. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

rue Montoyer 47, B-1000 Bruxelles

☎ +32 2 513 39 69 • Fax +32 2 513 26 43 • e-mail : info@efama.org • www.efama.org • VAT Nr BE 0446.651.445

to ensure diversification and to ensure that UCITS are able to meet the redemption requests of their investors.
These indispensable protections have been **supplemented over time to accompany market developments** by additional rules such as the CESR guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS (CESR/10-788) updated by ESMA in 2012 (ESMA/2012/197) and, most recently, by the ESMA guidelines on UCITS ETFs and other UCITS issues (ESMA 2012/74).

We believe that **it is this balance between flexibility** on the investment side **and rigorour** in terms of measurement and management of the associated risks **that has been central to the success of the UCITS brand**.

If UCITS are to continue to be the product of choice for promoters and investors, we believe it is essential that **retail investors should be able to continue to benefit from product innovation and developments in investment management techniques**.

Accordingly, we strongly believe that, rather than restricting the existing flexibility in terms of eligible assets, the focus should be to ensure that the protections in the UCITS framework in terms of risk management, liquidity management, organisational rules and internal audit remain up to the highest quality standards. This should involve in particular the ongoing review of risk management provisions and liquidity management standards (please refer also to our answer to question 3 below).

Within such an investor-protection driven framework, we do not see the need for a review of the scope of eligible assets and exposures for UCITS.

Furthermore it is important to underline that the fact that an investment structure or technique is complex for retail investors to understand should not be the determining factor in considering its UCITS eligibility. In many cases, the complexity of the instruments or techniques (e.g. derivatives) will serve to reduce the risk and to ensure that the product is actually more suitable for retail investors. However, it is important that such strategies, and any risks arising from their usage, are well understood by the investment manager and the competent authority in charge of supervising the UCITS and are explained in clear terms to investors.

We also note that there may be differences amongst National Regulators in the interpretation of existing rules and guidelines applicable to eligible assets, which in practice may have resulted in certain strategies being authorised in some Member States, but not in others. We believe it is for ESMA to ensure consistency in the interpretation of these rules.

(2) Do you consider that all investment strategies currently observed in the market place are in line with what investors expect of products regulated by UCITS?

It is important to bear in mind that, although the UCITS framework is primarily designed for retail investors, there are actually different types of UCITS investors, ranging from retail individuals trading for their own account, with or without professional advice, to large sophisticated institutional investors. These institutional investors, in turn, may be investing in UCITS for their own account or invest on behalf of their own (retail) clients.

As a result, the expectations and degree of sophistication of UCITS investors vary enormously and it is therefore difficult to identify a detailed set of common investor expectations in respect of UCITS strategies.

It also ought to be noted that not all UCITS are necessarily targeted specifically at retail investors. There are indeed a number of UCITS products that are targeted at more sophisticated (or even professional) investors, which does not mean that they would be unsuitable for retail investors. Indeed, it is one of the strength of the UCITS framework that it allows the development of products which, even though they were designed to meet the needs of certain types of clients, may also prove useful for other types of clients.

It is equally true that a number of investment strategies currently pursued by UCITS were not contemplated by regulators at the time the UCITS III directive was adopted. This is, for instance, the case for so-called "absolute return" strategies which strive to generate positive returns regardless of the prevailing market conditions. Such products often involve complex investment techniques which would not be feasible without extensive use of derivative instruments but altogether aim at mitigating risks for investors. Despite the complexity lying behind individual techniques, these products have been designed with a view to answering a clear demand from retail investors, often with the aim of reducing volatility and smoothing investor's returns, leading to reduced investment risks.

Another example of evolving investment strategies can also be observed in recent attempts to replicate hedge fund like strategies in the UCITS framework[2]. Potential issues raised by these types of strategies have already been adequately addressed by the ESMA guidelines on UCITS ETFs and other issues, in particular by providing that UCITS investment in financial indices are limited to broadly-used index products providing full transparency in terms of their constituents and calculation methodology.

Ultimately, we believe that the variety of investment strategies currently observed in the market place has been driven by investor demand and would not exist if the market had not sought such strategies with the inbuilt liquidity, transparency and other protections of the UCITS framework. If the currently available flexibility to develop these strategies was regulated away from the UCITS framework, the risk would then clearly be that retail investors would seek other –less regulated – products to still be able to benefit from these strategies, which would not be in their best interest.

[2] For further details, please refer also to the EFAMA report on « The evolving investment strategies of UCITS » http://www.efama.org/Publications/Public/UCITS/11-4028_Final_EFAMA_Newcits_report_08042011.pdf

(3) Do you consider there is a need to further develop rules on the liquidity of eligible assets? What kind of rules could be envisaged? Please evaluate possible consequences for all stakeholders involved.

Liquidity of the UCITS portfolio is a crucial element for warranting the open-ended structure of the product.

Accordingly, the UCITS framework already requires appropriate management of liquidity risks at portfolio level in order to maintain the ability of a UCITS to meet the redemption requests by investors at all times[3]. UCITS management companies therefore already have to implement an appropriate liquidity risk management process as part of their overall risk management duties.

Nonetheless, given the focus the UCITS Directive as well as the Eligible Assets Directive ("EAD") rightly puts on liquidity, we support the proposal to develop common standards or principles to be applied by UCITS in ensuring the liquidity of portfolios as a whole (please refer also to our answer to Box 4 on Extraordinary liquidity management rules below).

Such common standards would need to be considered as part of a liquidity assessment which could form an enhancement to the current risk management process conducted by UCITS management companies. More prescription and granularity on the liquidity rules would assist in greater harmonization across the industry and ultimately on the liquidity profiles of UCITS brought to the market. It should also as far as appropriate establish a consistent approach to liquidity risk management under the UCITS Directive and the AIFMD.

Great care should be taken, however, in formulating rules in relation to liquidity to ensure that they do not introduce the risk of creating a pro-cyclical effect by forcing funds to immediately dispose of assets that fail to meet any prescribed liquidity tests (thereby causing those assets to fall further in value or forcing funds to sell at an inconvenient moment at a loss, which could otherwise have been limited or avoided).

(4) What is the current market practice regarding the exposure to non-eligible assets? What is the estimated percentage of UCITS exposed to non-eligible assets and what is the average proportion of these assets in such a UCITS' portfolio? Please describe the strategies used to gain exposure to non-eligible assets and the non-eligible assets involved. If you are an asset manager, please provide also information specific to your business.

[3] Article 40(4) and 40(5)of Directive 2010/43/EU

As the Commission rightly notes on page 4 of the Consultation, under the current regulatory framework, UCITS may gain exposure to non-eligible assets through the following financial instruments which are themselves eligible assets:

- other collective investment schemes which are subject to supervision "*equivalent to that laid down in Community law*" and offer a level of protection "*equivalent to that provided for unit holders in a UCITS*" (those criteria are further developed under the Eligible Assets Directive and related CESR guidelines concerning eligible assets for investment by UCITS);

- Transferable securities, including participation notes, ADRs, GDRs, certain closed-ended funds or other instruments which meet the requirements of Article 2 of EAD and which do not embed a financial derivative instrument or themselves constitute a financial derivative instrument;

- Financial derivative instruments which give exposure to financial indices as expressly contemplated under UCITS Directive and Article 9 of the EAD (the recently adopted ESMA guidelines on UCITS ETFs and other UCITS also provide further details regarding the requirements to be met by these financial indices).

It is, however, difficult to provide a breakdown of the number of funds that obtain exposure in this manner or the average portion of such assets in a UCITS portfolio.

(5) Do you consider there is a need to further refine rules on exposure to non-eligible assets? What would be the consequences of the following measures for all the stakeholders involved:

- ***Preventing exposure to certain non-eligible assets (e.g. by adopting a "look-through" approach for transferable securities, investments in financial indices or closed-ended funds).***
- ***Defining specific exposure limits and risk spreading rules (e.g. diversification) at the level of the underlying assets.***

Although we are not aware of specific concerns in terms of investor protection raised by the UCITS exposure to non-eligible assets under the current legal framework, we have no objection in principle to the proposal to refine rules on exposure to non-eligible assets.

However, we believe that a proposal to place an absolute restriction on exposure to (certain) non-eligible assets would be very difficult to put into practice and would, in particular, have the consequence that the range of non-UCITS collective investment schemes in which investment is permitted would be narrowed considerably. Indeed, unless a target fund has been purposely structured in order to facilitate investments by UCITS, it is likely that it will have the ability to invest in some assets which do not meet the UCITS eligibility requirements which would render the target fund ineligible for investment.

Concerning the exposure obtained through financial indices, we note that in its guidelines on UCITS ETFs and other UCITS issues. ESMA has not proposed any absolute prohibition on the ability to obtain exposure to non-eligible assets. We believe this approach to be preferable to any absolute restriction.

Should the Commission perceive a need for regulatory action in this area, we would then have a strong preference for reviewing the existing exposure limits and potentially defining new risk spreading rules regarding non-eligible assets.

(6) Do you see merits in distinguishing or limiting the scope of eligible derivatives based on the payoff of the derivative (e.g. plain vanilla vs. exotic derivatives)? If yes, what would be the consequences of introducing such a distinction? Do you see a need for other distinctions?

We see no merits in distinguishing eligible derivatives on the basis of their payoff profile.

We do not believe that a derivative that does not pose any risk to a UCITS from a payoff perspective should be restricted simply because it is too complex for some investors to understand. Complexity is more a function of the use of the FDI strategy rather than the instruments themselves. The experience of the last decade demonstrates that, as part of their obligations under the UCITS legal framework, UCITS managers have developed sufficient risk management capabilities to deal adequately with such instruments. We therefore believe that UCITS managers should remain free to select derivative instruments (be they plain vanilla or "exotic"[4] derivatives) which in their opinion best suit the interests of their investors.

Furthermore, the payoff is only one element to be taken into account when determining standardisation of OTC derivatives for EMIR purposes5.

(7) Do you consider that market risk is a consistent indicator of global exposure relating to derivative instruments? Which type of strategy employs VaR as a measure for global exposure? What is the proportion of funds using VaR to measure global exposure? What would be the consequence for different stakeholders of using only leverage (commitment) as a measure of global exposure? If you are an asset manager, please provide also information specific to your business.

[4] Furthermore, we wish to underline that this term is negatively connoted and that its precise meaning is unclear. In any case, if a distinction had to be made between plain vanilla and "exotic derivatives", greater clarity should be given as to what constitutes an "exotic derivative".

[5] EMIR requires a comprehensive evaluation of legal and operational standardisation in terms of OTC Derivatives, see Article 5(4) of Regulation 2012/648/EU. Moreover, it should be borne in mind that in addition to standardised OTC derivatives which are subject to central clearing obligations under EMIR, there are also non-standardised derivative instruments which can be optionally cleared by a CCP.

We strongly believe that the VaR and commitment method are fully legitimate and complementary tools that should both be available to UCITS managers for measuring global fund exposure depending on the circumstances and specificities of the fund.
VaR is a well-recognised and widely-used method in the UCITS industry nowadays given that market risk remains the simplest way to take into account the exposure of a derivative instrument (delta-adjusted). Using VaR allows the manager to take into account the correlation of the assets as well as the current market conditions. In particular for portfolios using extensively derivatives, VaR provides investors and risk managers with a more accurate view of the global risk of a portfolio, especially when derivative exposures are offset by other derivatives (such as FX forwards, which are reversed by entering into a new forward agreement).

We would therefore be very concerned by any proposal to move to a regime where a leverage test (be it the commitment approach or the 'sum of gross notionals" test) becomes the only available method to calculate global exposure. Indeed, a narrow leverage test may provide a misleading assessment of a UCITS's risk profile or volatility. In particular, the commitment approach does not necessarily take proper account of investment strategy, portfolio of assets (e.g. equities or fixed income) or the purpose for which derivatives are used (e.g. reduction of risk or otherwise). Positions that economically offset risk, such as interest rate or currency hedge, may be required to be included in the commitment approach calculation even though such transactions would ultimately reduce risk in a portfolio. As a result, the determination of global exposure solely by reference to leverage could have an adverse effect in terms of investor protection in that it would discourage/make more difficult the use of derivatives to reduce the risk in a portfolio through hedging and efficient portfolio management.

In the interest of UCITS investors, we therefore believe that risk managers should retain the flexibility to use the method (VaR or Commitment or, possibly, a combination of both) they deem the most appropriate for evaluating the global exposure of a specific portfolio. We would, however, be very interested to engage in a dialogue with regulators about possible further harmonization and improvements to the currently-available methods.

(8) Do you consider that the use of derivatives should be limited to instruments that are traded or would be required to be traded on multilateral platforms in accordance with the legislative proposal on MiFIR? What would be the consequences for different stakeholders of introducing such an obligation?

As a preliminary remark, we wish to underline the fact that we are not aware of any particular issue in relation to investments by UCITS in OTC derivatives and that we therefore do not see the rationale for the proposed changes by the Commission.

With this in mind, we fundamentally object to any such limitation in the use of derivatives by UCITS, which, we believe, is unduly restrictive for the following reasons:

- Limiting the scope of eligible derivative instruments to those traded on multilateral platforms will effectively limit the ability for UCITS to mitigate the market risk of their investment. This is due to the fact that derivatives used for hedging purposes must often be specifically modeled in order to account for specificities of a UCITS portfolio;

- As of today, trading on multilateral platforms covers only a very limited range of derivatives. Moreover, the scope of central clearing obligations under EMIR which shall determine the extent of multilateral trading of derivatives is, for the time being, far from clear. It must be expected that the marketplace will start with some very standardized products and will only gradually expand to more sophisticated products. It is therefore to be feared that UCITS will not be able to find on multilateral platforms the range of derivative instruments they need to hedge their portfolios against a number of risks or to pursue their investment strategies.

We also wish to take this opportunity to reiterate once again the need to clarify the counterparty limits as defined in Article 52 of the UCITS directive in order to allow UCITS to make full use of the central clearing arrangements provided by EMIR.

According to that provision, UCITS have a 5% limit on exposures to a single counterparty on OTC derivatives (raised to 10% where the counterparty is a credit institution). However, there is an urgent need to clarify how these limits apply in the context of central clearing to CCPs and, in particular, as to who the counterparty is for the purposes of the 5% or 10% limit. We therefore recommend that clarity be provided on this issue and that the 5%-10% limit be removed for any exposure to a centrally cleared trade. In the absence of such clarification, the existing counterparty limits under Article 52 are likely act as a brake on UCITS moving to central clearing, therefore preventing UCITS and their investors from benefiting from the risk reduction associated with central clearing.

In the same vein, we are also very concerned about the fact that, as a result of the prohibition from reusing cash obtained through repo or reverse repo transactions for collateralization of other investments (as currently envisaged in the ESMA guidelines on ETFs and other UCITS issues[6]), UCITS may experience serious difficulties in providing sufficient liquidity as collateral to CCP[7]. Should this prohibition be maintained, it would also act as brake on UCITS moving to central clearing.

[6] See paragraphs 39 and 40j of the ESMA guidelines (ESMA/2012/474).
[7] For further details, please refer to EFAMA's reply to the recent ESMA consultation on the recallabillity of repo and reverse repo arrangements: http://www.efama.org/Publications/Public/UCITS/12-4043_EFAMA%20reply%20ESMA%20consultation%20on%20the%20treatment%20of%20repo%20and%20reverse%20repo%20agreements.pdf

Reply to questions in Box 2 – Efficient Portfolio Management techniques

(1) Please describe the type of transactions and instruments that are currently considered as EPM techniques. Please describe the type of transactions and instruments that, in your view, should be considered as EPM techniques.

Transactions that are currently considered as efficient portfolio management techniques include securities lending, repurchase agreements (including similar "sell&buy back" operations) and reverse repurchase agreements. We are of the opinion that these are the appropriate transactions to be considered as EPM techniques and see no reason to either extend or reduce the list of EPM techniques currently available to UCITS managers.

(2) Do you consider there is a specific need to further address issues or risks related to the use of EPM techniques? If yes, please describe the issues you consider merit attention and the appropriate way of addressing such issues.

We are of the opinion that the recently published ESMA "Guidelines on UCITS ETFs and other UCITS issues" (ESMA/2012/474) are already covering this area in a comprehensive manner and are addressing to a great extent the perceived risks relating to the use of EPM techniques by UCITS. We therefore do not see the need for further regulatory action in this area, even though some of the provisions in the ESMA guidelines would need to be clarified or even reconsidered, preferably before their entry into force, with a view to ensure that they will be interpreted and applied in the same manner across all Member States.

From a procedural point of view, we assume that the ESMA Guidelines will enter into force relatively shortly entailing important re-organisation by Management Companies and Funds. Any future work the Commission would undertake in areas already covered by the ESMA guidelines will create an inherent risk of further re-organisation once the additional rules adopted by the Commission would enter into force. Should there be a perceived need for further regulatory action in this area, we would then strongly encourage the Commission to co-ordinate its approach with ESMA with a view to harmonize their respective regulatory actions and, as the case may be, agree on postponing the entry into force of the ESMA guidelines until there is clarity as to the required regulatory standards for UCITS, so as to avoid unnecessary burdens and disruptions for the asset management industry and its investors.

Furthermore, we strongly recommend that any new legislation in these areas should provide for mandatory regulatory technical standards developed by ESMA rather than delegated acts or implementing measures, as the former can be adapted more promptly to cater for market developments and evolving regulatory concerns.

(3) What is the current market practice regarding the use of EPM techniques: counterparties involved, volumes, liquidity constraints, revenues and revenue sharing arrangements?

Counterparties involved:

UCITS managers take great care in selecting counterparties involved in EPM transactions.

Volumes, liquidity constraints:

It is very difficult to give an indication of the proportion of a UCITS's assets that is typically engaged in EPM techniques as it depends to a great extent on investment objectives and restrictions of each fund as well as on prevailing market conditions, quality of assets and client demands.

Revenues and revenue sharing arrangements:

We wish to underline that securities lending is a legitimate activity which benefits investors by generating additional revenues and, as a result, contributing to the performance of the fund.

However, in order to provide securities lending services and to generate incremental returns, significant investments are required (including in research and technology, infrastructure, administration and risk management capabilities to constantly review counterparties and collateral parameters). Those fixed and variable costs will usually be borne not only by the securities lending agent but also by the UCITS management company. In order to cover these costs, it is very important that fee-sharing agreements remain admissible not only with external agents involved in the lending activities but also between the UCITS and its management company.

Contrary to what has sometimes been said recently in the public debate, it is also important to understand that securities lending agents actually do take significant risks in facilitating these services. Indeed, they assume significant reputational risk in acting as lending agent. In many cases, the lending agent also provides the UCITS or its investors with explicit indemnification coverage against the default of a counterparty. In the European market specifically, counterparty default risk is generally considered to be the most significant risk to a lending program. As such, where indemnification is offered, the agent lender bears the bulk of the risk in securities lending (both reputational and pursuant to its indemnification obligations) and it is appropriate for the lending agent to be compensated on that basis.

It is also important to recognize that there are at least three active compensation models being used for securities lending in European markets today:

1) **Affiliated Model:** In-house lending programmes, where the asset manager or an affiliate performs securities lending services as the lending agent. The agent receives a proportion

of the gross securities lending revenue generated to compensate it for the cost of providing the service.

2) **Outsourced Model:** All securities lending services are outsourced to a lending agent, which could be a custodian, another asset manager or a specialised third-party lending provider. As before, the agent receives a proportion of the gross securities lending revenue generated to compensate it for the cost of providing the service.

3) **Three-Way Split Model:** Securities lending is outsourced as in the second model, but the investment manager also receives part of the securities lending revenues. Fees are split between lending agent, fund and asset manager.

Regardless of whether the fee split is applied through an outsourced model or through an affiliated model, the service fee (i.e. fee split) should comprise part of the 'direct and indirect costs' contemplated by ESMA's Guidelines.

The compensation arrangements for the provision of securities lending services should be disclosed to end-investors (which could be in the prospectus, annual report and/or website). Where the lending agent or asset manager deducts any other costs from the gross securities lending revenues, this should also be disclosed and made clear to end-investors. Noting our comments in respect of the third model above, only entities performing a service should be permitted to charge fees for those services.

The performance contribution to the UCITS from securities lending should be disclosed to end investors.

(4) Please describe the type of policies generally in place for the use of EPM techniques. Are any limits applied to the amount of portfolio assets that may, at any given point in time, be the object of EPM techniques? Do you see any merit in prescribing limits to the amount of fund assets that may be subject to EPM? If yes, what would be the appropriate limit and what consequences would such limits have on all the stakeholders affected by such limits? If you are an asset manager, please provide any information specific to your business.

We believe that it would not be in the best interest of investors to prescribe a limit as to the proportion of the UCITS portfolio that may, at any given point in time, be the object of EPM techniques. Limiting the proportion of a portfolio that can be lent or otherwise engaged in EPM techniques would limit the opportunities for UCITS to engage in securities lending transactions and would therefore lead to reduced competitiveness.

Provided that risk management processes are robust and ESMA's guidelines on Calculation of Global Exposure and Counterparty Risks are applied, establishing a limit at the UCITS portfolio level will be detrimental to the UCITS ability to ensure best pricing and to maximize returns without further mitigating counterparty risks.

(5) What is the current market practice regarding the collateral received in EPM? More specifically:

- ***Are EPM transactions as a rule fully collateralized? Are EPM and collateral positions marked-to-market on a daily basis? How often are margin calls made and what are the usual minimum thresholds?***

  The current market practice is that securities lending transactions are over-collateralized (indeed, in several Member States, over-collateralization is a requirement under national law). Securities on loan and collateral held by the UCITS are being marked-to-market on a daily basis with any fluctuations in value being settled at the same frequency. However, in certain cases a de minimis level is in place below which margin calls will not be made.

- ***Does the collateral include assets that would be considered non eligible under the UCITS directive? Does the collateral include assets that are not included in a UCITS fund's investment policy? If so, to what extent?***

  Collateral must comply with the requirements set out in the ESMA guidelines but is not required to match the UCITS' investment policy.

  In this context, we wish to reaffirm our fundamental objections to the proposed principle that there should be a certain degree of correlation between the collateral received and the UCITS portfolio.

  We believe that this approach is based on a wrong perception of the role of collateral in the context of EPM techniques. Indeed, it seems to assume that the collateral should be a suitable substitute to the portfolio of assets in loan which, in the case of default of the counterparty, would be directly transferred to the UCITS portfolio. In prevailing market practice, however, the collateral is provided as means of secondary recourse with respect to the entitlement to retransfer of portfolio assets. In case of default, the collateral is being immediately liquidated and the proceeds used to acquire new securities matching with the UCITS investment strategy.

  For these reasons, the first objective of regulatory requirements should be to ensure that the collateral received by the UCITS is both of a good credit quality and sufficiently liquid so as to warrant the possibility of smooth disposal and adequate pricing.

  Accordingly, we do not believe that correlation of the collateral with the portfolio is either necessary or desirable to protect investors. On the contrary, requiring such a correlation would even be detrimental to investors in a number of cases (e.g. a UCITS investing in equities would be prevented from accepting triple-A rated bonds in order to secure claims from EPM transactions).

For the same reasons, we do not believe that the collateral should comply with the UCITS diversification rules.

- ***To what extent do UCITS engage in collateral swap (collateral upgrade/downgrade) trades on a fix-term basis?***

  We are not aware that this is a common practice for UCITS to engage in collateral swap transactions.

  However, collateral upgrades might become much more relevant for UCITS in the future in order to account for enhanced liquidity needs relating to collateralization of centrally cleared OTC derivatives. Pursuant to ESMA guidelines on ETFs and other UCITS issues, UCITS could be prohibited from reusing cash acquired through repo or reverse repo transactions for the purpose of collateralizing other obligations. This new requirement would make it very difficult for UCITS to participate in the central clearing of OTC derivatives under EMIR as it must be expected that CCPs will require cash at least to settle the variation margin.

  In these circumstances, UCITS might be forced to engage in collateral upgrade transactions (e.g. with the involved broker) to facilitate provision of cash to the CCP. However, such arrangements are not the preferred option from the UCITS perspective because they involve additional fees and potentially create further counterparty risk.

(6) Do you think that there is a need to define criteria on the eligibility, liquidity, diversification and re-use of received collateral? If yes, what should such criteria be?

Criteria on the eligibility, liquidity, diversification and re-use of received collateral have already been defined by the recently-published ESMA guidelines on UCITS ETFs and other UCITS issues. . We therefore do not see the need for further regulatory action in this area, even though some of the provisions in the ESMA guidelines would need to be clarified or even reconsidered, preferably before their entry into force, with a view to ensure that they will be interpreted and applied in the same manner across all Member States.

From a procedural point of view, we assume that the ESMA Guidelines will enter into force relatively shortly entailing important re-organisation by Management Companies and Funds. Any future work the Commission would undertake in areas already covered by the ESMA guidelines will create an inherent risk of further re-organisation once the additional rules adopted by the Commission would enter into force. Should there be a perceived need for further regulatory action in this area, we would then strongly encourage the Commission to co-ordinate its approach with ESMA with a view to harmonize their respective regulatory actions and, as the case may be, agree on postponing the entry into force of the ESMA guidelines until there is clarity as to the required regulatory standards for UCITS, so as to avoid unnecessary burdens and disruptions for the asset management industry and its investors.

Furthermore, we strongly recommend that any new legislation in these areas should provide for mandatory regulatory technical standards developed by ESMA rather than delegated acts or implementing measures, as the former can be adapted more promptly to cater for market developments and evolving regulatory concerns.

(7) What is the market practice regarding haircuts on received collateral? Do you see any merit in prescribing mandatory haircuts on received collateral by a UCITS EPM? If you are an asset manager, please provide also information specific to your business.

EFAMA strongly objects to the prescription of mandatory haircuts on received collateral as this approach lacks the necessary flexibility to take into account the fluctuations and evolutions in the market. If mandatory haircuts were imposed, UCITS would experience reduced access to market.

Instead, EFAMA supports the approach taken by ESMA following which "*a UCITS should have in place a clear haircut policy adapted for each class of assets received as collateral. When devising the haircut policy, a UCITS should take into account the characteristics of the assets such as the credit standing of the price volatility, (…). This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut to a certain class of assets*" (paragraph 43 of ESMA guidelines on UCITS ETFs and other UCITS issues).

(8) Do you see a need to apply liquidity considerations when deciding the term or duration of EPM transactions? What would the consequences be for the fund if the EPM transactions were not "recallable" at any time? What would be the consequences of making all EPM transactions recallable at any time?

We note that this question is already addressed to a large extent by the recently published ESMA guidelines and also that ESMA has further consulted specifically on the question of recallability of repo and reverse repo arrangements before finalizing its guidelines in this area[8].

[8] EFAMA submitted an answer to that Consultation which is available at:
http://www.efama.org/Lists/Topics/form/DispItem.aspx?ID=8

When entering into EPM arrangements, a UCITS should certainly take into account liquidity considerations in such a manner as to ensure that such arrangements does not compromise its ability to meet its redemption obligations in accordance with Article 84 of UCITS directive.

However, we believe such objective can be achieved without imposing a requirement that EPM transactions must be 'recallable at any time'.

We also believe that a distinction ought to be made in this respect. Indeed, whereas securities lending transactions can usually be terminated at any time, the repo market, on the contrary, is dominated by fixed-term contracts. This fixed-term nature is binding for both parties to the transaction and allows UCITS to use repo and reverse repo proceeds for the purposes of effective portfolio management.

Should there be a requirement that all repo and reverse repo arrangements must be recallable at any time, the consequence would be that all repos other than overnight repos would de facto be forbidden for UCITS, which would have a damaging effect on the returns from such activities with little benefit from an investor protection perspective.

(9) Do you think that EPM transactions should be treated according to their economic substance for the purpose of assessment of risks arising from such transactions?

N.A.

(10) What is the current market practice regarding collateral provided by UCITS through EPM transactions? More specifically, is the EPM counterparty allowed to reuse the assets provided by a UCITS as collateral? If so, to what extent?

Regarding securities lending, UCITS are allowed to act only as the lending party[9] and hence are not required to provide collateral. As regards repo and reverse repo transactions, the proceeds from such arrangements had not been regarded as collateral up to now.

(11) Do you think that there is a need to define criteria regarding the collateral provided by a UCITS? If yes, what should be such criteria?

From the perspective of UCITS investors' protection, we do not see the need to define such criteria.

[9] Article 83(1) of Directive 2009/65/EC

If deemed necessary for other reasons, such criteria should definitely not form part of the UCITS regime. Moreover, any measures to be potentially addressed at relevant counterparties such as banks should not restrict the ability of a UCITS to provide assets eligible as collateral out of its investment portfolio.

(12) What is the market practice in terms of information provided to investors as regards EPM? Do you think that there should be greater transparency related to the risks inherent in EPM techniques, collateral received in the context of such techniques or earnings achieved thereby as well as their distribution?

As far as UCITS are concerned, we wish to underline that this objective of transparency is already largely achieved through the existing disclosure and reporting obligations foreseen in the UCITS regulation as well as in the recently-published ESMA guidelines.

In particular, paragraph 25 of these guidelines, which we fully support, provides that: "*A UCITS should inform its investors clearly in the prospectus of its intention to use the techniques referred to in Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. The use of these techniques and instruments should be in line with the best interests of the UCITS*."

Reply to questions in Box 3 – OTC Derivatives

(1) When assessing counterparty risk, do you see merit in clarifying the treatment of OTC derivatives cleared through central counterparties? If so, what would be the appropriate approach?

EFAMA is of the opinion that counterparty risk relating to OTC derivative transaction will be appropriately addressed by the EMIR regime. Under this set of rules, UCITS are deemed financial counterparties and, consequently, are subject to the entire EMIR provisions, including central clearing obligation.

Having regard to the purpose of EMIR, which is precisely the elimination of risk for OTC derivatives, we are thus of the opinion that any exposure to either a CCP or an intermediating clearing member should not be taken into account when calculating counterparty limits under Article 52(1) of the UCITS Directive. Otherwise, the existing counterparty limits may inhibit UCITS transition to central clearing, thus preventing UCITS investors from taking benefit from reduction of counterparty risk effectuated by the CCP model (please refer also to our answer to Question 8 in Box 1).

Commission Recommendation 2004/383/EC (27th April 2004) Para 5.1 states the following with regards to limitations of counterparty risk exposure of OTC derivatives
"*Member States are recommended to ensure that all the derivatives transactions which are deemed to be free of counterparty risk are performed on an exchange where the clearing house meets the following conditions: it is backed by an appropriate performance guarantee, and is characterized by daily mark – to market valuation of the derivative positions and an at least daily margining*". To this end we support the view that centrally cleared swaps are not the type of OTC derivatives which UCITS rules on counterparty exposure intend to capture.

Finally, we would like to remind the European Commission that, in this consultation as well as in the recently closed BCBS/IOSCO consultation on margining for bilateral transaction, investment funds should not be forced to post initial margins

EFAMA is of the opinion that non-prudentially regulated financial counterparties (NPFRC, e.g. such as most pension schemes, insurance vehicles and regulated collective investment schemes as defined in the Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP), which are not systemically important and which pose little or no systemic risk should not be required to post and collect Initial Margins (IM).

In this context, we would draw attention to the fact that the collateralization of cleared and non-cleared OTC derivatives by investment funds is quite different from credit institutions, since investment funds have to comply with investment fund law and contractual restrictions of the relevant investment fund. In addition, the provision of initial margin is likely to affect returns for such counterparties and as their positions will generally be directional, netting of exposures will rarely be available. By contrast credit institutions providing services to clients will have multiple exposures that are likely to net off.

(2) For OTC derivatives not cleared through central counterparties, do you think that collateral requirements should be consistent between the requirements for OTC and EPM transactions?

EFAMA's point of view is that the regulatory requirements applicable to collateral should be consistent for both categories of transactions.

A consistent approach on collateral should facilitate the operational management of the collateral. However, this consistency should not be too strict and should reflect the difference in nature (purpose, usual duration, legal entity counterparty, legal agreement terms or market's operational practices) of transaction requiring maintenance of sufficient flexibility to allow for the most appropriate risk management practices given the particular transaction/structure/counterparty combination.

These collateral requirements should be that such collateral should be sufficiently liquid so that it can be sold quickly at a price that is close to its pre-sale valuation and must at all times meet with the following criteria:

(a) Liquidity: collateral must be sufficiently liquid in order that it can be sold quickly at a robust price that is close to its pre-sale valuation;
(b) Valuation: collateral must be capable of being valued on at least a daily basis and must be marked to market daily;
(c) Diversification: there is an obvious risk if collateral is highly concentrated in one issue, sector or country
(d) Issuer credit quality: where the collateral issuer is not rated A1 or equivalent, conservative haircuts should be applied;
(e) Safe-keeping: collateral should be transferred to the custodian or its agent;
(f) Enforceable: collateral must be immediately available to the UCITS, without recourse to the counterparty, in the event of a default by that entity.

Additionally and to support liquidity in investment funds, especially in the perspective of EMIR requirements, EFAMA is strongly in favor of the possibility to reuse proceeds acquired through repos and reverse repos transactions under an adequate credit risk policy.

(3) Do you agree that there are specific operational or other risks resulting from UCITS contracting with a single counterparty? What measures could be envisaged to mitigate those risks?

Counterparty risk is already strongly regulated under the UCITS framework, with a maximum counterparty risk (per counterparty) limited to 10% of the fund's NAV.

EFAMA believes that there is no additional risk, operational or other, when UCITS contracts with a single.

If the counterparty is a CCP, despite it may be prudent to use multiple CCPs to reduce reliance on a single entity, it may not always be possible. Even if prudential management of clearing arrangements could entail the appointment of a 'back up' clearing member for end users accessing the CCP indirectly (in case of the default of the primary clearing member) this may not always be an option for any given asset class and jurisdiction. Currently for instance, there is only one CCP (LCH Swap Clear) capable of clearing IRS for indirect clients.

Additionally, contracting with a single counterparty can be a way to limit operational risk and in some instances best execution may lead to contracting with a single counterparty in the best interest of unit holders. It may be the case e.g. for some OTC derivatives transactions that can be done with the sole counterparty for a specific market.

However we note that as things stand (as European markets are constructed legally on a principal-to-principal basis, not on an agency basis) the UCITS is likely to be considered as the client counterparty to a clearing member of a CCP, but not to the CCP itself. Nevertheless, since an agency market model may be introduced subsequently, and EMIR is neutral as to both market models, we believe it is important to establish the principle that a single counterparty is acceptable if the counterparty is a CCP.

Additionally, and although it may be prudent to use multiple CCPs to reduce reliance on a single entity, it may not always be possible. Even if prudential management of clearing arrangements could entail the appointment of a 'back up' clearing member for end users accessing the CCP indirectly (in case of the default of the primary clearing member), but this may not always be an option for any given asset class and jurisdiction. Currently for instance, there is only one CCP (LCH Swap Clear) capable of clearing IRS for indirect clients.

For other types of investment vehicle, we are of the opinion that there might be some risks in contracting with a single counterparty as concentration ratio might not be as closely monitored as they are for UCITS funds.

Given that the counterparty risk must be reduced to a maximum of 10% by the provision of appropriate collateral, proper management of collateral assets in such UCITS is of particular importance. The measures that may be used to mitigate those risks include:
(a) posting of collateral;
(b) appropriate disclosure of the use of single counterparties to investors and what this practically means from an exposure viewpoint.

From the operational perspective, however, collateral management in the case of one counterparty is certainly easier to handle than with several counterparties involved, especially having regard to the new ESMA requirements on collateral diversification .

On the other hand, in certain cases it may be prudent for asset managers to maintain several counterparties of high quality from a credit worthiness, as well as market and operational capability standpoint ready for trading to support portability of transactions.

From a best execution perspective though, having high single counterparty risk concentration would need to be reflected with an appropriate best execution policy.

Nonetheless, enhancements of transparency standards are welcome in order to further enhance investor protection. If contracting with a single counterparty is part of a UCITS' investment policy, this could be disclosed in the prospectus together with general information on the applicable collateral policy and possibly the liquidation process of collateral. Further details on exposure to the counterparty and collateral received should be included in the annual report in accordance with the ESMA guidelines on ETFs and other UCITS issues.

Operational and collateral efficiency require the utilization of a limited (or single) CCP in each asset class and duly selected counterparties for bilateral transactions. Requiring excessive diversification would increase exposure through the loss of netting benefits, the increase of risks (mostly operational) as well as impacting returns.

(4) What is the current market practice in terms of frequency of calculation of counterparty risk and issuer concentration and valuation of UCITS assets? If you are an asset manager, please also provide information specific to your business.

EFAMA would like to remind that it is already current market practice to calculate counterparty risk and issuer concentration limits on a daily basis for most of the funds' types.

Specifically, exposure is calculated net of the market value of collateral received from (or posted to) a legal entity counterparty and netting is applied as contractually allowed per governing legal agreements. We believe it is best practice for OTC transactions to have these calculations and valuation made on a daily basis. For example, in Germany, this is even perceived as part of the regulatory requirements for effective risk measurement.

The funds that have other valuation frequency have a prospectus, approved by the relevant authorities, and are duly reflecting this different frequency.

(5) What would be the benefits and costs for all stakeholders involved of requiring calculation of counterparty risk and issuer concentration of the UCITS on an at least daily basis?

From EFAMA's experience, the current market practice is to to calculate counterparty risk on a daily basis as frequently as possible and as long as the prospectus foresees it. The vast majority of our members already implemented a calculation process for counterparty risk and issuer concentration, which ensures daily governance.

As is the case for daily asset/contract valuation, from a risk management perspective, the standard should be for daily counterparty risk and issuer concentration calculations. This increases market transparency as well as risk oversight on the overall financial system. Issuer concentration should be monitored at each valuation point by the investment manager of the investment funds. Daily counterparty exposure calculation would provide for a significant degree of transparency and active management of counterparty risk, allowing for the increased risk mitigation/reduction actions (e.g., diversification, hedging, margining) to be taken as deemed appropriate.

Please also refer to our answer to the question 4 above in this Box

(6) How could such a calculation be implemented for assets with less frequent valuations?

EFAMA's experience is that in case of UCITS investments in transferable securities, daily valuations should not present severe problems.

For assets with less frequent valuations, the last available quotation should be considered. Alternatively, valuation models could be used in order to facilitate calculation of the relevant limits. Derivatives and collateral should be valued on a daily basis.
EFAMA is of the opinion that although a single vehicle may become illiquid, market figures do not as are frequently updated.

Different alternative models could be used to derive valuation of portfolios with less frequent valuation, e.g. use of stale prices (any breache resulting from this model should be considered as passive and realignment with the guidelines should take place on the valuation time of the assets) or use a model that would approximate pricing and risk measures daily with reference to some kind of proxy data which updates daily (This could be used for certain holdings of externally managed funds which only price monthly - e.g. for segregated portfolios, or limited exposures in non UCITS funds) - by applying "drifted" prices according to mid-month moves of an appropriate benchmark index or proxy).

Reply to questions in Box 4 – Extraordinary Liquidity Management Tools

General remarks

As a preliminary observation, we think it is important to bear in mind that UCITS are already subject to state-of-the-art requirements in terms of liquidity risk management which have been further enhanced with the entry into force of the UCITS IV Directive. UCITS managers are required to employ an appropriate liquidity risk management process in order to ensure that the funds they manage are able to meet redemption requests from investors. This liquidity risk management process forms part of the permanent risk management function that UCITS investment management companies must establish and which must be functionally and hierarchically independent from other departments within the management company. Managers are required to monitor and measure at any time the risks to which the fund is or might be exposed, including the risk of massive and unexpected redemptions.

Should the Commission see the need for additional regulatory action in this area it should then take due account of the currently existing liquidity management requirements to which UCITS managers are already subject today.

Against this background, we wish to underline that we support to a large extent the recently published principles set out in the IOSCO Consultation Report on Principles of Liquidity Management for Collective Investment Schemes, which we believe, reflect the best practice already in application in the UCITS industry[10].

We would also recommend the Commission to take account, where relevant, of ESMA's technical advice to the European Commission on possible implementing measures of the AIFMD (ESMA/2011/379, in particular pages 73-81) which offers a number of suggestions for applying common principles in a proportionate manner regardless of the liquidity profile of the underlying fund.

Lastly, we draw attention to the fact that discussions on liquidity measures typically focus on challenges related to redemptions. It is also important in the case of open-ended funds such as UCITS for management companies to focus on liquidity issues throughout the life-cycle of a fund. Liquidity issues can be equally relevant when the UCITS is in the start-up phase, taking in large numbers of subscriptions. It is also important to situate the UCITS in the wider context of the manager's book of business. In specialized or growth markets a key issue governing liquidity is the size of the underlying markets. If a fund grows too quickly or becomes too large it may not be able to invest in available assets without damaging its liquidity profile. In this case, the manager will have to prepare for and consider a variety of options, such as temporary closure to new subscriptions and providing suitable warnings to investors about market constraints. As a result, we would stress the need for continuous engagement by the management company with its portfolio and risk managers to assess whether specific measures need to be taken to manage liquidity.

(1) What type of internal policies does a UCITS use in order to facilitate liquidity constraints? If you are an asset manager, please provide also information specific to your business.

First and foremost, UCITS managers take great care in the set-up and design of their products to take liquidity aspects into consideration with a view to avoid as much as possible liquidity bottlenecks and other liquidity issues throughout the entire life-cycle of the products.

Furthermore, as already highlighted in our general remarks above, UCITS management companies, as part of their legal obligations, already have a liquidity risk management process in place to monitor liquidity constraints and to ensure that the fund is able at all time to meet redemption requests from investors in line with the redemption policy for that fund laid down in the prospectus.

As part of this liquidity management process, the directors of a UCITS will typically require additional exceptional reporting in the event of liquidity issues, e.g. where market events

[10] EFAMA's reply to IOSCO principles on liquidity management for collective investment schemes is available at: http://www.efama.org/Publications/Public/Risk%20Management/12-4036_EFAMA%20reply%20to%20IOSCO%20Liquidity%20Risk%20Mgt.pdf

cause UCITS assets to become less liquid and/or more difficult to price, in which case the directors will liaise closely with the portfolio manager, risk manager and the administrator of the UCITS in order to assess and manage the implications of the issue.

Where appropriate, given the nature of a particular fund, the portfolio manager of a UCITS shall, after taking into account the nature of a proposed investment, undertake analysis concerning that particular investment's potential contribution to the UCITS portfolio composition in terms of liquidity and risk and reward profile before making the investment.

In addition, UCITS will usually also put in place risk warnings, in respect of each fund, in order to monitor and to highlight where appropriate material changes in liquidity (cash positions and equivalents such as holding of liquidity funds), taking into account the nature of the relevant fund.

Depending on the legal requirements applicable in their respective jurisdictions, UCITS managers may be able to use a number of tools in order to deal with liquidity bottlenecks in circumstances where a UCITS experiences severe cash outflows and to remedy the potential dilutive effect of large redemptions. Some of these tools will be used preventively in order to prevent liquidity bottlenecks from occurring, whereas other tools will be used to deal with exceptional cases where liquidity bottlenecks could not be avoided. In any case, the overarching objective is to ensure a fair and equal treatment of all the unit holders (i.e. those who want to redeem and those who remain invested in the UCITS).

<u>Preventive tools</u>

- Prior notice
  In a number of cases, the UCITS offering documents foresee that unit holders must give prior notice of their intention to redeem in order to give the portfolio manager the possibility to anticipate these redemptions and to generate sufficient cash to be able to process these redemptions orders without delay.

- Prior agreement
  When it appears that requests for redemptions on a specific day are likely to exceed the threshold foreseen in the UCITS prospectus (e.g. 10% of the Fund's NAV), the UCITS manager may also attempt to contact the unit holders making the largest redemption requests and work to negotiate with them a phased approach to redemptions so as not to have to defer redemptions.

- Swing pricing/fair value pricing
  Swing pricing is not primarily a liquidity management tool but may in certain circumstances of liquidity constraints be a useful tool to ensure a fair valuation price with the benefit of treating all unit holders equally.

- *In specie* redemptions

Exceptional/Last resort tools

- *Deferred redemptions/gates*
  Deferred redemptions or gates may sometimes prove useful in UCITS with a limited number of investors known to the management company (e.g. institutional investors) but will prove almost impossible to use in practice in the case of widely distributed UCITS with a large number of investors and intermediation in the distribution.

- *Suspension of redemptions*
  In exceptional circumstances where – despite the liquidity management process in place – a UCITS would temporarily be unable to meet the redemption requests from investors, the fund manager still has the ability temporarily to suspend redemptions in the interest of its unit holders (as foreseen in Article 84 of the UCITS Directive). This is an important protection tool for investors. This possibility of temporary suspension of redemptions is, however, only envisaged as a last resort measure and used with the greatest caution and for the shortest possible period of time by UCITS managers.

(2) Do you see a need to further develop a common framework, as part of the UCITS Directive, for dealing with liquidity bottlenecks in exceptional cases?

We do not believe there is a need to develop further a common framework for dealing with liquidity bottlenecks in exceptional cases.

Bearing in mind that liquidity issues can be driven by a wide variety of events, depending on the specific fund and market situation, we are of the opinion that it would be very difficult to set up a common framework with sufficient flexibility to allow different types of UCITS to respond effectively to exceptional liquidity constraints in a wide variety of situations.

Should the Commission nonetheless see the need for such a common framework, it should then be developed with a view not to restricting UCITS managers' flexibility to deal with liquidity bottlenecks using the most appropriate tools, in the best interest of investors.

(3) What would be the criteria needed to define the "exceptional case" referred to in Article 84(2)? Should the decision be based on quantitative and/or qualitative criteria? Should the occurrence of "exceptional cases" be left to the manager's self-assessment and/or should this be assessed by the competent authorities? Please give an indicative list of criteria.

For the reasons outlined in our reply to question 2 above, we believe it would be very difficult to define such criteria to define "the exceptional case", be it in on a quantitative and/or qualitative basis.

(4) Regarding the temporary suspension of redemptions, should time limits be introduced that would require the fund to be liquidated once they are breached? If yes, what would such limits be? Please evaluate benefits and costs for all stakeholders involved.

We do not believe that time limits would actually be useful given that there already is a strong incentive for UCITS managers to keep the suspension period shortest as possible in order to avoid reputational damages and to provide the best possible service to clients.

In this context, it is important to bear in mind that the situation which has led to the temporary suspension may be outside the UCITS's control (e.g. liquid assets suddenly become illiquid for a long period of time) and a requirement to move to liquidate a performing UCITS as a result is clearly not to the benefit of the investors in the UCITS, if possible at all. In certain situations, imposing time limits might even work to the detriment of the investors as it would trigger a forced liquidation of the fund.

(5) Regarding deferred redemption, would quantitative thresholds and time limits better ensure fairness between different investors? How should such a mechanism work and what would be the appropriate limits? Please evaluate benefits and costs for all the stakeholders involved.

Please refer to our answer to question 1 as to the practical difficulties related to the use of deferred redemptions. As for temporary suspensions, We do not believe that time limits would actually be useful given that there already is a strong incentive for UCITS managers to keep the suspension period shortest as possible in order to avoid reputational damages and to provide the best possible service to clients.

(6) What is the current market practice when using side pockets? What options might be considered for side pockets in the UCITS Directive? What measures should be developed to ensure that all investors' interests are protected? Please evaluate benefits and costs for all the stakeholders involved.

Currently, UCITS in general do not have a right to use side pockets, even under exceptional circumstances.

Side pockets might however be a useful extraordinary tool in helping meet the needs of UCITS investors in exceptional circumstances. Should the Commission decide to consider the possibility of side-pockets for UCITS, we would then recommend using the IOSCO "Principles on Suspensions of Redemptions in Collective Investment Schemes" as a reference to determine the conditions that should be met in the interest of investor's protection and fair treatment.

In any event, the use of side-pockets should remain extraordinary tools and should never be compulsory but left to the UCITS manager's choice, depending on its evaluation of the specific circumstances of each case.

(7) Do you see a need for liquidity safeguards in ETF secondary markets? Should the ETF provider be directly involved in providing liquidity to secondary market investors? What would be the consequences for all the stakeholders involved? Do you see any other alternative?

We do believe that is essential to ensure the availability of liquidity for ETF investors and fully recognize that the right for UCITS ETFs unit-holders to redeem their shares at any time is a fundamental tenet of UCITS products.

Having said that, ETFs are – by their very nature – intended to be traded in the secondary market on regulated stock exchanges. These venues have existing rules on the provision of liquidity providers for secondary market trading of ETFs, as well as other equities. The exchanges have also detailed rules covering market disruptions and volatility events for all traded securities. Generally speaking, we believe that these rules are sufficient to ensure efficient function of the secondary markets.

Nonetheless, it is important to bear in mind that in some Member States (such as Germany or Denmark, for instance), all UCITS including UCITS ETFs are bound to grant direct redemption rights to their investors. Otherwise, ETF providers should have an obligation to intervene directly to provide for direct redemptions by the UCITS ETFs only in exceptional circumstances of (secondary) market disruptions (e.g. as a result of the absence of market makers). This is also a logical consequence of the definition of UCITS in Article 1 paragraph 2(b) of Directive 2009/65/EC following which "*action taken by a UCITS to ensure that the stock exchange value* *of its units does not significantly vary from their net asset value shall be regarded as equivalent to such repurchase or redemption".*

(8) Do you see a need for common rules (including time limits) for execution or redemption orders in normal circumstances, i.e. in other than exceptional cases? If so, what would such rules be?

We do not see the need for additional rules, provided that time limits are properly disclosed in the fund documentation.

Reply to questions in Box 5 – Depositary Passport

General remarks

EFAMA has no objection in principle to the introduction of a passport for UCITS depositaries, provided that it can be demonstrated that it will bring tangible benefits to UCITS investors (such as lower depositary fees as a result of increased competition among depositaries) without undermining their protection.

With this preliminary statement in mind, EFAMA would refer to the 2005 Green Paper on the enhancement of the EU framework for investment funds[11] (which addressed the introduction of a depositary passport as a possible cost-efficiency measure) and to the consultations the Commission organised on the UCITS depositary function in 2009 and 2010. It appears from the feedback statement to the first consultation organised in 2009, "*a majority of respondents, including the banking and securities industry and investors considered that harmonisation of the status, role and liability regime of UCITS depositaries* ***should be an unconditional pre-requisite for a UCITS depositary passport"***[12]**.**

As a result of this, in the second consultation organised at the end of 2010, the Commission "*envisaged that a provision* [be] *introduced into the UCITS Directive creating a commitment to assess and re-examine the need to address depositary passport issues, to be undertaken a few years after the new depositary framework has come into force*.[13]"

EFAMA was – and remains – fully supportive of that careful, step-by-step approach. Indeed, we believe that it is important to make sure that the objectives that the UCITS V review seeks to achieve in terms of harmonisation across Member States of the status, functions and liabilities of UCITS

[11] http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0314en01.pdf
[12] http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/feedback_statement_en.pdf
[13] http://ec.europa.eu/internal_market/consultations/docs/2010/ucits/consultation_paper_en.pdf.

depositaries are indeed verified in practice[14]. Another prerequisite to the provision of cross-border depositary services would also be the coordination of insolvency and securities law (as currently envisaged by the Commission Services under the Securities Law Directive) in order to avoid that UCITS investors in the same jurisdiction would run the risk of being subject to different regulatory treatment and outcomes, depending on the location of the depositary.

Once the Commission is satisfied that those conditions are met, the possibility of introducing a depositary passport should be further considered.

(1) What advantages and drawbacks would a depositary passport create, in your view, from the perspective of: the depositary (turnover, jobs, organisation, operational complexities, economies of scale …), the fund (costs, cross-border activity, enforcement of its rights …), the competent authorities (supervisory effectiveness and complexity …), and the investor (level of investor protection)?

Our views on the potential advantages and drawbacks from the above mentioned perspectives are set out below. Another perspective that should also be taken into account is that of the UCITS management company.

Fund/investors

- Advantages:
    - Potentially lower depositary fees due to increased competition in the market place and possible economies of scale.
    - Potentially better quality of depositary services due to anticipated emergence of centres of excellence

- Drawbacks:
    - Risk that the non-local depositary does not correctly understand/apply local regulation;
    - Risk that the oversight may be less robust if the non-local depositary does not have a local presence in the UCITS domicile country
    - Tax implications should also be examined, in particular for contractual-type UCITS as the location of the depositary in another country might impact the tax treatment of UCITS unit-holders by the national tax authorities.

[14] We note that the Commission has the power to request that ESMA launch an enquiry into compliance with EU requirements. It may be appropriate, for example, for ESMA to review compliance across Member States after entry into force of the UCITS V Directive to ensure that the required level of harmonisation has been reached

- As regards enforcement rights, the Commission would need to ensure that UCITS and its investors have the same rights as they would if the depositary was established in the domicile of the UCITS

Depositary

- Advantages:
  - The potential for a more competitive market place in depositary services, opening new business opportunities for market players.
  - The potential for economies of scale and efficiency gains
- Drawbacks:
  - We see a potential risk that increased competition in the depositary market place would benefit bigger players that may be better equipped to seize new business opportunities, which in turn might result in a reduction in the number of players on the markets (and, hence, increase concentration risks)
  - Depositaries willing to make use of the passport will have to become acquainted with local regulatory and legal requirements and market practices that apply in the relevant UCITS domiciles. This may result in potential costs (training of staff …) and legal/operational risks for depositaries (if the local requirements are not correctly understood or applied) offsetting some of the potential for economies of scales.

UCITS Management Company

- Advantages:
  - If a UCITS Management Company is managing UCITS domiciled in different EU Member States it may be more efficient from an operational point of view to have a single depositary for all these UCITS (UCITS promoters are indeed increasingly looking for global service models and players to service their products).
  - Due to larger volumes, UCITS management companies would also be in a better position to negotiate prices with the depositaries.
- Drawbacks:
  - As for funds above

Competent authorities

- Advantages:

  - We do not think that the depositary passport presents any advantage in terms of supervision of the entities involved. On the contrary, the fact of having the UCITS, its management company and its depositary potentially located in three different countries would make their supervision more complex and would require a high level of cooperation between the different competent authorities involved

- Drawbacks:

  - Risk that the non-local depositary does not correctly understand/apply local regulation;
  - Risk that the oversight may be less robust if the non-local depositary does not have a local presence in the UCITS domicile country

(2) If you are a fund manager or a depositary, do you encounter problems stemming from the regulatory requirement that the depositary and the fund need to be located in the same Member State? If you are a competent authority, would you encounter problems linked to the dispersion of supervisory functions and responsibilities? If yes, please give details and describe the costs (financial and non-financial) associated with these burdens as well as possible issues that a separation of fund and depositary might create in terms of regulatory oversight and supervisory cooperation.

The fact that the UCITS and its depositary must be located in the same Member State is not perceived as a source of problem for the European asset management industry. As indicated in our answer to question 1 above, the depositary passport presents a number of potential advantages but also a number of possible drawbacks. From an investor protection perspective, it is not evident that the possible drawbacks of the depositary passport are outweighed by its benefits. On the contrary, many managers benefit from the local knowledge and experience that locally based depositaries, who are in constant dialogue with local regulators, bring to the oversight of UCITS.

This one of the reasons (together with the current lack of harmonisation of depositary regimes, insolvency laws and securities laws) that explain why EFAMA has always adopted a prudent approach to the depositary passport and does not see it as a major priority for the future development of the UCITS brand.

(3) In case a depositary passport were to be introduced, what areas do you think might require further harmonisation (e.g. calculation of NAV, definition of a depositary's tasks and permitted activities, conduct of business rules, supervision, harmonisation or approximation of capital requirements for depositaries…)?

As already emphasized in our general remarks above, EFAMA holds the view that the harmonisation of the UCITS depositary regime in all EU Member States is an essential pre-requisite for a UCITS depositary passport. The purpose of such harmonisation is to ensure that all UCITS investors enjoy the same level of protection and to avoid possibilities of regulatory arbitrage.

In line with the UCITS V legislative proposal presented by the Commission and currently examined by Council and European Parliament, this high level of harmonisation should be achieved in areas such as the depositary status (eligibility requirements, including capital requirements and appropriate conduct of business rules), a clear description of its functions and duties as well as its liability regime.

On the contrary, EFAMA does not see the need in this context for harmonisation of the NAV calculation as it is usually not part of the depositary functions.

(4) Should the depositary be subject to a fully-fledged authorization regime specific to depositaries or is reliance on other EU regulatory frameworks (e.g. credit institutions or investment firms) sufficient in case a passport for depositary functions were to be introduced?

In the light of the fact that the depositary is playing an essential role in the supervision of the fund's activities and that it is a crucial cornerstone in the high-level of investor protection, EFAMA believes that the authorization regime for the depositary should be in line with the respective authorization requirements for the eligible entities acting as depositaries.

(5) Are there specific issues to be address for the supervision of a UCITS where the depositary is not located in the same jurisdiction?

EFAMA believes this question is best answered by the competent authorities. Generally speaking and as already highlighted in our answers to questions 1 and 2, having a UCITS and its depositary located in two different countries is likely to complicate the supervision of these entities. Robust supervision by competent authorities, including thorough monitoring reviews, is key to maintaining worldwide confidence in UCITS products.

Reply to questions in Box 6 to 9 – Money Market Funds

General remarks

1) Representing the European investment fund industry, an already highly-regulated part of the financial sector, EFAMA is fully supportive of the objectives pursued by the European Commission and other international bodies such as the Financial Stability Board (FSB) and IOSCO to identify and close any regulatory gaps as well as inefficiencies in the supervision of the financial sector in general, with a view to mitigating systemic risks and reducing the possibilities of regulatory arbitrage.

2) EFAMA believes that MMFs have been through some reforms that have strengthened their resilience, such as the CESR/ESMA guidelines on a common definition of European MMFs. Hence, at this stage, the reform of MMFs should focus on the fund's internal liquidity risk, including by requiring MMFs to adhere to certain liquidity requirements (such as by stipulating that a minimum amount of a fund's portfolio should mature within one day and within five business days) and to take into account investor concentration and segments, industry sectors and instruments, and market liquidity positions.

Box 6

(1) What role do MMFs play in the management of liquidity for investors and in the financial markets generally? What are close alternatives for MMFs? Please give indicative figures and/or estimates of cross-elasticity of demand between MMFs and alternatives.

MMFs are instruments that provide to investors daily liquidity and asset diversification. Investors get a diversified short-duration exposure which they otherwise could not get due to minimum investment amounts of securities.

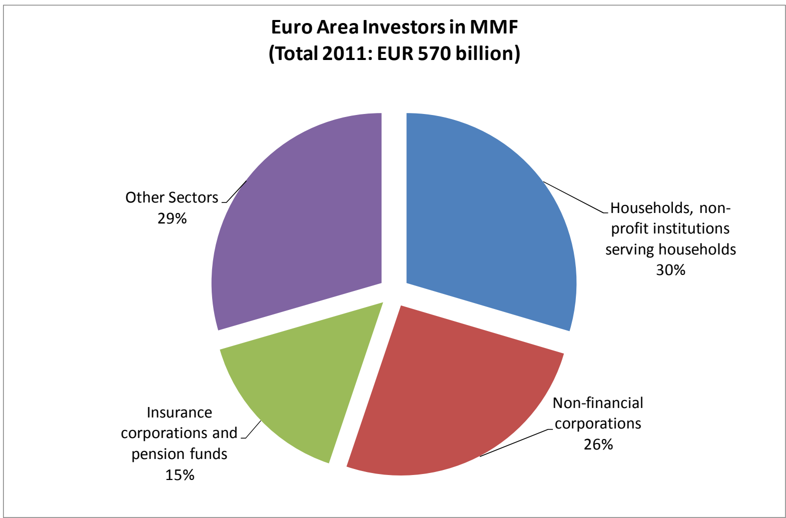
MMFs allow corporate treasurers and other institutional investors to manage deposit credit risk through diversification, thereby avoiding the risk associated with the concentration of deposits in a few select banks and the absence of unlimited deposit guarantee schemes. MMFs can also be used as an outsourcing tool as regards the analysis of credit and counterparty risks, as they are managed by professional and specialist asset management teams.

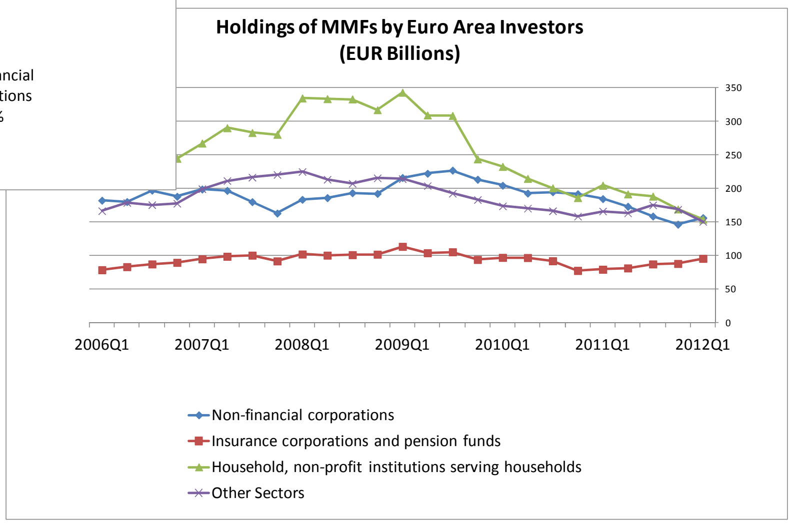
The alternatives to MMFs are fiduciary deposits, repurchase agreements and direct holdings of short-term debt instruments. For retail investors, the only feasible alternatives are structured products or bank deposits, both of which exhibit concentrated counterparty risk.

As buy-side entities, MMFs contribute to the demand for securities issued by companies, offering them the possibility to diversify their financing from bank loans to securities. The same applies to governments and financial institutions. In this way, MMFs constitute alternative funding for the real economy, which is particularly useful when traditional banking or market channels become temporarily impaired. As Commissioner Barnier recently stated[15], financial intermediation should not be left entirely and solely in the hands of banks. Indeed, alternative sources of financing have an important role to play in these difficult times for the European economy, where the banks have to adhere to more stringent prudential ratios.

(2) What type of investors are MMFs mostly targeting? Please give indicative figures.

MMFs are broadly used by retail and institutional investors as an efficient way to achieve diversified cash management. At the end of 2011, MMF shares/units were held by euro area investors in the following way: households (EUR 169 billion), non-financial corporations (EUR 146 billion), insurance corporations and pension funds (EUR 87 billion), and other sectors (EUR 169 billion).



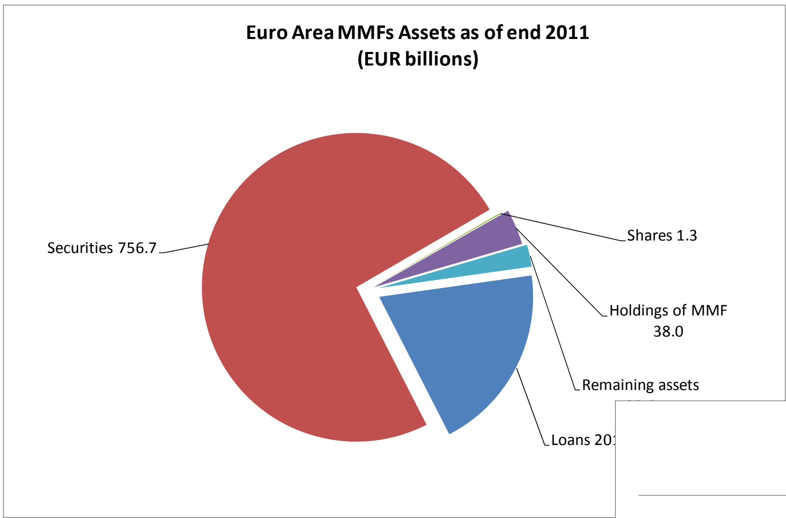


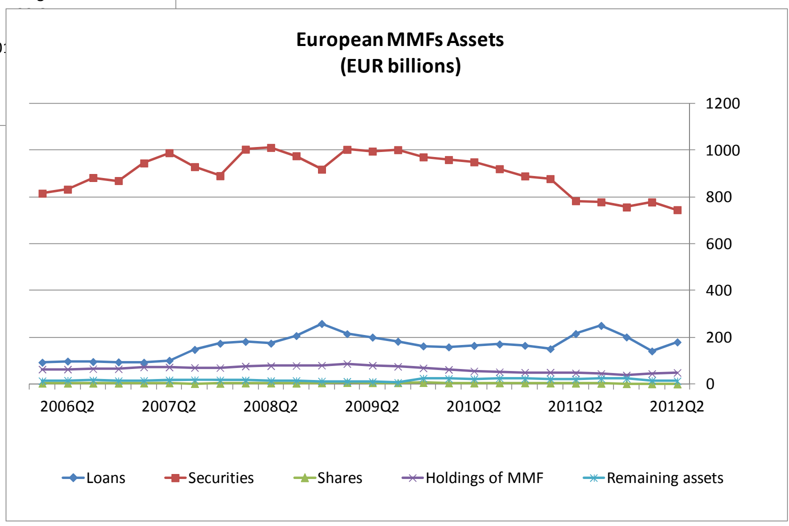
15 Speech 27/04/12 Shadow Banking conference

(3) What types of assets are MMFs mostly invested in? From what type of issuers? Please give indicative figures.

MMFs are investing in all types of short term products: Commercial Papers, Treasury Bills, Floating Rate Notes, Short Term Bonds, Repos, Fiduciary Deposits.
Types of issuers are banks, financials, corporate issuers, sovereigns, agencies, supranational.

The ECB data show that MMFs held **2.7%** of all debt securities issued by euro area non-financial sectors at end 2011, and **5.4%** of all debt securities issued by euro area credit institutions.





(4) To what extent do MMFs engage in transactions such as repo and securities lending? What proportion of these transactions is open-ended and can be recalled at any time, and what proportion is fixed-term? What assets do MMFs accept as collateral in these transactions? Is the collateral marked-to-market daily and how often are margin calls made? Do MMFs engage in collateral swap (collateral upgrade/downgrade) trades on a fixed-term basis?

Repos are used by MMFs to place cash on very short periods. Such repos involve a short-dated maturity and are fully collateralised. In addition to the fact that the repos are short-dated, they very often allow both parties to terminate the transaction early (within 24 or 48 hours), which is a positive feature for MMFs. Depending on the local market practices, bilateral or tri parties repo are used. On the other hand, securities lending is not very frequent for MMFs given the counterparty risk facing the securities lenders.

The securities taken as collateral are also usually of high quality and liquid, considering the new Guidelines of ESMA. Therefore, cash collateral agreements (which can also be called "margining arrangements") can be implemented so as to take into account variations in the market value of the collateral, if any. It is important to point out that collateral attached to the repo transaction implies that, all other things being equal, repos are less risky than other collateral-free financial instruments, such as direct buying of debt securities.

The key is the adequacy of the investment risk management process to ensure sufficient liquidity in the fund. Ideally, collateral should be marked to market daily and should trigger daily margin calls when necessary, as is often done for other types of operations (FX swaps, OIS swaps…), but this may increase the operation cost and reduce its attractiveness, thus weighing on global repo volume. However, the threshold level triggering calls may help to reduce this administrative cost.

In general, the conditions under which investment funds may engage in repo or securities lending are already partly covered by the UCITS Directive, supplemented in many European countries by additional rules applicable at national level. Furthermore, ESMA has just concluded a consultation on repo and reverse repo arrangements when used by UCITS and has also published guidelines on UCITS criteria for the management of collateralised transactions.[16] We also draw the Commission's attention to our comments on the recently-published Interim Report of the FSB work stream on Securities Lending and Repos.[17]

[16] EFAMA's response is available at the following web address: http://www.efama.org/Publications/Public/UCITS/12-4043_EFAMA%20reply%20ESMA%20consultation%20on%20the%20treatment%20of%20repo%20and%20reverse%20repo%20agreements.pdf

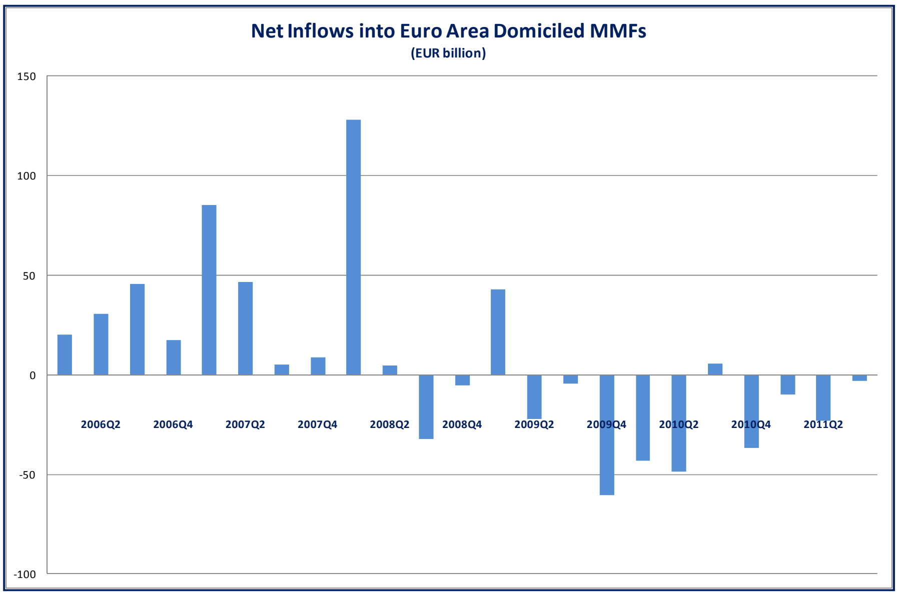
[17] EFAMA's comments are available at the following web address: www.efama.org

(5) Do you agree that MMFs, individually or collectively, may represent a source of systemic risk ('runs' by investors, contagion, etc…) due to their central role in the short term funding market? Please explain.

MMFs did not cause the financial crisis, but were caught up in it

MMFs did not cause the financial crisis. Rather, and as is well-documented, an extended period of easy credit caused the financial system as a whole to become over-leveraged, culminating in series of headline events in September 2008, and a crisis of confidence in the financial system in general, and the banking system in particular.

In **2007**, we agree that the financial crisis caused strains among MMFs in Europe after the outbreak of the subprime crisis. Investors' concerns about the quality of MMFs reflected the fact that a small number of "cash-enhanced" funds had purchased asset-backed securities to boost their returns. The difficulties experienced by these funds, which were not classified as MMFs, created confusion for investors about the definition, classification and risk characteristics of MMFs.



In **2008**, euro area domiciled MMFs experienced net outflows only when the market for short-term credit ceased to function following the Lehman bankruptcy in the third quarter of 2008. The difficulties were compounded by the broad extension of state-supported guarantees to bank deposits, which are the greatest competitor of MMFs in Europe. At the time, the industry feared that redemptions could outpace investment managers' ability to raise liquidity because the market for short-term commercial paper had closed. In the end, however, the efforts by the industry and the measures taken by the ECB to support short-term money markets, proved effective, and the pressures faced by MMFs started to recede in

November 2008, without necessitating any intervention by governments. In a nutshell, while MMFs were associated with systemic risk, it can hardly be argued that they were a cause of – or amplified – systemic risk, particularly in regard to the financial chaos of 2008.

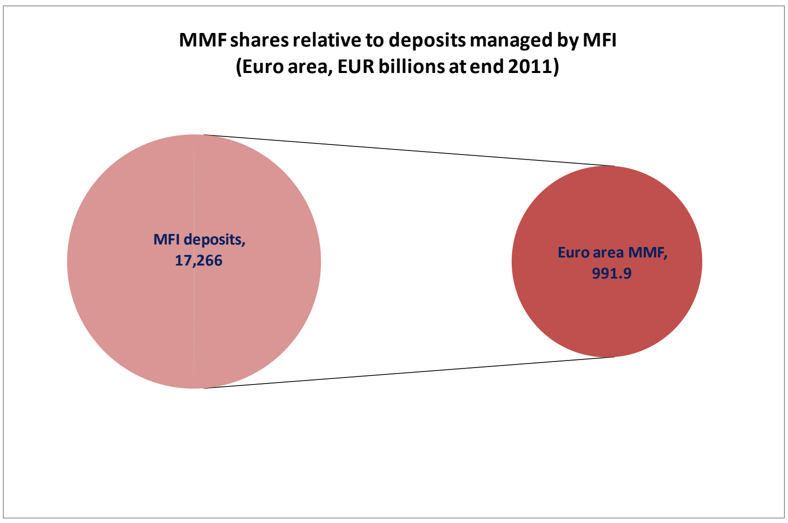
In **2010-2011**, investors reduced significantly their holdings of MMFs, mainly because of the competition from banks, particularly in Continental Europe, which have actively encouraged their clients to reallocate their portfolios out of MMFs to deposits to strengthen their balance sheets. The steepening of the yield curve, with money market yields moving to unprecedented lows, also had an impact on the attractiveness of MMFs as an investment vehicle. There is no evidence, however, that investors redeemed pre-emptively from their funds to be on the side of caution. What is certain is that MMFs were able to cope with the withdrawals without being forced to sell securities at fire-sale prices.

The role of MMFs in the short term funding market should not be overestimated

We agree that MMFs are important providers of short-term funding to financial institutions, businesses and governments. However, the importance of this role and of the risks associated with the link of MMFs to the short-term markets should not be overestimated as MMFs have not reached a systemic size in Europe.

Monetary data from the European Central Bank (ECB) show that MMFs' balance sheets represent only 4% of the balance sheets of Monetary Financial Institutions (MFIs) in the euro area, with credit institutions (banks) accounting for the remaining 96%. This statistic confirms that bank deposits are the principle vehicle used by retail investors in Europe to manage their cash and MMFs are playing a very modest role in credit intermediation in Europe. This is largely due to the fact that European financial system is bank-dominated.

Furthermore, as noted in our response to Question 3, the ECB data also show that MMFs hold a very limited share of the debt securities issued by euro area non-financial sectors and credit institutions.



MMFs are entities that are not exposed to a similar level of risks as banks

The liquidity transformation performed by MMFs is an order of magnitude significantly less than that performed by banks, and is subject to tight controls.

Under "normal" market conditions a MMF has daily liquidity, as do the short-term debt instruments the fund invests into. As such, no liquidity transformation takes place and no liquidity mismatch occurs. It is worth noting that this is also true for a MMF with daily liquidity even where its duration exceeds one day because the underlying securities have daily liquidity as well. Only if the securities the fund is invested into no longer have daily liquidity, for example due to an abnormal market situation, and the fund maintains its daily liquidity to its investors (especially to those redeeming shares), is there a liquidity mismatch. Such a case can be addressed by liquidity risk management (as already established under UCITS IV) and where the situation does not improve, by a (temporary) suspension of redemption (equally possible under UCITS).

The asset/liability maturity mismatch of MMFs is very limited and the credit quality of their portfolio is high. MMFs do not make loans but instead invest only in very short-term, high quality, marketable debt instruments.

MMFs are highly-regulated institutions

The vast majority of MMFs are **UCITS**. This means that their managers must, amongst other things, employ a risk management process that enables them to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.[18] For a MMF, this includes a prudent approach to the management of currency, credit, interest rate and liquidity risk, and a proactive stress-testing regime. In addition, managers of MMFs must have appropriate expertise and experience in managing these types of funds.

It should also be noted that **the implementation of the new CESR/ESMA guidelines**, which took effect in July 2011, represents a major and decisive step towards greater transparency and increased clarity. The guidelines crystallize the two-tier approach EFAMA suggested in its initial joint proposal with IMMFA, by creating two MMF subcategories: "short-term MMFs" and "MMFs". They also provide a robust framework to limit the main risks to which MMFs are exposed, i.e. interest rate risk, credit/credit spread risk and liquidity risk.

Among other things, the reduction in the weighted average maturity (to no more than 60 days for Short-term MMFs and 6 months for MMFs) limits the overall sensitivity of the funds' NAV to changing interest rates, and the reduction of the weighted average life (to no more than 120 days for Short-Term MMFs and no more than 1 year for MMFs) limits credit and credit spread risk. Overall, the requirement to invest in high quality money market instruments

[18] See Article 51 of the UCITS Directive.

reduces credit risks. **In practice, the requirements from the CESR/ESMA guidelines and the UCITS Directive oblige MMF managers to keep high-quality and liquid portfolios to avoid running into liquidity difficulties.**

According to the European Central Bank, the change in the definition brought about by the CESR/ESMA guidelines had a significant impact on the size of the MMF industry. In particular, in Ireland and Luxembourg, the redefined MMF industry was approximately 28% and 22% smaller respectively in terms of the total net asset value. The overall impact of changes to the reporting population in the euro area amounted to a reduction of EUR 193.7 billion (18%) of the MMF sector's total net asset value since July 2001.[19]

The **CESR/ESMA guidelines** also require managers of MMFs to draw investors' attention to the difference between the MMF and investment in a bank deposit. Enhancing investor awareness about the exact nature of MMFs will strengthen MMFs' resilience in crises.

Against this background, all EFAMA members believe that the recently reinforced regulatory framework provides a sound base for limiting the MMFs' susceptibility to runs or other systemic risks. This point is documented in the next table.

[19] See ECB Monthly Bulletin April 2012.

Susceptibility of European MMFs to Key Systemic and Run Risks Assessment of the Existing Regulatory Framework as a Line of Defense against these Risks	
Key Systemic Risk Factors[20]	**Existing Regulatory Framework**
Maturity transformation	The **CESR/ESMA guidelines** on the MMF portfolio WAM and WAL restrict very much the degree of maturity divergence between the MMF assets and liabilities.
Credit risk transfer	The **Basel II** enhancement of July 2009 provides a proper framework to address reputational risk/implicit support provided by banks to MMFs.
Leverage	The **UCITS Directive** ensures that MMFs operate with little if any leverage.
Liquidity transformation	The **CESR/ESMA guidelines** and the **UCITS Directive** ensure that MMFs invest in high-quality, liquid assets and employ a conservative risk management process and a proactive stress-testing regime.
Key Run Risk Factors[21]	**Existing Regulatory Framework**
Liquidity shock & credit event/deterioration	The global efforts toward financial reform undertaken by the **G-20/FSB** and the provision of funding liquidity and market liquidity by **central banks** constitute major steps to address some of the most important financial instability problems.
1st mover advantage	The **UCITS** criterion that MMFs must calculate their NAV to reflect the market value of their investment portfolios should prevent MMF investors from redeeming without paying the increased cost of liquidity.
Risk aversion of the investor base & flight to safer assets	The CESR/ESMA guidelines have created a high-quality MMF brand that ensures that the risks associated with MMFs are as low as the risk aversion of the investor base, and lower than the risk associated with other investment vehicles.
Uncertainty regarding availability of sponsor support	MMFs are investment funds which are not providing any capital guarantee. Therefore investors should not count on any sponsors to bail them out.

[20] Source: FSB report of 27 October 2011, p. 10-11.
[21] Source: IOSCO Document for Discussion in preparation of Industry hearing of 20 January 2012.

(6) Do you see a need for more detailed and harmonised regulation on MMFs at the EU level? If yes, should it be part of the UCITS Directive, of the AIFM Directive, of both Directives or a separate and self-standing instrument? Do you believe that EU rules on MMF should apply to all funds that are marketed as MMF or fall within the European Central Bank's definition?

EFAMA considers that it would be best to stay away from a new self-standing piece of legislation to avoid the propagation of a large number of separate directives covering different segments of the investment fund industry. Therefore, new rules on MMFs should be accommodated within the UCITS Directive, under a new section This section could start by establishing a common definition of European money market funds, whilst leaving it to ESMA to develop technical standards using the current CESR/ESMA guidelines as a reference point..

However, in order to ensure that the new rules also apply to non-UCITS MMFs to ensure the quality of the “Money Market” brand, a new paragraph should be added within the AIFMD to require that the new rules on MMFs introduced in the UCITS regulation and the ESMA technical standards also apply to all MMFs that are not UCITS.

We would like also to draw the Commission’s attention to the fact that, after a transitional period that ended on 31 January 2012, the ECB definition of MMFs (for euro area statistical purposes) has been brought into line with the criteria applied for supervisory purposes under the CESR/ESMA[22].

The EU rules on MMF should apply to all funds that are marketed as MMF. No fund should be allowed to use the “MMF” label if it does not comply with all the EU rules on MMFs.

(7) Should a new framework distinguish between different types of MMFs, e.g.: maturity (short term MMF vs. MMF as in CESR guidelines) or asset type? Should other definitions and distinctions be included?

EFAMA is in favour of maintaining a two-tier approach based on “short-term MMFs” and “MMFs” as defined by the CESR/ESMA guidelines in 2010. The main advantage of a two-tier system would be to leave the choice which is very appreciated by investors

[22] As per ECB Press Release: http://www.ecb.int/press/pdf/if/ofi_201201.pdf.

7.1 Valuation and Capital
Box 7

(1) What factors do investors consider when they make a choice between CNAV and VNAV? Do some specific investment criteria or restrictions exist regarding both versions? Please develop.

CNAV and VNAV MMFs have been offered in parallel in Europe for many years. Many investors find it convenient and efficient to diversify their assets in CNAV MMFs for tax reasons and because the variability in the price of a VNAV complicates their cash-flow planning. It should also be noted that in some countries the availability of CNAV MMFs provide investors with the same tax and accounting treatment that would apply if they invested directly in their own cash management portfolios and thus reduces the administration costs for investors, providing ease as the return is qualified as "income" and not "capital gain".

Regarding the investment criteria and restrictions, we support the approach taken in the CESR/ESMA guidelines whereby short-term MMFs can be CNAV or VNAV, whereas MMFs can only be VNAV.

It should also be stressed that CNAV funds apply amortised accounting to instruments with less than 397 days residual maturity. The use of amortised accounting to calculate their net asset value is in line with the CESR's guidelines concerning eligible assets for investment in UCITS. CNAV funds must ensure that the amortization method does not result in a "material discrepancy" between the value of the money market instrument and the value calculated according to the amortization method. In practice, a material discrepancy is assessed by comparing the amortised price of the portfolio with an alternative estimate of its market price.

That alternative estimate comprises actual market prices where they are available, and model prices where they are not - for example, prices modeled off of an issuer's interest rate curve. That alternative estimate of the market price is called the "shadow price".
On the other hand, the net asset value of VNAV MMFs is valued based on the most current market valuation. In general, only when market prices are not available at the very short end of the yield curve, VNAV MMFs are entitled to apply amortised accounting – instrument by instrument – solely to negotiable debt instruments with less than three months residual maturity that have no specific sensitivity to market parameters.

(2) Should CNAV MMFs be subject to additional regulation, their activities reduced or even phased out? What would the consequences of such a measure be for all stakeholders involved and how could a phase-out be implemented while avoiding disruptions in the supply of MMF?

Today MMFs are sold as a "risk mitigating" tool for short term placements. A phasing out of CNAV MMFs would mean to clients a lower risk diversification and the requirement to build up significant own risk management resources. From a regulatory point of view this would mean an increase of systemic risk in the banking sector.

The reform of MMFs should focus on the fund's internal liquidity risk, including by requiring money market funds to adhere to certain liquidity requirements (such as by stipulating that a minimum amount of a fund's portfolio should mature within one day and within five business days) and to take into account investor concentration and segments, industry sectors and instruments, and market liquidity positions.

We believe that it would normally be inappropriate to disincentivise redemptions from MMFs (or any other investment fund) – after all, investors are entitled to redeem from a MMF if they have legitimate concerns about the creditworthiness of one of its underlying issuers. However, we recognize that high levels of redemptions from a CNAV MMF during a financial crisis can, in a self-fulfilling fashion and in extremis, cause redeeming investors to disadvantage remaining investors. On that basis, we cautiously recommend that the European Commission should investigate the viability and consequences of empowering CNAV MMF boards to impose a trigger-based liquidity fee on redemptions.

(3) Would you consider imposing capital buffers on CNAV funds as appropriate? What are the relevant types of buffers: shareholder funded, sponsor funded or other types? What would be the appropriate size of such buffers in order to absorb first losses? For each type of the buffer, what would be the benefits and costs of such a measure for all stakeholders involved?

We have strong reservations against the proposal that CNAV funds should accumulate capital requirements or buffers as this policy approach would destabilize very much the business model of MMFs, especially in a situation like today, where money market rates are at historically low levels. In addition, the design and implementation of capital buffers on CNAV funds would give rise to numerous questions which will be difficult to answer, including the potential size of the buffer, whether it is high enough and to whom it actually belongs when investors redeem shares.

MMFs need to be fully transparent and easy to be explained to investors. Complex features relating to buffers would confuse the investment community.

In addition, we would like to make the following more specific comments:

- "Shareholder-funded" buffers: Shareholder-funded NAV buffers funded by retained earnings: the cost would be borne by first generation investors to the benefit of later generation investors. This is not consistent with the basic principles of securities regulation. Shareholder-funded NAV buffer funded by capital shares: we do not believe investors would invest in CNAV MMFs if they were required to make a parallel investment in riskier subordinated shares/capital securities. It defeats the purpose of their investment, i.e. to manage credit risk through diversification.

- "Sponsor-funded" buffers: Subordinated shares funded by sponsors or sponsor-funded NAV buffer are options which would result in a two-tier MMF industry, i.e. a top-tier comprising sponsors who have easy access to capital, and a bottom-tier comprising sponsors who do not have easy access to capital. In the end, these options would cause sponsors of bottom-tier CNAV MMFs to lose market share to sponsors of top-tier CNAV MMFs. More importantly, if sponsors are requested to provide the capital, this would exacerbate investors' perception that CNAV MMFs sponsors are "obliged" to stand behind their funds. There is no reason to apply this solution to CNAV funds to the extent that they are investment products which might lose value.

Overall, EFAMA considers that this is not the right approach to strengthen the resilience of CNAV funds to stressed market conditions. The reform should be going in the opposite direction in order to:

- enhance investor expectations that MMFs are not impervious to losses;
- prevent moral hazard by encouraging investors to search for the best MMF; and
- encourage MMF sponsors to apply prudent risk management to avoid losing clients.

(4) Should valuation methodologies other than mark-to-market be allowed in stressed market conditions? What are the relevant criteria to define "stressed market conditions"? What are your current policies to deal with such situations?

As many money market instruments, for example commercial paper and certificates of deposit, are LIBOR-referenced but difficult to price because the market trades OTC or when market prices are not available at the very short end of the yield curve, it is important to allow MMFs to continue applying amortized accounting to a certain extent, subject to certain tests.

7.2 Liquidity and redemptions
Box 8

(1) Do you think that the current regulatory framework for UCITS investing in money market instruments is sufficient to prevent liquidity bottlenecks such as those that have arisen during the recent financial crisis? If not, what solutions would you propose?

As explained above, given that the vast majority of MMFs are UCITS, their managers must, amongst other things, employ a risk management process that enables them to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.

Having said this, the crisis has highlighted the importance of a uniform European definition of MMFs based on defensive portfolio strategies and liquidity risk management system for being prepared for a long-lasting liquidity shock. The CESR/ESMA guidelines have rightly addressed this concern on a pan-European basis.

Hence, at this stage, the reform of MMFs should focus on the fund's internal liquidity risk, by requiring MMFs to adhere to certain liquidity requirements (as explained further below) and to take into account investor concentration and segments, industry sectors and instruments, and market liquidity positions.

(2) Do you think that imposing a liquidity fee on those investors that redeem first would be an effective solution? How should such a mechanism work? What, if any, would be the consequences, including in terms of investors' confidence?

EFAMA believes that effective liquidity requirements and 'know your client' rules are sufficient to mitigate the risk of run. However should more be required, we believe the option of imposing a liquidity fee should be an approach available to the board or manager of **CNAV MMFs**, as appropriate.

If the board or manager determines that exceptional market conditions exist, it could introduce a liquidity fee, with the understanding that

- Liquidity fees would not be needed in normal market conditions.
- Liquidity fees impose a real cost on redeeming rather than providing a mild incentive to stay, as could capital requirements.
- Liquidity fees are not intended to prevent investors from redeeming for everyday business purposes, but to discourage exceptional redemptions that would harm remaining fund investors.

Liquidity fees need not apply to **VNAV MMFs** as they are valued on market prices. They also have the option to move to bid pricing in stressed markets in order to protect non-redeeming investors.

(3) Different redemption restrictions may be envisaged: limits on share repurchases, redemption in kind, retention scenarios etc. Do you think that they represent viable solutions? How should they work concretely (length and proportion of assets concerned) and what would be the consequences, including in terms of investors' confidence?

Whilst we consider that creating a requirement to distribute large redemptions in kind would create certain benefits, especially by forcing redeeming shareholders to bear their own liquidity risks, there are serious drawbacks of creating a requirement to distribute large redemptions in kind.

Additionally, due to valuation, operational, and jurisdictional issues we do not see how redemption in-kind could grant an equal treatment among all shareholders, including all redeeming and remaining shareholders of the fund alike.

We would also like to highlight the following drawbacks:

- Difficulty to divide fund asset into very small positions. Small pieces cannot be traded and investors would be reluctant to receive unsellable instrument.
- In case of low liquidity, the valuation of assets could be complicated; the redemption conditions would therefore be difficult to determine and very easily opposed by investors.
- If instead of receiving cash, redeeming investors would receive securities, they would seek to sell them in order to receive cash. This will lead to a decline in the market price of these securities as described above. As such, whilst redemption in-kind is a (inefficient) way to internalize transaction costs, it is not a solution to prevent market prices from falling. Redemption in-kind is inefficient not only because of the lot size problem but also because small investors typically get even less favourable bid-ask spreads (due to small transaction sizes) compared to fund managers when selling. In addition, transactions in-kind are also an operative hassle for the fund administrator and the broker settling the securities and hence will not come for free.

Against this background, and considering that it is unclear that redemption in-kind would reduce the risk of a run to redeem shares, we consider that the potential benefits of generalizing redemption in-kind mechanisms would be very small compared to the difficulties and drawbacks of such measures.

It should also be noted that the **UCITS Directive**[23] establishes that national supervisors should be empowered to suspend the redemption of units or shares, provided that such suspension is justified for the protection of the unit-holders.

(4) Do you consider that adding liquidity constraints (overnight and weekly maturing securities) would be useful?
How should such a mechanism work and what would be the proposed proportion of the assets that would have to comply with these constraints?
What would be the consequences, including in terms of investors' confidence?

We agree that MMFs should hold a certain percentage of their assets in cash or securities accessible very quickly, to be able to meet redemptions without incurring losses that could affect the remaining shareholders. Against this background, the introduction of mandatory portfolio liquidity requirements, i.e. minimum holdings of assets held in assets that would be accessible within one day and within one week, could be envisaged.

Still, we also acknowledge some challenges/drawbacks of imposing minimum liquidity requirements:

- Minimum liquidity requirements would force MMFs to shorten their investments or buy a higher percentage of government securities at the expense of banking or corporate commercial papers. This would limit the access to money markets for a lot of issuers and, in the end, reduce the MMF industry size.
- Regulators would have to address how to define "liquid" assets, in close consultation with the industry.
- It should also be clear that the regulatory requirements would apply only when a security is purchased. A temporary difference should be acceptable if the liquidity position is used to meet a redemption that causes the fund liquid assets to fall below the liquidity ratios. There should not be any (global) liquidity restrictions for liquid or illiquid assets.
- The usefulness of minimum liquidity requirements should not be over-estimated, as the liquidity of short-term debt securities may change strongly over short periods of time. From this perspective, sound liquidity risk management might be a superior approach to manage liquidity.

(5) Do you think that the 3 options (liquidity fees, redemption restrictions and liquidity constraints) are mutually exclusive or could be adopted together?

EFAMA believes that liquidity fees should be enforced only for CNAVs, being introduced, in principle, during distressed market conditions so as to reflect the increased cost of liquidity.

[23] Article 45, paragraph 2 of the UCITS Directive.

Redemption restrictions are already covered by the UCITS Directive whereas liquidity constraints should be imposed to both CNAV and VNAV funds, as stated above.

(6) If you are a MMF manager, what is the weighted average maturity (WAM) and weighted average life (WAL) of the MMF you manage? What should be the appropriate limits on WAM and WAL?

EFAMA believes that **CESR/ESMA guidelines** provide a robust framework to limit the main risks to which MMFs are exposed, i.e., interest rate risk, credit/credit spread risk and liquidity risk. Specifically, the WAM is limited to no more than 60 days for short-term MMFs and 6 months for MMFs, which constrains the overall sensitivity of the funds' NAV to changing interest rates. And the WAL is limited to no more than 120 days for short-term MMFs and no more than 1 year for MMFs, which constrains credit and credit spread risk.

7.3 Investment criteria and rating
Box 9

(1) Do you think that the definition of money market instruments (Article 2(1)(o) of the UCITS Directive and its clarification in Commission Directive 2007/16/EC16) should be reviewed? What changes would you consider?

We believe that the approach taken by CESR regarding the eligible money market instruments includes sufficient restrictions to protect the interests of investors.

(2) Should it be still possible for MMFs to be rated?
What would be the consequences of a ban for all stakeholders involved?

MMFs AAA-ratings may be important to some clients in some countries who invest in AAA-rated CNAV funds. External ratings provide an external validation that the portfolio of the fund satisfies a series of independent criteria in order to qualify for the rating. This was particularly important when there was no pan-European regulatory definition of a MMF.

Notwithstanding the fact that there are investors who value MMF ratings, there are concerns with the way the rating agencies have performed in recent years; their credibility has undoubtedly been affected. It would therefore appear appropriate to review the methodology employed by credit rating agencies and their reliability with a view to identify and correct weaknesses.

For instance, the rating of bonds bears little forecasting capability, as a couple of defaults happened without the rating agencies being able to issue early enough warnings of the deterioration in credit. With this in mind, it is not realistic to expect that a rating of MMFs offers any additional information value to investors.

(3) What would be the consequences of prohibiting investment criteria related to credit ratings?

We fully support the recent European Commission's proposals[24] that aim at reducing the risks of over-reliance of fund managers on credit ratings and introduce a requirement for the managers not to rely solely or mechanistically on external credit ratings for assessing the creditworthiness of a fund's assets.

External credit ratings may be used as one factor among others in this process but should not prevail.

In this context, we strongly believe that the use of credit rating agencies to determine whether or not a MMF may invest in a money market instrument should also be reconsidered, as the significance of ratings of credit rating agencies in CESR's guidelines on MMF is overstated.

What matters is that management companies employ a risk-management process which enables them to monitor and assess the credit quality of the money market instruments they invest in, within a framework that should not be limited *a priori* by the rating of credit rating agencies. In other words, the responsibility of the assessment of the quality of a money market instrument should lie with the management company. In carrying out its due diligence, the management company should be able to overwrite the credit rating of an instrument if it can conclude that the instrument is of high quality, taken into account a range of factors such as the liquidity profile and the nature of the asset class represented by the instrument.

Against this background, we have proposed that ESMA deletes paragraph 4 in Box 2 and paragraph 1 in Box 3 of the CESR´s guidelines, which stipulate that a money market instrument is not of high quality if it has not been awarded one of the two highest available short-term credit ratings by each recognized credit rating agency that has rated the instrument.

This decision would also allow another major problem raised by the guidelines and the ESMA Q&A to be addressed, in relation to the requirement that the MMF management company must check the short-term credit ratings awarded by each recognized rating agency that has rated an instrument to determine if the instrument is of high quality. As there are already 28 credit rating agencies registered with ESMA – a number that is likely to increase in the future - we strongly believe that this is unworkable for compliance and economic reasons.

[24] See proposal for a Directive of the European Parliament and of the council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings and proposal for a regulation amending Regulation (EC) No 1060/2009 on credit rating agencies.

Finally, we would also draw attention to an additional problem raised by ratings, which concerns the lack of flexibility of the rating agencies in the case of an issuer's downgrade and its procyclical herding behavior, particularly on the downside.

(4) MMFs are deemed to invest in high quality assets. What would be the criteria needed for a proper internal assessment? Please give details as regards investment type, maturity, liquidity, type of issuers, yield etc.

Many factors can be used internally to assess the quality of an issuer or a specific paper:

- fundamentals: regulatory and economic environment, management and corporate strategy, balance sheet dynamics, earnings previsions….
- technicals: supply/demand, Central Bank eligibility, Commercial Paper program size, back up lines, public issue/private placement, FRN/asset swaps…
- relative value: sector peers, similar maturities, instrument type comparison…

Reply to questions in Box 10 – Long-Term Investments

General remarks

As a preliminary remark, we note that the term "long-term investments" is used by the Commission in different contexts and with different meanings, including investing over the long-term, long-term financing and investing in less liquid or illiquid assets. In this Consultation Paper we understand that the Commission is actually using the term "long-term investments" as a synonym for "investments in long-term, i.e. illiquid or less liquid, assets" such as infrastructure projects, real estate or non-listed companies.

By doing so, one should however avoid creating the wrong perception that long-term savings' needs of retail investors can be served, or will be better served, only through investments in "long-term assets". It is crucial to recognize that investment in very liquid assets can also be specifically dedicated to long-term goals and thus conducted for long-term investment horizons. As an illustration of this, we strongly believe that UCITS, despite the fact that they are allowed to invest only in liquid assets, are actually very suitable products for investors with a long-term horizon (the same goes for most fund related pension funds in Europe whose investment strategies involve investments in liquid financial instruments).

Having said that, we are very much in favor of long term investments in Europe supporting infrastructure and social development and contributing to the growth of the economy, and believe that the asset management industry has a key role to play in channeling retail investors' money towards such financing, with a view also to better serve the long-term savings needs of those investors. **We therefore welcome the Commission's proposal to work towards the development of an appropriate EU framework for retail investment funds investing in long-term assets and we stand ready to bring our contribution to that analysis**.

In our view, in order to be successful, a framework for retail investment funds investing in long-term assets should be developed starting from the perspective of the investors' needs and expectation, notably in terms of product design (please refer also to our answer to Box 10, question 1 below). In order to take full advantage of the EU Internal Market, this framework should comprise an EU retail passport for all such funds.

In this context, we also believe it is important to underline the essential role that the asset management industry is already playing today in channeling (retail) investors' money towards the financing of the real economy. Indeed, by providing equity capital in both primary (IPOs and private placements) and secondary markets, as well as credit capital – directly via corporate bonds or indirectly via money markets – asset managers are fueling the real economy, helping corporations, banks and government agencies to meet their short-term funding needs but also their long-term capital requirements. By contributing to very high levels of activity and turnover in the secondary markets, they also contribute to the determination of the price of the securities reflecting all relevant information. Put differently, if asset managers were not contributing to the supply of funds in financial markets as much as they do today, firms would borrow in less favourable conditions. This would lead to higher cost of capital, lower levels of investment and poorer long-term growth performance.

(1) What options do retail investors currently have when wishing to invest in long-term assets? Do retail investors have an appetite for long-term investments? Do fund managers have an appetite for developing funds that enable retail investors to make long-term investments?

We do believe that there is an appetite, in particular from wealthier/more sophisticated retail investors, to invest in long-term assets such as real-estate and commodities as a way for them to diversify their portfolio and, in particular in the current turbulent market conditions, to gain exposure to new asset classes that are less correlated to financial markets. This appetite is illustrated, for instance, by the popularity among retail investors for open-ended real estate funds.

As the Commission rightly notes in the Consultation Paper, investing in illiquid assets also implies a number of constraints in the sense that such products usually require a certain level of minimum initial and ongoing subscriptions, long lock-in periods due to the investment types, low liquidity and challenges with valuation, meaning that it is not necessarily a suitable investment for retail investors with very modest sums to invest (this is certainly the case for "project financing" which is a very specialist area).

Another element to be taken into consideration is that the appetite of retail investors to invest in long-term assets is largely dependent on the sufficient attractiveness of the applicable product design. As an illustration of this, the experience of our members shows that retail investors are usually not interested in investments that provide no exit possibilities for several years unless they obtain significant advantages in return (such as associated tax benefits, state allowances or the inclusion in some form of pension savings schemes, for instance).

From a fund manager's perspective, there certainly is an appetite to develop funds that enable retail investors to seek long-term outcomes in pursuit of their individual goals. Fund managers do have an appetite to invest in long-term assets in the interest of retail investors, as part of a well-diversified and risk-reward adjusted investment portfolio.

(2) Do you see a need to create a common framework dedicated to long-term investments for retail investors? Would targeted modifications of UCITS rules or a stand-alone initiative be more appropriate?

As already mentioned in our general remarks above, we would welcome the creation of a common EU framework dedicated to investment funds investing in less liquid assets, which would include an EU passport.

Generally speaking, we advocate against an inflation of new directives or regulation covering investment funds and would have a strong preference for having as many products as possible covered by the already existing directives (i.e. UCITS and AIFMD).

Bearing in mind the objectives that the Commission seeks to achieve, we believe that these long-term retail investments do not fit into the AIFMD framework, as it is primarily designed for institutional investors (and does not provide for an EU retail passport) and also because it is not conceived as a product regulation. Furthermore, because of the "all-encompassing" approach of the AIFMD, retail funds investing in tangible assets are currently classified as AIFs and subject to many requirements which do not take into account their existing product regulation at national level (in particular, these funds are subject to extensive reporting obligations under Article 24 of the AIFMD that are entirely inappropriate in the context of unleveraged regulated retail investment funds, such as real-estate funds).

This being said, there are different strategic arguments to take into account when considering whether this new framework should be developed as a new category of funds within the existing UCITS framework or if it would be more appropriate to develop a new stand-alone framework specifically dedicated to retail investment funds investing in long-term assets. This is indeed a complex issue which would probably require further analysis, given that each option has a number of advantages and drawbacks and there does not seem to be a 'perfect solution'.

In principle, the UCITS Directive as it currently stands does not provide the best environment to accommodate such type of investments. Providing a suitable legal framework for investments in less liquid assets would actually require modifying many existing UCITS provisions and adding rules within a new distinct Chapter to the UCITS Directive (notably in terms of eligible assets, borrowing powers and redemption requirements). There is a risk to create confusion among retail investors and endanger the UCITS brand which is recognized as a quality label by regulators and investors worldwide. Accordingly, a new EU framework, including also a new name/brand for those funds (such as non-UCITS retail funds or longer-term funds (LTF) for instance), represents a valid option to establish new rules for retail investments in long-term assets.

Alternatively, the introduction of a new, distinct chapter to the UCITS Directive would also have its advantages. The new chapter would take into account the specificities of LTFs by replacing only as necessary those UCITS rules that do not fit with other types of assets (eligible assets, borrowing powers and redemption requirements) and by otherwise deferring as much as possible to the UCITS rules on e.g. governance, organization, depositary duties and obligations, etc. This approach would ensure that LTFs benefit from many of the well recognized UCITS rules and would provide an efficient way to achieve cross-border LTF distribution to the retail market. This would also allow Member States to transpose the new EU LTF regime into already existing national law, without being forced to start from scratch. Should this option be selected, we would strongly recommend giving a name for these funds (such as LTFs) in order to establish these funds as a very distinct investment product within the UCITS framework and point to their specific features notably in terms of liquidity.

Whether they are in favor of developing a standalone framework or a new category of funds within the UCITS environment, EFAMA members concur in considering that this new framework should be framed alongside the investor protection principles of the UCITS Directive while taking into account the specificities of investments in real or other illiquid assets, and should facilitate EU-wide marketing (via an EU passport) and management of this new fund type (please refer also to our answer to question 9 below).

Lastly, we believe that these funds should explicitly be carved out from the AIFMD: they would not be AIF and marketing to retail investors would not happen under Article 43 of the AIFMD but under the new regime specifically developed for them. For closed-ended funds falling under the new category of funds, it will also be important to ensure appropriate alignment with the Prospectus Directive to avoid conflicting marketing and distribution rules.

(3) Do you agree with the above list of possible eligible assets? What other type of asset should be included? Please provide definitions and characteristics for each type of asset.

Generally speaking, we agree with the list of possible eligible assets suggested by the Commission although it would probably require some clarifications/further refinements (e.g. the inclusion of "unlisted companies" as an eligible investment potentially results in almost any types of holdings through a company possible).

In this context, we also believe that it is very important to ensure sufficient flexibility in the determination of the eligible assets in order to react swiftly to potential new financing needs of the real economy. We would therefore recommend following the UCITS approach, whereby only broad categories of eligible assets are defined in the level 1 Directive, subsequent details being provided through technical standards to be developed by ESMA.

Furthermore, investments in liquid assets such as financial instruments or bank deposits should be possible in order to allow for proper liquidity management

(4) Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced?

We understand the reference to a "secondary market for the assets" to be related to the need to provide investors in longer-term investment funds with redemption opportunities.

Given the fact that a retail investor's personal situation and/or financial position may change over time due to unforeseen circumstances, requiring the disposal of certain financial in short order, it may be appropriate to build in some form of extraordinary early redemption facility for such investors.

In order to increase the attractiveness of such products to retail investors, we would also recommend permitting at least semi-open funds structures enabling investors to redeem their units at regular intervals. Such funds already exist in a number of Member States and meet investors' needs.

(5) What proportion of a fund's portfolio do you think should be dedicated to such assets? What would be the possible impacts?

We believe it is impossible to give a single answer to this question.

In practice, the proportion of a portfolio allocated to longer-term or less liquid investments would depend upon the fund's investment objectives and the liquidity that it offers to its retail investors. The closer the objective and the more liquid the terms offered to shareholders, the lower the allocation to longer-term or less liquid investments.

It is conceivable that some funds would allocate the greatest part of their portfolios to such assets but they would then probably be funds specializing in longer-term assets rather than funds specialising in longer-term investor outcomes (in which case they would present specific risks and might be lest suitable to the needs of retail investors).

In other words, we believe the proportion of long-term assets in the portfolio should be aligned with the product structure in line with the principle enshrined by Article 16(2) AIFMD. Accordingly, entirely closed-ended funds investment in illiquid assets could account for up to 100% of the portfolio. Semi-open ended funds, on the other hand, will require a certain proportion of more liquid assets in order to maintain their capability of redeeming fund units at certain intervals or to deal with extraordinary early redemptions as referred to in our answer to question 4 above.

(6) What kind of diversification rules might be needed to avoid excessive concentration risks and ensure adequate liquidity? Please give indicative figures with possible impacts.

As a general rule, diversification is an essential feature of fund investments and is of particular relevance in the case of open-ended funds.

In relation to closed-ended funds, it could be envisaged to allow products focusing on single investments such as a specific infrastructure or energy projects with high financing needs. In that case, however, additional safeguards should apply at the distribution level in order to ensure appropriate investor protection. Such safeguards could comprise a general requirement for investment advice with strict suitability standards or particular conditions for qualification of investors (including minimum investment amounts).

(7) Should the use of leverage or financial derivative instruments be banned? If not, what specific constraints on their use might be considered?

The use of financial derivatives instruments in longer-term investment funds should not be banned, considering that these instruments may be very useful to mitigate certain investment risks, such as currency risks for instance, in the best interest of investors.

Similarly, those funds should also be allowed to make borrowings. Indeed, investment funds investing in real assets such as real estate, infrastructure, energy plants etc. cannot operate without external financing. Modern infrastructure projects generally feature high funding needs, which cannot be efficiently covered by the supply of investor capital, especially in the early development stage. Nonetheless, with a view to ensuring retail investor protection, borrowings should be limited to a percentage of the fund's assets.

(8) Should a minimum lock-up period or other restrictions on exits be allowed? How might such measures be practically implemented?

In order to ensure the most efficient functioning of longer-term or less liquid investments in the best interest of all the shareholders, it may be sensible to allow a prescribed minimum

investment period prior to allowing redemptions and also generally to allow redemptions to be limited on an ongoing basis. On the other hand, UCITS managers should also be given the ability to continuously issue fund units in the initial phase of the new product, so as to smoothly gather the capital necessary to build up a fund portfolio.
As already mentioned in our answer to question 4 above, it would be required to define certain parameters around allowable circumstances which may allow earlier redemption by an investor, without unduly negatively impacting the other investors and also allowing the fund manager to efficiently carry out the investment mandate to the best of its ability.

(9) To ensure high standards of investor protection, should parts of the UCITS framework be used, e.g. management company rules or depositary requirements? What other parts of the UCITS framework are deemed necessary?

Yes, as already mentioned in our answer to question 2, we believe that an EU framework for longer-term investment funds should be framed alongside the investor protection principles of the UCITS directive, while taking into account the specificities of investments in real or other illiquid assets, and should facilitate EU-wide marketing (via an EU passport) and management of this new fund type.

The UCITS framework contains, inter alia, provisions relating to risk management, liquidity management, organizational rules and internal audit requirements that are fit for purpose. Also inherent is that UCITS must maintain ongoing risk management procedures and continued evolutions of requirements in relation to stress tests, back-testing systems, reporting to competent authorities and disclosure of information to investors through the KIID, prospectus and periodic reports.

Additionally, we also believe that the benefits of UCITS governance concepts, such as the management company and the depositary, would also be important building blocks to develop a framework dedicated to funds investing in longer-term assets.

(10) Regarding social investments only, would you support the possibility for UCITS funds to invest in units of EuSEF? If so, under what conditions and limits?

In order to facilitate fund-of-funds structures providing enhanced diversification to retail investors, we would see benefits in allowing funds established under the new framework to hold units of target funds investing in unlisted companies or other longer-term or less liquid assets, including EuSEF and EVCF.

Reply to questions in Box 11 – UCITS IV improvements and alignment with AIFMD

(1) Do you think the identified areas (points 1 to 4) require further consideration and that options should be developed for amending the respective provisions? Please provide an answer on each separate topic with the possible costs/benefits of changes for each, considering the impact for all stakeholders involved.

We welcome the fact that the Commission takes the opportunity of this Consultation to consider a number of improvements to the UCITS IV legal framework. Subject to the detailed comments below, we fully agree that the areas identified by the Commission would indeed require further regulatory action, notably in order to facilitate the use of some of the efficiency measures adopted under UCITS IV and maximize their benefits for investors.

We also wish to draw again attention to the letter EFAMA sent to the Commission Services on 16 January 2012, which contained a number of further recommendations aiming also at ensuring the effectiveness of some of the key measures adopted under UCITS IV. We reiterate below the recommendations contained in that letter and provide additional information as to the cost-benefit analysis of some of the amendments we recommend to the UCITS IV Directive.

We strongly believe that these technical recommendations would be relatively easy to implement and would significantly help in achieving the objectives of the UCITS IV directive, without diminishing in any manner the high level of protection enjoyed by UCITS investors.

Self-managed investment companies

A large majority of EFAMA members agree with the Commission's proposal to empower the Commission to adopt Level 2 measures specifying the administrative procedures and internal control mechanisms that should apply to self-managed investment companies, similar to those already foreseen under Article 12 of the UCITS Directive for UCITS Management Company.

Master-feeder structures

We have no objection to the Commission's proposal to extend the same information standards to the third scenario identified by the Commission in its consultation paper. We agree that the conversion from a feeder UCITS to a ordinary UCITS represents a significant change in investment strategy and therefore similar information to that set out in Article 64 of the UCITS Directive ought, *mutatis mutandis*, to be provided to the investor in this scenario.

More importantly, however, we strongly recommend amending as follows the so-called "10%-rule" under Article 50(1)(e)(iv) of Directive 2009/65/EC. In practice, **this rule is seriously hampering the development of master-feeder arrangements, with the consequent lack of realisation of economies of scale (and, hence, benefits to consumers) which UCITS IV was meant to deliver**.

Indeed, In accordance with that provision, UCITS ("investing UCITS") are able to invest in another UCITS or other collective investment undertaking ("target UCITS/CIU") only if, inter alia, the target UCITS/CIU has terms that prohibit more than 10% of its value consisting of units of other CIS ("the 10% rule"). The reason for this provision was to limit circularity of investment.

It was intended that UCITS be able to invest in feeder funds, as evidenced by the master-feeder provisions[25]. But the 10% rule currently prevents UCITS, such as funds of funds, from investing in feeder funds, as those necessarily invest more than 10% in another scheme (a feeder must invest at least 85% in the master).

We therefore request that Article 50 (1)(e) be amended in such a manner that the 10% rule applies only to investments into funds other than feeder UCITS and to add to Article 50 feeder UCITS as another category of permissible investment.

The purpose behind the 10% rule would still be given effect: the proposed approach would still limit circularity of investment as a master UCITS must meet the 10% rule. Also, in order to make itself available as a master, a UCITS must not hold the units of a feeder UCITS (Article 58.3(c) of the UCITS Directive).

It is also the case that, until the 10% rule is addressed, managers are unlikely to consider pooling using master-feeder arrangements as it would make their range unsaleable in the discretionary market place. Such investors do not just manage UCITS monies; they run other investment mandates and will not want to use two separate funds for their asset allocations.

In addition, a number of scaled European and global intermediaries, who have broad discretionary and advisory businesses, make use of substantially similar buy lists. So, if the discretionary team cannot use a manager's fund, the manager will not get it onto the single buy list. A manager therefore risks potentially damaging business from advisory clients, too.

<u>Fund mergers</u>

We share the Commission's view that provisions concerning the timeline of mergers, and in particular Article 39(3) of Directive 2009/65/EC, could usefully be amended to clarify the timeline involved in the authorization of a merger of two UCITS, particularly in circumstances where the competent authorities of the receiving UCITS requests the fund to modify the information to be provided to investors.

[25] The fact that it was intended that UCITS be able to invest in feeder funds clearly appears from the master-feeder provisions. In order to make itself available as a master, a UCITS must not hold the units of a feeder UCITS (Article 58.3(c) of Directive 2009/65/EC). Such a requirement would not be necessary if a UCITS was not permitted to hold units in a feeder UCITS.

The review of these provisions should bear in mind the overall objective that approval timescales should be as short as reasonably practicable.

In relation to fund mergers, we also strongly recommend amending the UCITS provision whereby notice of a prospective merger must be given in writing to the unit holders in the receiving UCITS. In practice, this method of communication, which entails very high costs for the affected UCITS and their investors, appears not to be justified in all circumstances and we do not see why the information requirements here should be provided in a different manner than any other information to the unit holders (invitation to a General Meeting, change in the name of the fund, etc).

If, for instance, the merging fund has 100 investors and 1 million EUR in assets and the receiving fund has 50.000 investors and 10 billion EUR in assets, then there will be no material impact on the unit holders in the receiving fund. However, the costs of informing them would be so prohibitive that the merger would not be viable.

The same issue arises in relation to liquidations/mergers/divisions of master-feeders. Given that master-feeder structures were not permitted in some EU jurisdictions prior to 1 July 2011, it is difficult to quantify the incremental costs of this requirement in this context; but it is certainly the case that the flexibility of the master-feeder structure is seen as one of the main ways in which UCITS managers can achieve economies of scale across the EU.

The problem is the method by which this information has to be provided. When the Commission produced the draft Directive it introduced the requirement that the information had to be provided on paper or (where certain conditions are met) another durable medium.

As regards mergers of UCITS, the initial approach to UCITS IV, according to which provision of information to the unit-holders of the receiving UCITS was required only if the proposed merger would have substantial impact on their investments[26], should be re-examined in the light of the above-mentioned experiences in order to enhance the efficiency of mergers without compromising investor protection.

In addition, we suggest that circumstances requiring notification of unit-holders in writing or by means of other durable medium be carefully reviewed by the Commission having due regard to the need for effective investor-protection and cost-efficiency in UCITS management. The goal should be to establish a list of relevant circumstances at EU level in order to eliminate the current regulatory arbitrage.

Lastly, we would like to stress once again that tax remains a significant barrier to cross-border fund mergers. Indeed, from a UCITS' shareholders viewpoint, the current Mergers Directive does not guarantee the tax neutrality of cross-border mergers irrespective of the

[26] Cf. Article 40 para. 2 and Article 36 para. 3 of the Commission's proposal for UCITS IV (COM(2008) 458/3).

legal type of vehicle (corporate type or contractual type funds). Further changes to the European legal framework would therefore be required to fully deliver on the benefits of UCITS IV[27]. We know that the Commission services are fully aware of these tax-barriers and we understand that this matter does not fall within the direct remit of the Asset Management unit, but we should be grateful if the importance of solving this issue could again be brought to the attention of the Directorate General on Taxation.

Notification procedure

We strongly support the Commission's proposal to consider the extension of the regulator-to-regulator notification procedure to any changes to the initial notification letter. As the communication channels for regulator-to-regulator notification are already in place anyway, we believe they should be utilized also for the purpose of notifying amendments to the original information (in the interest of both the industry and the regulators themselves).

The clear benefit of that measure is that management companies would no longer be forced to maintain separate procedures for notifying new funds and filing changes to the existing ones, therefore avoiding duplication of efforts as well as unnecessary costs.

Other recommendations to improve UCITS IV

KIID

1) ***Provision of the KIID to professional investors***: The requirement to send a KIID applies to professional and retail investors, despite the fact that the KIID was specifically designed for retail customers. This is clearly unnecessary, particularly in view of the level of due diligence that any institutional investor would undertake before placing an order with a UCITS manager. Indeed, in its recent proposals for venture capital funds, the Commission rightly notes that "*Venture capital funds covered that would operate under the proposed passport system would not be obliged to face the traditional disclosure obligations and requirements linked to investor protection which would imply an offer to retail clients (prospectus in accordance with Directive 2003/71/EC, KIID, MiFID standards). Venture capital investors are professional investors and are supposed to apply high standards of due diligence, while undertaking a thorough examination of any fund before they decide to make an investment. These investors are expected to closely monitor the activity of the manager of the venture capital fund and the evolution of their investments*."

[27] Please refer in this respect to the conclusions of the EFAMA/KPMG report "Analysis of the Tax Implications of UCITS IV.

Accordingly, we request that the requirement for a KIID to be provided to professional investors be removed. As a consequence of this, UCITS management companies should not be required to produce a KIID for funds or share classes marketed solely to professional investors, as there would be no point in having to produce a KIID if there is no need to provide it.

2) ***Distance Marketing Directive*:** We note that the PRIPs KID proposal contains a Distance Marketing Directive exemption for PRIPs sold via distant communication. We support this proposal and urge that this exemption, which was available for the UCITS simplified prospectus, should be reinstated for the UCITS KIID.

Exemption from the need to appoint a paying agent where a UCITS is being marketed solely to professionals – alignment with AIFMD

Chapter XI of the UCITS Directive sets out the process that needs to be followed in order for a UCITS to market its units cross border. Again, many of these provisions are designed for marketing to retail investors, for instance the requirement to appoint a paying agent under Article 92. This is time-consuming and costly. In many cases, UCITS will be marketed cross border to professional investors only, and such provisions are unnecessary.

Accordingly, we request that the UCITS directive be brought into line with AIFMD in this respect and, in particular, that Member States should not be allowed to require the appointment of paying agents where a UCITS is being marketed solely to professional investors.
More fundamentally, and in particular in light of the development of new technologies[28], we doubt that the practical justifications that prevailed when it was decided that each UCITS should appoint a paying agent still exist today. We would therefore encourage the Commission to reconsider if there is still a real need to appoint a paying agent, even in the case of UCITS sold to retail investors.

(2) Regarding point 5, do you consider that further alignment is needed in order to improve consistency of rules in the European asset management sector? If yes, which areas in the UCITS framework should be further harmonised so as to improve consistency between the AIFM Directive and the UCITS Directive? Please give details and the possible attached benefits and costs.

As the Commission noted in 2009, *"The UCITS regulatory framework has proved very resilient during the current crisis. Despite very difficult market conditions, asset illiquidity and investor redemptions, no more than a handful of funds have been forced to suspend trading or close.*

[28] It is important to bear in mind that that the obligation to appoint a paying agent appeared in the original UCITS Directive, at a time when e-communications was not prevalent.

The regulatory safeguards embedded in the regulatory model have been instrumental in helping UCITS funds weather this crisis."

EFAMA understands that with the current review of UCITS, the Commission seeks to enhance investor protection and tackle systemic risk issues. Modifications to the well-established UCITS framework should be made only where required in this regard.

EFAMA therefore understands the Commission's question should be read as: *"Which areas in the UCITS framework require a harmonisation with the AIFMD in order to ensure investor protection and fight systemic risk?"*

As of today, we have still not seen the final version of the different the AIFMD Level 2 texts and corresponding measures by ESMA. We strongly suggest waiting for these final provisions and to see how these are applied in practice in order to assess which of the provisions in AIFMD should be implemented into the UCITS framework in the interest of the investors. The corresponding AIFMD provisions should be reviewed individually in view of their practicality and suitability for the already well-functioning UCITS framework.

We believe that apart from the alignment of the depositary regime which is already in progress under the UCITS V proposals there are no major requirements for further alignment with AIFMD. The issues raised in the Commission consultation are already addressed by the detailed product rules in the existing UCITS framework.

In particular:

- UCITS management company rules already set out detailed organisational and conduct of business rules which differ from the AIFMD. Different rules of this nature in AIFMD were considered necessary because the AIFMD, contrary to the UCITS Directive, does not contain detailed product rules. Given this absence of product rules and the broad diversity of products covered, detailed rules different from UCITS seemed necessary;

- The existing delegation structure in UCITS and controls over letter box entities work without specific regulatory concerns. Delegations are subject in most cases to pre-approval to ensure the management company and delegates are able to comply with applicable UCITS requirements.

- UCITS have a detailed risk management process

- The leverage tests in AIFMD are primarily there to manage systemic risk potentially generated by AIFs.

- UCITS are already subject to detailed valuation rules and oversight by the depositary over a pre-determined set of assets.

- UCITS typically report their positions to their national regulators on an ongoing basis. Some AIFMD requirements, however, are clearly tailored to the specificities of alternative investments lacking any kind of restricting product regulation such as hedge funds. This applies in particular to the reporting obligations towards competent authorities to be specified in detail in the Commission's Level 2 regulation. These reporting standards are meant to gather information about systemic implications of AIF investments and should not be considered appropriate for highly regulated vehicles such as UCITS which obey strict investment limits and restrictions on leverage.

Brussels, 18 October 2012

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