EFAMA
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RESPONSE

Brussels, 7 August 2024

EFAMA RESPONSE TO ESMA CALL FOR EVIDENCE ON THE REVIEW OF THE ELIGIBLE ASSETS DIRECTIVE

Q1: In your view, what is the most pressing issue to address in the UCITS EAD with a view to improving investor protection, clarity and supervisory convergence across the EU?

Maintaining the credibility and recognition of the UCITS label is central to this review. The global reputation of the UCITS as an effective conduit for retail investors is built on being a secure, well-diversified, liquid, and transparent collective investment vehicle. This would be supported by better convergence between Member States in the implementation of the current rules, so as to retain a degree of flexibility to access in a controlled manner the benefits of limited exposure to assets uncorrelated to financial markets. It is necessary to balance the need of investors for convenient access to an investment portfolio selection which is contemporary and relevant to their needs, as well as the ability of asset managers to tap into the most extensive possible investment universe, and the societal ambition to optimally facilitate the green transition. This also includes efficient diversification among traditional assets and limited but balanced access to alternative investments – as the latter can enhance returns and income, when accompanied by guardrails that ensure less volatility, and thorough due diligence processes, in line with the UCITS regime.

The impact on the UCITS Directive itself should be limited in order to maintain regulatory stability, which is a key supporting factor behind the development of the European financial market. Regulatory stability requires that the primary actions of convergence and clarity should be the first port of call, as opposed to imposing new restrictions or additional look-through obligations. It is also critical to ensure that changes to the UCITS framework do not damage the reputation of the UCITS as a regulatory export brand. EFAMA underlines the importance of close dialogue with the regulators in major export markets to ensure that equivalence decisions and inward marketing requirements are not affected by any forthcoming changes to the EU UCITS regime.

Overall, the **consistent** interpretation and application of the EAD across the EU ensures a level playing field and investor protection. Sufficient **flexibility** is nonetheless needed to accommodate specific market conditions and practices in different EU jurisdictions. We **recognise ESMA's efforts since the enactment of the EAD** to address many of the critical areas requiring clarification, through Q&As and guidance, and as such we don't see an immediate need for a Level 1 change.

Greater convergence between Member States in the implementation of the UCITS and EAD at national level on certain targeted topics, through EU-wide guidelines or Q&As would further enhance the credibility of the UCITS brand and provide better clarity and legal certainty for managers. Specifically, cross-border

divergences between permitted exposures creates competitive advantages and disadvantages in what is meant to be a harmonised regime for investors, and generates obstacles for managers offering UCITS in multiple EU Member States.

The current Call for Evidence by ESMA regarding the asset eligibility framework should bear in mind interlinkages with other legislative measures which emerged since 2007, as well as market and technological advances, including the wide range of financial instruments which have emerged since then, where the exposure is commensurate with the characteristics of transferable securities.

Q2: Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITS EAD rules with respect to financial indices? If so, please describe any recurring or significant issues that you have experienced and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence. Where relevant, please specify what indices this relates to and what were the specific characteristics of those indices that raised doubts or concerns. Where possible, please provide data to substantiate the materiality of the issue.

The EAD and ESMA Guidelines on ETFs and other UCITS issues in general provide sufficient clarity regarding the application of the principles on indices and to secure investor protection.

Divergent approaches stem from the ability of Member States to decide, under Article 51(3), whether or not UCITS are required to combine investments in index-based financial derivative instruments (FDIs) for the purposes of compliance with the diversification limits in Article 52. In Member States where the index components must be monitored on an ongoing basis for compliance with concentration limits, this implies a higher operational and administrative burden, as well as greater costs of index licenses and access to underlying data. This could be addressed by guidance providing that there is no obligation to look-through to the index components to verify compliance with concentration limits where the index is diversified in accordance with Article 53 of UCITS.

We note some areas of overlap with the Benchmarks Regulation (Regulation (EU) 2016/1011), though we also recognise that the outcome of the ongoing review of that Regulation may have an impact on these overlaps. The Benchmarks Regulation was enacted almost a decade after the EAD, and its requirements overlap with those set out in Article 9(1) of the EAD. Where the benchmark administrator is authorised or registered in accordance with the Benchmark Regulation, clarification could be provided via guidance that the requirements of Article 9 of the EAD would be limited to requiring the index to be sufficiently diversified – as governance and transparency issues relating to financial indices are regulated in the Benchmarks Regulation. Furthermore, in light of the governance and conflict of interest requirements for benchmark administrators under Article 4 of the Benchmark Regulation, it should be clarified via guidance that, when investing in a derivative instrument of a financial index, there is no restriction on the counterparty being from the same financial group. As noted, however, the outcome of the ongoing review of the Benchmarks Regulation will have a significant impact on these considerations, given the potential changes to the scope of application of the Benchmarks Regulation.

Q3: Have you experienced any recurring or significant issues with the interpretation or consistent application of the UCITS EAD rules with respect to money market instruments? If so, please describe the issues you have experienced and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence. Where relevant, please describe the specific characteristics of the money market instruments that raised doubts or concerns.

We do not note significant issues in this respect.

Q4: Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITS EAD provisions using the notions of "liquidity" or "liquid financial assets"? If so, please describe the issues you have experienced and how you would propose to amend the UCITS EAD to better specify these notions with a view to improving investor protection, clarity and supervisory convergence. Where relevant, please explain any differences to be made between the liquidity of different asset classes.

In light of the body of rules and guidance which has emerged to supplement these notions since 2007 to guide fund managers in designing their liquidity risk management policies, we do not observe a need to adapt or further specify these notions.

While the rules do not specify whether these terms refer to there being adequate liquidity in the overall fund or whether the assessment is with respect to each individual asset, these notions relate to the ability to fulfil investors' redemption requests while upholding the interests of all unitholders. This means that asset level liquidity is to be seen from the perspective of the overall portfolio composition, such that assets of limited liquidity are not disallowed as long as the exposure is kept to an appropriate level and subject to liquidity risk monitoring in line with the central role of the UCITS manager in maintaining adequate liquidity risk management rules and processes. This is supported by the broader legislative framework, notably Article 40(3) of Directive 2010/43, ESMA's guidelines on liquidity stress tests in UCITS and AIFs, and recent changes under the UCITS review and upcoming Level 2 measures and guidance introducing further rules regarding LMTs and liquidity risk management.

We also refer to EFAMA's response to the FSB Consultation Report on Addressing Vulnerabilities From Liquidity Mismatch in Open-Ended Funds from September 2023. As mentioned above, the notion of liquidity, with respect to the eligibility of assets, is framed in the UCITS framework as relating to the impact that asset could have on the ability to fulfil investors' redemption requests while upholding the interests of all unitholders. As we explain in our September 2023 paper, it is important to keep in mind that, in contrast to banks, investment funds can engage in liquidity transformation without having to match the liquidity of their assets and liabilities. This derives from the fact that most fund investors have a longer term investment perspective compared to bank depositors. In addition, in light of additional sources of liquidity for funds as well as current liquidity management practices, including the availability and use of LMTs, asset managers can credibly manage the liquidity transformation of their funds. The notion of a 'liquidity mismatch' should therefore not ignore other sources of liquidity or cash on the asset side, and should recognise that meeting redemption requests does not necessarily equate to selling an equivalent amount of assets. Managers often have access to other liquidity sources, such as cash reserves or credit lines which can be used to meet redemption requests without liquidating assets. Therefore, liquidity as a concept should not be seen as centring solely on the liquidity of the individual asset, but rather more comprehensively within a broader portfolio.

Q5: The 2020 ESMA CSA on UCITS liquidity risk management identified issues with respect to the presumption of liquidity and negotiability set out in UCITS EAD. In light of the changed market conditions since 2007, do you consider such a presumption of liquidity and negotiability still appropriate? Where possible, please provide views, data or estimates on the possible impact of removing the presumption of liquidity and negotiability set out in the UCITS EAD?

As drafted, the presumption in Article 2(1) of the EAD stipulates that it applies only where there is no information available to the UCITS that would lead to a different determination. Managers may not rely on this presumption as a universal rule, as admission to trading on a regulated market does not universally make an instrument inherently liquid – robust risk management processes require a liquidity 'reality' check regardless of an existing listing, out of a fiduciary duty towards the clients.

Since 2007, this presumption has been supplemented/superseded by additional rules, strengthening the core role of the manager as being to manage investment risks. In particular, the additional provisions on liquidity risk management introduced by Implementing Directive 2010/43/EU (Articles 40(3) and (4)), ESMA guidelines on liquidity stress testing, IOSCO Recommendations for Liquidity Risk Management for Collective Investment Schemes, as well as recent amendments to the UCITS Directive, provide managers with additional rules and guidance to make sound judgement calls on the information available when making a different determination to the presumption of liquidity, as required by the EAD Article 2(1) final paragraph. We also note that the presumption is in reality a presumption of eligibility as opposed to a presumption of liquidity, and it does not override the liquidity risk management obligations of the manager.

When used in conjunction with these broader principles of liquidity management, the presumption of liquidity is an effective, well-functioning tool which reflects the pragmatic, risk-based approach managers take to such situations.

The 2020 ESMA CSA on UCITS liquidity risk management identified, in paragraphs 9 – 11, a few cases in which NCAs identified significant liquidity risks which could jeopardise the ability of the UCITS under review to meet redemption requests or fulfil other obligations. For a very limited number of UCITS, liquidity profiles pointed to potential asset/liability mismatch risks, which were only sometimes mitigated using liquidity management tools. In most cases, the exercise found that the level of compliance with the applicable rules on liquidity risk management was satisfactory with entities meeting their regulatory obligations. While the ESMA review highlighted some firms' shortcomings, both in terms of over-reliance on the presumption of liquidity and the application for non-listed securities, we believe the EAD rules around the presumption of liquidity remain relevant to the overall risk management of liquidity for open-ended funds.

Q6: Please explain your understanding of the notion of ancillary liquid assets and any recurring or significant issues that you might have experienced in this context. Please clarify if these are held as bank deposits at sight and what else is used as ancillary liquid assets. Where relevant, please distinguish between ancillary liquid assets denominated in (1) the base currency of the fund and (2) foreign currencies.

The UCITS Directive does not currently define a set limit for ancillary liquid assets. The purpose of this, according to Recital 41 of UCITS, was to provide flexibility to cover payments, facilitate reinvestment of proceeds from the sale of portfolio holdings or where market conditions require suspension of investment in other financial assets.

However, limits for the holding of ancillary liquid assets are established at national level, differing from one jurisdiction to the next. The application of different limitations requires asset managers to establish different compliance systems for each country for their cross-border operations, generating high costs and administrative burdens, and impeding transparency and comparability for end-investors. When determining the approach which would produce the best result for investors, we note it can be beneficial to permit the limit to be temporarily exceeded in cases of operational exigencies, such as significant changes in investment allocation, or substantial subscription/redemptions.

Therefore, in compliance with UCITS Directive, we would support guidance to clarify that a UCITS can hold ancillary liquid assets 'to the extent necessary for the management of the fund' and defines as ancillary liquid assets cash, cash equivalents that have negligible risk of change in value, bank deposits accessible at any time and overnight term deposits, not limited to the base currency. Should this proposal not be deemed appropriate, we would encourage national regulators to exchange on this topic, in order to achieve a convergence in standards which reflects the local market and secures the best interests of investors.

Q7: Beyond holding currency for liquidity purposes, do you think UCITS should be permitted to acquire or hold foreign currency also for investment purposes, taking into account the high volatility and devaluation/depreciation of some currencies? Where relevant, please distinguish between direct and indirect investments.

We note that it is already possible for UCITS to gain exposure to foreign currency for investment purposes (e.g. through foreign state bonds or other international assets, and derivative exposure under Article 50(1)(g)(i) of the UCITS Directive), and that that it should remain possible to do so, directly or indirectly, provided the associated risks are adequately disclosed and effectively managed in accordance with the same principles as for other assets, and that the exposure itself is disclosed in the prospectus. For example, the currency in question should be assessed in light of its capacity to meet the necessary liquidity requirements. This allows for the efficient active management of currency risk, and provides access to a large and liquid market together with the diversification benefits and investment features this may offer. Notably, benchmarks can be hedged or unhedged, requiring the fund manager to take positions in foreign currency. Foreign exchange can also serve both as a return contributor and diversifier in a multi-asset context.

Q8: Have you observed any recurring or significant issues with the interpretation or consistent application of the 10% limit set out in the UCITS Directive for investments in transferable securities and money market instruments other than those referred to in Article 50(1) of the UCITS Directive? If so, please explain the issues and how you would propose to address them in the UCITS EAD with a view to improving investor protection, clarity and supervisory convergence.

Outdated referencing to now repealed provisions of the UCITS Directive within the wording of Article 2(1) of the EAD also creates uncertainty and would benefit from clarifications through a table mentioning the latest version of the articles, which replace the old ones.

We suggest there could be merit in considering guidance by which certain CIUs which do not comply with Article 50(1)(e)(i) – (iv) could be included within the 10% ratio. As we note in **Question 14 and 15**, the regulatory framework has evolved since 2007 giving rise to a wider variety of CIUs than was available at that time (including AIFs and ELTIFs). While we do not advocate that all CIUs which are not captured by Article 50(1)(e) should be included within Article 50(2)(a), we do suggest there could be a benefit in permitting some limited exposure to certain of these CIUs, with the parameters for this to be subject to further consideration.

Q9: Are the ‘transferable security’ criteria set out in the UCITS EAD adequate and clear enough? If not, please describe any recurring or significant issues that you have observed and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

These are broadly considered appropriate. We are not aware of significant difficulties in the interpretation or application of these criteria.

Notably, the definition of a ‘financial instrument’ in MiFID II, which includes ‘transferable securities’, was recently expanded to include any traditional ‘financial instrument’ listed in Section C of Annex I of MiFID II which is issued via distributed ledger technology – for the purposes of legal certainty, guidance would be welcome clarifying that this revised definition should be seen as extending to the EAD. Given the increasing use and market benefits of tokenised assets, in particular tokenised fund units, this clarification would be beneficial and consistent with the direction of travel of European legislation.

Q10: How are the valuation and risk management-related criteria set out in the UCITS EAD interpreted and applied in practice, in particular the need for (1) risks to be "adequately captured" by the risk management process and (2) having "reliable" valuation/prices. Please describe any recurring or significant issues that you have observed with the interpretation or consistent application of these criteria and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

These criteria should generally focus on the required expertise and experience of staff in relation to the relevant asset class and the implementation of adequate procedures for managing the relevant risk. In other words, we interpret these criteria to imply that the manager is obliged to ensure that all material risks associated with the investment are encapsulated within the risk and investment compliance processes, captured by the global exposure calculations, as well as the capability of IT infrastructure to integrate and compute risk metrics. UCITS managers follow specific procedures when onboarding new instruments or strategies, which will differ depending on the profile of the asset. Standard instruments will typically be covered by the risk management process and valuation policies, which are periodically assessed and amended as necessary, while new instruments will be subject to a dedicated risk and valuation assessment. That 'new' instrument will then only be integrated into the portfolio where it is determined that it can be adequately captured by the risk and valuation process.

With respect to the availability of reliable valuation/prices, members note comprehensive procedures for the valuation of portfolio instruments. Members have cited the presence of observable prices (i.e., exchange quote or multiple counterparty sourced) or where, due to the nature of the asset or circumstances (e.g. assets frozen by sanctions), the presence of a clearly established pricing policy and independent pricing committee. Members cite the maintenance of lists of price sources for each type of instrument, defining the preferred main and alternative price source for each assets group/type, and also note that vendors used as a source of pricing must be reputable and have expertise in pricing and are made subject to periodic due diligence. Internal valuation teams are tasked with ensuring that instrument valuations are consistent across each business area and pricing sources are in line with procedures and subject to monitoring and price challenge procedure. Third parties are also engaged to conduct price quality control checks.

Similar to our answer to **Question 5** above, the role of the manager is that of risk management. This practice is a constant element when adding new assets to the portfolio, including via indirect exposure to underlying assets.

Q11: Are the UCITS EAD provisions on investments in <u>financial instruments backed by, or linked to the performance of assets other than those listed in Article 50(1)</u> of the UCITS Directive adequate and clear enough? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

Differences exist between Member States on the question of whether there is an obligation for the manager to look through to the underlying where a UCITS invests in a financial instrument backed by or linked to the performance of assets which are not directly investable. These divergent interpretations imply a greater or lesser possibility of obtaining indirect exposure to underlying assets which are not directly investable by the UCITS.

We discuss these points in detail in **Question 13 and 22**. We suggest that the objective should be to achieve a degree of relative harmonisation which would facilitate cross-border distribution, address competitive distortions and provide transparency and comparability for end-investors. The correct approach must balance the character of the UCITS as being the predominant structure for retail investors while permitting the manager to further diversify the portfolio.

We note the merits of the establishment of explicit disclosure rules to assist investors in better understanding the operation, merits and risks of these techniques and would refrain from a framework that is too narrow and restricts the flexibility when establishing new or amending existing instruments. Notably, adopting a more restrictive approach may not be in the best interests of investors, who may benefit from indirect investment to a broader set of underlying assets, and whose existing UCITS investments may be impacted should a change in the rules require them to divest.

Q12: Is the concept of « embedded » derivatives set out in the UCITS EAD adequate and clear enough? Please describe any recurring or significant issues that you have observed with the interpretation or consistent application of this concept and how you would propose to amend UCITS EAD to improve investor protection, clarity and supervisory convergence.

This concept is considered clear, in light of Articles 2(3) and 10 of the EAD read in tandem. We do not have specific changes to suggest to the Level 1 rules at this time.

Q13: Linked to Q11 and Q12, ESMA is aware of diverging interpretations on the treatment of delta-one instruments under the EAD, taking into account that they might provide UCITS with exposures to asset classes that are not eligible for direct investment (see also Section 3.2). How would you propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence? Please provide details on the assessment of the eligibility of different types of delta-one instruments, identify the issues per product and provide data to support the reasoning.

The approach taken to this issue must place at the centre the best outcome for the investor.

EFAMA recognises that **diverging interpretations** between Member States regarding the treatment of delta-one instruments has negative repercussions on investors and on industry – creating distortions in competition, legal uncertainty for industry, and influencing decisions in portfolio composition in order to avoid national barriers to cross-border distribution.

However, we also note **key benefits for investors** in allowing indirect exposure to assets which are not directly investable by UCITS, notably through delta-one instruments, which are allowed in certain prominent jurisdictions on the basis that they are considered to not embed a derivative. This practice allows for diversification, protecting investors during stressed markets by providing uncorrelated returns when traditional asset classes become correlated. Indirect exposure via delta-one instruments can also offer benefits of an institutional-grade product due diligence (assessing the legal, operational and service provider setup and the particularities of the underlying, including custody arrangements) and can provide liquidity and efficiency of ETP investments. We also note that although delta-one instruments may provide exposure to non-UCITS eligible assets, these assets share the characteristics of transferable securities and are themselves consistent with the UCITS Directive, such that allowing exposure to certain asset classes via delta-ones mitigates some of the risks and challenges that would be associated in investing directly in the asset class. However, we note that, when considering these benefits, the manager will consider that **delta-one products differ** from one type to another, ranging from regulated products like UCITS ETFs to other exchange-traded or OTC products, and consequently differ in terms of structural benefits they can bring to the portfolio. It would be for the asset manager to determine the benefit a particular delta-one instrument could provide in this regard.

To remediate national divergencies while ensuring investors retain the benefits of limited indirect exposure to ineligible asset classes, we encourage addressing these divergences in a manner which would achieve a **level of relative harmonisation** to **ensure the best investor outcome**. We suggest a common tool across jurisdictions – such as in the framework of a common questionnaire – outlining differences in approach between regulators as a pragmatic tool to foster dialogue, for regulators to work together with ESMA towards coordination and consistency of approach, and ultimately to provide legal certainty to

industry operating cross-border. Within the framework of this common questionnaire, and with the benefit of the information it provides, each regulator can continue to accommodate specific market conditions and practices of their jurisdiction which are seen as benefiting investors while ultimately working, through dialogue, to greater convergence of approach through ESMA.

When investing indirectly through a delta-one instrument, the manager remains obliged through its fiduciary duties to perform a look-through approach from a risk management perspective, to be in a position to understand, measure and monitor the risk of a financial instrument and its underlyings. New underlyings require the performance of a New Instrument Onboarding process ("NIO"), integrating the new underlying into existing processes and systems, ensuring it fits into the fund's investment strategy, transparently setting out any additional risks in the fund documents (including the prospectus) and considering exposure limits. The new underlying must be integrated into the operating model, all IT-systems and relevant risk models, which may require system changes, additional market data integration and process enhancements. We also note that delta-one notes are typically issued by bankruptcy remote SPVs and can be issued on a secured basis using the assets of the issuer as security for the note, which limits counterparty risk.

In addition, as stated in Chapter IX of the UCITS Directive, we acknowledge the importance of appropriate **disclosures** to investors in the prospectus as regards the investment universe and assets. The fund should, in line with these rules, only invest in accordance with the descriptions provided in its prospectus, ensuring that investors are furnished with pertinent information.

With respect to cost implications of indirect investing through delta-one instruments, we address more fully in **Question 21**.

Q14: Have you observed any recurring or significant issues with the interpretation or consistent application of the rules on UCITS investments in other UCITS and alternative investment funds (AIFs)?

In this context, have you observed any issues in terms of the clarity, interaction and logical consistency between (1) the rules on investments in UCITS and other open-ended funds set out in the UCITS Directive and (2) the provisions on UCITS investments in closed-ended funds set out in the UCITS EAD? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the relevant rules to improve investor protection, clarity and supervisory convergence.

Where relevant, please distinguish between different types of AIFs (e.g. closed-ended, open-ended), investment strategies (real estate, hedge fund, private equity, venture capital etc.) and location (e.g. EU, non-EU, specific countries).

In this context, please also share views on whether there is a need to update the legal wording used in the UCITS EAD and UCITS Directive given the fact that e.g. they refer to 'open-ended' and 'closed-ended funds', whereas it might seem preferable to use the notion of 'AIFs' by now given the subsequent introduction of the AIFMD in 2011.

We agree that the distinction in the EAD between 'open-ended' and 'closed-ended funds' is outdated in light of legislative developments since the enactment of the EAD in 2007, namely the AIFMD and also the ELTIF Regulation, and the prevalence of semi-liquid funds, with the latter being particularly relevant for supporting the transition towards sustainability. This distinction is quite simplistic in light of these developments, and does not necessarily reflect the liquidity profile of the target fund – for example, an eligible investment in a non-EU venture capital vehicle may be less liquid than certain open-ended AIFs or ELTIFs. However, careful consideration would be needed if this reference were to be updated or supplemented – for example, not all open-ended AIFs or ELTIFs would be suitable for investment as an

eligible asset under Article 50(1), and so a replacement of the notion of ‘closed-ended funds’ would need to reflect a range of factors. We have outlined, in our response to **Question 8** above, that limited exposure to certain open-ended non-UCITS funds could be desirable as part of the 10% ratio in Article 50(2)(a).

A separate point arises with respect to certain REITs, which are typically not structured as investment companies but rather corporations with a specific business purpose (real estate development/management), as well as other corporations which are not constituted as investment companies but which have investment in securities as their business purpose. As ESMA’s Guidelines on key concepts of the AIFMD provide that the fact that an undertaking “does not have a general commercial or industrial purpose” will be indicative as to its status as a CIU, the fact that REITs are structured in the abovementioned manner often requires a case-by-case analysis as there are some REITs which undertake a mixture of development and investment activities. We suggest it can be clarified by way of guidance that such entities would be considered CIUs for the purposes of Article 2(2)(a) of the EAD.

A jurisdiction-specific obstacle relates to the French Fonds Commun de Placement, which, as closed-ended funds, cannot qualify as eligible assets as Article 2(2)(a) or (b) of the EAD as they are not, under French law, considered to fall into any of these categories (notably, French law does not recognise the concept of a ‘unit trust’). We also note another instance of national divergence in France under **Question 19**.

Q15: More specifically, have you observed any recurring or significant issues with the interpretation or consistent application of the rules on UCITS investments in (1) EU ETFs and (2) non-EU ETFs?

The current Level 1 rules (in the EAD and UCITS Directive) have not led to recurring or significant issues among our membership. We do not have specific changes to suggest to the Level 1 rules at this time.

Q16: How would you propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence with respect to the Efficient Portfolio Management (EPM)-related issues identified in the following ESMA reports:

(1) Peer Review on the ESMA Guidelines on ETFs and other UCITS issues;

(2) Follow-up Peer Review on the ETF Guidelines; and

(3) CSA on costs and fees.

In this context, ESMA is interested in also gathering evidence and views on how to best address the uneven market practices with respect to securities lending fees described in the aforementioned ESMA reports with a view to better protect investors from being overcharged.

We view the existing rules as providing sufficient detail in relation to the conduct of EPM and disclosures to be made.

EPM techniques have long been a source of additional performance for UCITS shareholders. This extra revenue stems from the offering of multiple services and from the know-how of the lending agent that is in charge of implementing these specific activities. EPM techniques cover a value-chain that includes various tasks and requires several capabilities such as the sourcing of market interests, collateral management, assessment of counterparty risk, and the implementation of detailed disclosure requirements.

EPM techniques are employed to reduce risk and costs and/or generate additional income. Any change to the ESMA Guidelines which would limit the costs which can be deducted for engaging in EPM would result either in also limiting the range of affordable protections available to the fund manager in terms of risk management techniques outlined in the next paragraph or would simply lead managers to discontinue their use of EPM techniques altogether. This in turn would reduce competition in the market for EPM providers,

leading to investors possibly being offered terms that are less suitable for them due to lack of competition. In addition to cutting investors off from a significant source of additional performance, this would also negatively impact the functioning of financial markets in removing a source of liquidity as securities lending activities decline. As is already the case per ESMA guidelines, we suggest that any concerns that EPM techniques are not being employed for the best interests of investors can be allayed by transparency as to the features, revenue and costs of the EPM technique employed.

UCITS managers, irrespective of whether the activity is outsourced to a third-party or performed by the UCITS management company itself or a subsidiary, should be allowed to deduct a fair market rate fee (including a margin) for the initiation, preparation and execution of securities lending transactions of the gross revenues generated by these transactions. The costs expended for engaging in EPM techniques must be viewed in the context of the quality of protection afforded to investors against risks inherent in EPM techniques. The level of cost will be commensurate with, for example, the degree of collateralisation, the experience of the securities lending agent, the counterparty risk management framework (such as appropriate levels of collateral and haircuts, suspensions to trade) provided for counterparty default, the percentage of the portfolio on loan.

We believe that disclosure to investors providing transparency into the revenue split to be applied in the precontractual documents of the UCITS, permitting investors to make an informed decision, is the best approach. Provisions regarding disclosures, risk management, contractual terms and others are already reflected in the ESMA Guidelines for competent authorities and UCITS management companies and as such are currently being applied. The use of EPM techniques benefit both end-investors (as a source of additional revenues improving the performance of their investments) and markets as a whole (by providing additional liquidity in the markets).

Q17: Would you see merit in linking or replacing the notion of EPM techniques set out in the UCITS Directive and UCITS EAD with the notion of securities financing transaction (SFT) set out in the SFTR? Beyond the notions of EPM and SFT, are there any other notions or issues raising concerns in terms of transversal consistency between the UCITS and SFTR frameworks?

We do not see merit in replacing the notion of EPM techniques in the UCITS framework with the notion of securities financing transactions in the SFTR.

Doing so would limit EPM techniques to securities lending transactions, repurchase agreements and reverse purchase agreement transactions, whereas techniques and instruments outside of these are routinely used in the efficient and cost-effective management of a portfolio. For example, the CSSF states that EPM is not restricted to the concept of SFTs, and that financial derivative instruments (for instance options, futures, swaps) can be used under the EPM provisions if they comply with the related provisions. Accordingly, the definition of SFT in the SFTR is more restrictive than the common understanding of what EPM techniques include.

There is also the risk that techniques developed in the future would not fall under such definition.

To retain the flexibility that the current definition of EPM techniques provides but at the same time have a greater consistency across NCAs it could be considered to add a non-exhaustive list of techniques that are considered by ESMA as EPM techniques.

Q18: Apart from the definitions and concepts covered above, are there any other definitions, notions or concepts used in the UCITS EAD that may require updates, further clarification or better consistency with definitions and concepts used in other pieces of EU financial legislation, e.g. MiFID II, EMIR, Benchmark Regulation and MMFR? [...]

Readability of the EAD would be greatly enhanced by updating references within the EAD to outdated legislation – in particular, replacing references to the repealed Directive 85/611/EC with the existing UCITS Directive.

This would also be a good opportunity to align the definition of concepts such as 'financial instruments' with those provided for in MiFID II, recognising the possibility to invest in emission allowances consisting of recognised units for the purposes of compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme). With respect to the notion of 'financial instruments', please note also our comment above concerning the revised definition under MiFID II which now includes traditional financial instruments listed in Section C of Annex I which are issued by means of distributed ledger technology.

As outlined above, the EAD established a number of requirements for the use of financial indices by a UCITS, however of which have been surpassed by the establishment of specific regulations of direct application in the Benchmarks Regulations and ESMA's Guidelines on ETFs and other UCITS Issues. However, we note that the ongoing review of the Benchmarks Regulation may remove the majority of benchmarks and their administrators from the scope of those rules, which would impact on a rationalisation between the EAD and Benchmark Regulation. Also, with respect to the definition of an index in the Benchmark Regulation, we note that not all indices may fall into the scope of the Benchmarks Regulation and therefore an alignment of the definition of an index would not be appropriate for the moment.

Q19: Are there any national rules, guidance, definitions or concepts in national regulatory frameworks that go beyond ('gold-plating'), diverge or are more detailed than what is set out in the UCITS EAD? If so, please elaborate whether these are causing any recurring or significant practical issues or challenges.

A number of divergencies between Member States have been identified. As outlined in our responses to other questions, convergence in the interpretation of existing rules across the EU (through guidance or FAQs) would enhance the UCITS framework by providing further legal certainty, transparency and comparability for investors and remove obstacles for cross-border distribution:

- Other funds: Danish law requires a UCITS to only allocate investments to other funds that adhere strictly to the risk-spreading principles of UCITS, which appears more stringent than required by EU law.

- Financial indices: national competent authorities have diverging interpretations with respect to the eligibility criteria and approval process for financial indices. For instance, the eligibility criteria in Luxembourg appear more detailed than those stipulated in the UCITS Directive, and in Denmark, the Danish Financial Supervisory Authority (DFSA), which is responsible for approving financial indices, has adopted a more conservative stance in their approval of new indices. We also note that there is no consistent application across jurisdictions regarding exposure to ineligible assets through financial indices. Spanish legislation requires financial indices to be benchmarked against eligible or pre-approved underlying assets.

- Ancillary Liquid Assets: we have outlined a number of instances of national divergences imposing different limitations on ancillary liquid assets.

- The requirement in Luxembourg for certain assets, strategies, and instruments to be disclosed in the prospectus in order to be permitted, as per the template for new funds (Questionnaire for the approval of a new sub-fund – CSSF), is an interpretation which we have noted being adopted in other Member States.

- Derivatives: in Denmark, specific local requirements exist on the use of derivatives by UCITS. In Italy, specific rules exist on the method of calculation of the amount to cover the cash commitment arising from short positions in derivative financial instruments, and the VaR model can only be used for the calculation of the global exposure where it is specifically authorized by the NCA. In France, some ETPs are analysed with a look-through approach while it is not the case in other EU jurisdictions.

- Audits: in Luxembourg, auditors generally adopt a strict interpretation of the requirement, leading to varying levels of scrutiny and differing expectations on eligibility from auditors in other Member States.

- Securities lending: in Sweden, national rules limit the percentage of the fund's assets which can be used for securities lending to a maximum of 20%. This creates an unlevel-playing-field for UCITS registered in Sweden, particularly index funds. In Spain, the lack of national regulation has meant that securities lending is not permitted.

- Global Exposure: when calculating global exposure using the commitment approach, the Swedish Financial Supervisory Authority provides that financial derivatives can be netted only against "cash which is invested in risk free assets" but not against a "cash position". This is based on an interpretation of the CESR Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, which provides that FDIs should not be taken into account when (for example) "The combined holding by the UCITS of a financial derivative instrument relating to a financial asset and cash which is invested in risk free assets is equivalent to holding a cash position in the given asset." The Swedish position means that cash would have to be invested in certain assets to be considered "risk free" and thus eligible for netting. This has forced some management companies to use the VaR-calculation approach instead of the commitment approach which may otherwise be more suitable for the fund. For legal certainty reasons and for a level playing field it should be clarified that "cash" is considered a risk-free asset and eligible for netting.

- Enhanced scrutiny: in Ireland, the Central Bank of Ireland operates an enhanced scrutiny regime during the authorisation process for certain proposed exposures for UCITS – e.g., for exposure to CFDs, CLOs, coco bonds or binary options. This comprises a request for additional information when reviewing the UCITS' application for authorisation to ensure the exposure is appropriate taking into account the overall portfolio of assets proposed.

- Loans: there is divergence as to whether loans can be considered transferable securities. In Luxembourg, since August 2020, loans were stated not to be considered constitute eligible assets. In other jurisdictions (such as Ireland, UK), they are potentially permitted provided they meet the transferable security criteria. In Ireland, investment in CLOS are permitted subject to enhanced scrutiny at the authorisation phase. We continue to see a convergence in the functioning of the broadly syndicated loan market compared to that of high yield bonds. Such trend is more pronounced in the US where bank loans are traded similar to high yield bonds and have active retail fund participations.

- Certificates representing commodities: in Austria and Germany, UCITS are not permitted to acquire certificates representing commodities which lead to a physical delivery, either by way of agreement with the issuer or by de facto not exercising the right of delivery.

- Short-term borrowing: Article 83(2)(d) of UCITS permits UCITS to borrow up to 10% of their NAV for a short-term period. In Austria, the regulator restricts this to be permitted only for exceptional redemptions.

- Investments in other CIUs: in France, the term 'asset segregation' in Article 50(1)(e)(ii) was implemented with an incorrect translation, which led the AMF to interpret that criterion as equivalent to the risk spreading rule in Article 52 of UCITS. This creates an issue for French UCITS, as most AIFs are not eligible for the 30% ratio.

20: Please fill in the table below on the merits of allowing direct or indirect UCITS exposures to the asset classes listed therein, taking into account the additional instructions provided in the footnotes. Please assess and provide evidence on the merits of such exposures in light of their risks and benefits taking into account the characteristics of the underlying markets (e.g. availability of reliable valuation information, liquidity, safekeeping). To substantiate your position, please fill the table with any available data and evidence (e.g. on liquidity or valuation of the relevant asset classes and underlying markets). ESMA acknowledges that the availability of data on direct/indirect exposures to some of the asset classes listed in this table is limited and would welcome receiving any available data (whether on individual market participants and products or marketwide) and even rough estimates that help to understand the practical relevance of the relevant asset class for UCITS and the possible impact of any future policy measures.

[To follow]

Q21: Please elaborate and provide evidence on how indirect exposures to the aforementioned asset classes (e.g. through delta-one instruments, ETNs, derivatives) increase or decrease costs and/or risks borne by UCITS and their investors compared to direct investments.

Further detail is provided in the answer to **Question 13**.

Investing indirectly can imply cost reductions for investors, for example through economies of scale, and through avoiding operationally burdensome aspects associated with direct investing in certain asset classes outlined below. Indirect exposure may also, conversely, increase costs by virtue of the associated structing fees, index license fees, cost of market data, which would be weighed against the benefits of obtaining exposure to the underlying asset through this mechanism (some of which are outlined below). As mentioned in our response to **Question 13**, instruments through which indirect exposure can be obtained differ and it is the responsibility of the management company to choose whether direct or indirect investment is in the best interest of UCITS shareholders, and this choice should be preserved as it allows the manager to select the most effective solution for the benefit of investors.

Obtaining indirect exposure through delta-one instruments, other ETPs and OTC derivatives can be of great value to investors. Transparency to investors is central however, to assist the investor to understand the costs specific to these instruments – e.g. costs may include margins to provide providers/OTC derivative counterparty, or returns may be adjusted e.g. for withholding taxes not applicable for direct investment.

Indirect exposure can be achieved through a number of mechanisms:

1. Through open or closed AIFs, which carries the benefit of obtaining exposure via a well-managed and regulated fund, allowing diversification and de-correlation of the portfolio and with limited leverage.

2. Through derivatives, which permits exposure to assets not directly investable (e.g. gold or oil futures) with market depth and volume, again allowing diversification and de-correlation of the portfolio, provided that they are netted and diversification limits are respected.

3. Through indices, which carry the advantage of being regulated financial instruments, permitting indirect investments into specific markets, commodities and various other financial instruments, as long as the diversification limits are respected.

4. Through exchange-traded products (ETPs) which can provides diversification without leverage and lower replication costs.

The main advantages overall of investing through these mechanisms are operational ease and regulatory security, reducing costs and risks borne by UCITS investors. UCITS asset managers may not have the necessary expertise to enable direct investments, or doing so would require many resources, for example setting up custody for assets such as carbon allowances (via a union registry account), crypto assets (via a crypto asset custody account) and precious metals, or accessing the liquidity venues for these assets. UCITS asset managers must regardless perform detailed due diligence on the indirect access vehicles they invest in and confirm the adequacy of the product setup (for example, with respect to custody). ETCs in particular are a regulated well-established transparent security form typically held within a regulated Central Securities Depository and traded on regulated exchanges throughout the day, offering increased liquidity over the physical market.

Q22: Under the EAD, should a look-through approach be required to determine the eligibility of assets? Please explain your position taking into account the aforementioned risks and benefits of UCITS gaining exposures to asset classes that are not directly investible as well as the increased/decreased costs associated with such indirect investments. A look-through approach would aim to ensure that the list of eligible asset classes set out in the UCITS Level 1 Directive would be deemed exhaustive and reduce risk of circumvention by gaining indirect exposures to ineligible asset classes via instruments such as delta-one instruments, exchange-traded products or derivatives. Where possible, please provide views, data or estimates on the possible impact of such a possible policy measure.

The approach taken with respect to the application of a look-through approach must be guided by the outcome which best serves investors.

As outlined in our response to **Question 13** above, EFAMA notes the **key benefits for investors** in allowing limited indirect exposure to assets which are not directly investable by UCITS. This practice can allow for diversification, protecting investors during stressed markets by allowing the portfolio to be decoupled from the financial market, providing uncorrelated returns when traditional asset classes become correlated. This practice has become widely used and should be permitted to continue for the benefit of investors. We note, also, the importance of ensuring that this is done in a way which ensures essential safeguards for liquidity and risk management and which **preserves the UCITS brand**, both in the EU and abroad, as a safe, liquid investment product.

We note that **diverging interpretations** between Member States regarding when a look-through approach is required has negative repercussions on investors and on industry – creating distortions in competition, legal uncertainty for industry, and influencing decisions in portfolio composition in order to avoid national barriers to cross-border distribution. To remediate national divergencies while ensuring investors retain the benefits of limited indirect exposure to ineligible asset classes, we encourage addressing these divergences in a manner which would achieve a **level of relative harmonisation** which is aimed at **ensuring the best investor outcome**. We outlined, at **Question 13**, the possibility of a **common questionnaire between regulators outlining their approaches**, which could serve to foster dialogue with a view to working,

together with ESMA, towards coordination and consistency of approach, provide legal certainty to managers, in particular those operating cross-border, and transparency for investors.

As outlined in our response to **Question 13**, this should have regard to the specific instrument through which indirect investment is obtained in terms of its liquidity and other characteristics. Regard should also be had to the role of risk management and adequate redemption frequency in securing a high level of investor protection.

We also note that the possibility to invest into asset classes that are otherwise ineligible for a UCITS should not be framed as a 'circumvention' of the rules, as per the wording of Question 22, as it is expressly permitted in the EAD, per Article 2(2)(c)(ii) (which permits investments in securities backed by, or linked to the performance of, "other assets, which may differ from those referred to in" Article 50(1) of UCITS).

Q23: What are the risks and benefits of UCITS investments in securities issued by securitisation vehicles? Please share evidence and experiences on current market practices and views on a possible need for legislative clarifications or amendments.

We support the regulatory framework regarding due diligence, considering it a necessary component, however we would like to explore methods to better streamline and make the process more efficient to better facilitate investment by UCITS funds, including methods to incentivise compliance by non-EU issuers in order to broaden the investible universe. We look forward to considering this more holistically as part of a broader discussion on the securitisation legal framework. As a separate point, we note that the authorisation process at national level could be made more efficient by ensuring that regulators make available the criteria according to which regulators will scrutinise and determine whether investments in particular CLOs and CDOs will be permitted.

Q24: What are the risks and benefits of permitting UCITS to <u>build up short positions</u> through the use of (embedded) derivatives, delta-one instruments or other instruments/tools? Please share evidence and experiences on current market practice and views on a possible need for legislative clarifications or amendments.

We understand that it is already possible to build up short positions under the existing legal framework, and we advocate to maintain this so long as it is clearly within the investment strategy of the fund (e.g. long-short equity strategy funds). Financial short positions can be a natural element in an investment strategy for both investment and risk management purposes. We are not aware of any practice in the market which would warrant a reopening of this topic by regulators.

Benefits include, for example, the ability for a UCITS with a simple bonds strategy to manage its credit risk through short positions in a CDS-index or manage its interest rate risk by taking short positions in bond futures. More complex strategies targeting certain risk premia, such as hedge fund or allocation strategies, could use short positions to lock in the risk premia they aim for. The current distinction between a fund using the commitment approach and the limit of 100%, and a fund using the VaR approach, is in our experience quite effective in differentiating between funds that use derivatives less or more extensively and the extent of the use of short positions.

In terms of risks, using physical short positions, which can be used by selling assets 'borrowed' via reverse repos or securities borrowing, is difficult for UCITS, as it collides with the very limited allowance to re-use collateral. We would also add options risk in terms of short position, and need for internal measures for managing "potentially" unlimited downside risks associated with selling options.

Q25: Apart from the topics covered in the above sections, have you observed any other issues with respect to the interpretation or consistent application of the UCITS EAD? If so, please describe the issues and how you would propose to revise the UCITS EAD or UCITS Directive with a view to improve investor protection, clarity and supervisory convergence.

Article 54 of UCITS permits a UCITS to invest up to 100% of their assets in public debt of a single issuer if the securities are from at least 6 different issues. The requirement for at least 6 different issues may be unduly restrictive. It is not intended to mitigate credit risk but rather had initially been to ensure the proper functioning of the capital market would not be disturbed (as per the Recitals to the UCITS). Compliance with this rule requires passive funds with a recommended minimum holding period whose portfolio is often based on a zero coupon bond to include more ISIN benchmarks in the portfolio, increasing the difficulty and expense of management as well as duration risk, to the detriment of the product's performance. Furthermore, this requirement was extended to government securities received by UCITS as collateral in ESMA's Final Report on the Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS, solely for the reason of aligning with the provisions of Article 54(1) of the UCITS Directive despite recognising the operational challenges of implementation.

Article 4(1)(15) of MiFID now provides that a *'financial instrument' means those instruments specified in Section C of Annex I, including such instruments issued by means of distributed ledger technology,"* following the insertion by Article 18 of the DLT Pilot Regime Regulation (EU) 2022/858. Similar clarifications should be issued by ESMA confirming the status of an eligible asset is not impacted by virtue of having been tokenised.

ABOUT EFAMA

EFAMA is the voice of the European investment management industry, which manages around EUR 28.5 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities. EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

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