7 May 2024
ESMA 34-1270380148-1033

Reply form

On the review of the UCITS Eligible Assets Directive

Responding to this paper

ESMA invites comments on all matters in this paper and in particular on the specific questions summarised in Annex 1. Comments are most helpful if they:

- respond to the question stated;
- indicate the specific question to which the comment relates;
- contain a clear rationale; and
- describe any alternatives ESMA should consider.

ESMA will consider all comments received by **Wednesday 7 August 2024.**

All contributions should be submitted online at www.esma.europa.eu under the heading 'Your input - Consultations'.

Instructions

In order to facilitate analysis of responses to the Call for Evidence, respondents are requested to follow the below steps when preparing and submitting their response:

- Insert your responses to the questions in the Call for Evidence in this reply form.
- Please do not remove tags of the type < ESMA_QUESTION_EADC_0>. Your response to each question has to be framed by the two tags corresponding to the question.
- If you do not wish to respond to a given question, please do not delete it but simply leave the text "TYPE YOUR TEXT HERE" between the tags.
- When you have drafted your responses, save the reply form according to the following convention: ESMA_CP1_EADC_nameofrespondent.

  For example, for a respondent named ABCD, the reply form would be saved with the following name: ESMA_CP1_EADC _ABCD.

- Upload the Word reply form containing your responses to ESMA's website (**pdf documents will not be considered except for annexes**). All contributions should be submitted online at https://www.esma.europa.eu/press-news/consultations/call-evidence-review-ucits-eligible-assets-directive under the heading *'Your input - Consultations'.*

Publication of responses

All contributions received will be published following the close of the consultation, unless you request otherwise. Please clearly and prominently indicate in your submission any part you do not wish to be publicly disclosed. A standard confidentiality statement in an email message will not be treated as a request for non-disclosure. A confidential response may be requested from us in accordance with ESMA's rules on access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by ESMA's Board of Appeal and the European Ombudsman.

Data protection

Information on data protection can be found at www.esma.europa.eu under the heading 'Data protection'.

Who should read this paper?

This Call for Evidence is of particular interest for investors and consumer groups interested in retail investment products, management companies of Undertakings for Collective Investment in Transferable Securities (UCITS), self-managed UCITS investment companies, depositaries of UCITS and trade associations.

1 General information about respondent

Name of the company / organisation	BlackRock Investment Management
Activity	Investment services
Country / Region	International

2 Questions

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?

<ESMA_QUESTION_EADC_1>

The Undertakings for Collective Investment in Transferable Securities (UCITS) framework is recognised as a benchmark for high standards for European and global investors alike. Preservation of the integrity of the framework that has made UCITS a success for European capital markets is of core importance in this review of the Eligible Assets Directive (EAD. BlackRock also welcomes the opportunity provided by the Call for Evidence to reflect on the evolution of market practices and other sectoral regulation since the EAD first came into force, and so consider whether additional changes should be made to the EAD, or whether targeted realignment of the overarching UCITS Directive could be beneficial.

The UCITS framework has proved itself as a valuable regulatory brand, with UCITS widely distributed outside the EU. To ensure the stability of the UCITS offering, any potential recommendations to make material changes to the range of eligible assets included in UCITS should be widely discussed with the broader international regulatory community before implementation, and should be consistent with relevant IOSCO Guidelines to ensure certainty for both EU and international investors.

We note that ESMA has regularly reviewed and updated a number of investment related issues impacting UCITS funds, whether through Guidelines or Opinions, and, as a result, we believe the EAD is functioning well and the requirements are well understood. In terms of updating the framework to reflect changes in other sectoral regulation we see opportunity for updates to the EAD in the areas of securitisation, pledging assets as collateral and the recognition of tokenised assets.

- The ability for UCITS to invest more widely in securitisations could provide access to a number of potential benefits by revisiting the scope of existing due diligence and administrative requirements. We see opportunities to make this process more efficient for both issuers and investors in this market, given there are currently significant disincentives on both sides.

- Innovation has emerged in the way collateral is received in respect of securities lending, whereby lenders can now take a security interest over, rather than title to, the collateral, which could enhance the competitiveness of UCITS in securities lending markets, while preserving the high level of investor protection provided under title transfer collateral arrangements. We are supportive of consistency in the interpretation of the permissibility of these arrangements, to continue to protect the competitiveness of UCITS, and reduce the cost of investing.
- UCITS are increasingly turning to Money Market Funds (MMFs) for cash and collateral management purposes. Their ability to do so is, however, capped by the restrictions on any UCITS from investing more than 10% of its assets in other collective investment undertakings. We would support the introduction of a derogation from the 10% threshold where EU MMFs are held for cash or collateral management purposes.
- We agree with the proposed clarification to MiFID II, put forward in ESMA's draft Markets in Crypto-assets Regulation (MiCA) guidelines, which state that any asset which currently classes as a financial instrument under MiFID II should remain so if this asset is tokenised, and believe this principle should be extended to transferable securities under EAD. Such tokenised assets can enhance liquidity for a particular asset class, reduce costs and enable smoother and faster settlement, increasing efficiency and value for UCITS investors.

Robust liquidity management to support regular dealing constitutes a core element of the UCITS framework. We believe the existing framework and ESMA Guidelines and Opinions provides a sufficiently strong framework. We welcome recent changes to the UCITS Directive to provide a common legal framework for the use of liquidity management tools across EU UCITS. These changes provide the opportunity to harmonise industry-leading best practices and reinforce regulatory obligations across Member States.

Overall, we have seen increasing convergence of regulatory practices since the introduction of the EAD. The most notable area where more consistency could be beneficial is the application of the requirements on look through and the eligibility of instruments such as exchange traded certificates where we provide our feedback on good practices in achieving an appropriate balance between investor protection and beneficial portfolio diversification.

Finally, the issue of eligibility of crypto-assets, as an instrument so distinctive to those originally considered in the UCITS Directive, raises issues around the extent to which the rigorous UCITS framework could or should adapt to such innovations. We believe this will require further detailed analysis on whether the UCITS framework is the most appropriate setting for facilitating retail access to these assets or whether another framework such as MiCA would be more appropriate bearing in mind the multiple issues regarding custody, valuation, liquidity and the development of the wider market ecosystem.

<ESMA_QUESTION_EADC_1>

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.

<ESMA_QUESTION_EADC_2>

We believe the current framework generally works effectively. We acknowledge that the diversification requirements can sometimes affect the eligibility of investing in certain indices which might be weighted more heavily towards an overrepresented sample of large cap stocks, and feel that any changes to this framework would have to achieve an appropriate balance between avoiding excessive concentration while ensuring appropriate levels of diversification.

<ESMA_QUESTION_EADC_2>

Q3 Have you experienced any recurring or significant issues with the interpretation or consistent application of 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.

<ESMA_QUESTION_EADC_3>

We note certain inconsistencies between the Money Market Funds Regulation (MMFR) and the UCITS EAD concerning the eligibility of reverse repurchase agreements (reverse repo) as eligible money market instruments, which could benefit from alignment.

Reverse repo is considered to be a very liquid and secure financial asset under Articles 9 and 10 of the MMFR. As such, reverse repo is permitted as an eligible asset for money market funds (MMFs), subject to several requirements in Article 15 MMFR which are intended to ensure the collateral provided under these agreements are of high quality, are liquid and are short dated.

In addition, under European Money Market Reform (EMMFR), reverse repo is only used on an overnight basis, a portfolio management technique which offers investors more protection than an unsecured bank deposit or MMI with 1 day maturity. In the event of a default of the counterparty, holding overnight reverse repo would mean that the investor is left with the basket of highly liquid, high-quality collateral.

This protects liquidity by giving the fund access to underlying eligible debt securities that can be held in place of the reverse repo itself.

In light of these protections, and considering that reverse repo has a contractual end, primary repayment is to the counterparty and collateral is only accessed in the event of default, we believe reverse repo should be viewed as money market instruments for the purpose of the UCITS EAD. <ESMA_QUESTION_EADC_3>

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.

<ESMA_QUESTION_EADC_4>

The notions of ‘liquidity’ and ‘liquid financial assets’ are difficult to define in prescriptive terms. Deciding how liquid a specific asset is, is a matter of judgment dependent on the assessment of many factors which are unique to each fund, including the availability of pricing data, the market jurisdiction, historical trading volumes and more. What is considered liquid today, may become less liquid in more challenging market conditions.

We consider that the definitions of these notions in the UCITS EAD are clear and sufficient. Attempting to narrow the definition of liquidity could prevent investors from being able to access a number of asset classes currently considered eligible, which have presented few liquidity challenges. Any further guidance on how the notions of ‘liquidity’ and ‘liquid financial assets’ can be interpreted would be more appropriate as Level 3 guidance from ESMA or the relevant NCA, and ideally should be principles-based, to both avoid regulatory arbitrage, and cater to the dynamic nature of liquidity.

<ESMA_QUESTION_EADC_4>

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.

<ESMA_QUESTION_EADC_5>

The presumption of liquidity in the EAD states that instruments which are admitted or dealt in on a regulated market shall be presumed to be negotiable “unless there is information available to the UCITS that would lead to a different determination.” In our view, this language is clear, as it emphasises the portfolio manager’s responsibility to conduct due diligence concerning the various elements that make up an asset’s liquidity, as mentioned in Q4. Liquidity risk management is a core element of a manager’s fiduciary duty to investors, and should remain so, considering their expertise and specific understanding of both the underlying elements of a fund and its investors.

Given the breadth of regulatory guard rails which have been put in place we believe it is appropriate to maintain the presumption of liquidity. The removal of the presumption of liquidity is likely to lead to substantial implementation cost, as a result to the change in operational and assessment processes arising out of the need of increased coverage over more standard assets, rather than focussing on increased scrutiny and analysis over less standard assets.

While we acknowledge that some market participants have interpreted the requirements in ways adverse to investor protection, these incidents represent a limited proportion of isolated failures, raising issues around the quality of governance, risk management and compliance at the individual firms concerned, rather than a lack of clarity in the legislation. Most notably, ESMA’s January 2020 Common Supervisory Action (CSA) highlighted that certain managers placed an overreliance on the presumption of liquidity, failing to base this on reliable data on trading volumes on an ongoing basis, or indeed applying the presumption to assets which were not traded on a regulated market, and which were not subject to liquidity analysis and forecasts.

In the last five years, ESMA and NCAs have placed extensive focus on liquidity assessment and management, promoting use of a wide variety of regulatory and supervisory tools which provide ample guidance to guard against these failures on a broader basis.

This includes several additions to the liquidity risk management framework for UCITS put in place after the CSA was conducted. Firstly, UCITS funds have become subject to ESMA’s Guidelines on liquidity stress testing, from September 2020, which has bolstered the UCITS EAD liquidity presumption by positioning regular, consistent, and thorough liquidity stress testing at the centre of a UCITS fund’s risk management process. This includes being able to show sufficient liquidity through stressed and normal conditions to the relevant NCA in order to obtain fund authorisation; demonstrating a detailed understanding of the specific liquidity risks associated with the assets and liabilities of the fund; and carrying out regular liquidity stress testing (at least annually, but typically conducted more frequently).

Secondly, the recent revisions to UCITS Directive[1] are set to enhance both the availability and use of Liquidity Management Tools (LMTs) in UCITS funds, given the requirements to select at least two LMTs

[1] By means of the revised AIFMD / UCITS texts, as published in the Official Journal of the EU in March 2024.

for open-ended funds which must be based on an assessment of how suitable the LMTs are in relation to the investment strategy, liquidity profile and redemption policy of the fund.

<ESMA_QUESTION_EADC_5>

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.

<ESMA_QUESTION_EADC_6>

Definitions of ancillary liquid assets

There are different interpretations of the term "ancillary liquid assets" among the EU Member States, with a minority of jurisdictions limiting this only to bank deposits at sight, not in line with other EU regulators.

Ancillary liquid assets according to the UCITS Directive are not explicitly defined (the Directive provides a framework rather than a definitive list), though they are typically understood to be supplementary to the main objective of the fund and are liquid, in that they can be easily converted to cash very close to their current value e.g. cash deposits, money market instruments such as short-dated government treasury bills, money market funds (MMF), reverse repurchase agreements. We recommend harmonising different interpretations on this basis.

Differences in concentration limits

The UCITS Directive does not specify any explicit concentration thresholds for ancillary liquid assets. Instead there are various limits applying to the type of instruments that could be ancillary liquid assets, irrespective of whether they are for investment or ancillary liquid purposes e.g. maximum 20% of NAV can be in the cash account at the custodian, maximum 30% could be held in any one treasury bill, maximum 20% in any one MMF etc.

- The CSSF has implemented a specific 20% limit to ancillary liquid assets.
- In France, the AMF has set a separate ratio for ancillary liquid assets and for deposits. Ancillary liquid assets be held up to 10% and can be raised to 20% in exceptional circumstances. In this case, the AMF requires a maximum of 30% total exposure to a single counterparty, by including this (unsegregated) cash held at sight.
- The Bank of Ireland's approach under the Directive has been not to add an additional limit specifically for ancillary liquid assets.

The supervisory differences on the limits applicable to ancillary liquid assets, as well as the treatment of potential breach classifications, have come to light recently due to discussions on the move of US, Canadian and Mexican assets to a T+1 settlement basis. Settlement mismatches between fund dealing cycles and the standard settlement cycle for securities in a domestic market have led to temporarily increased/decreased cash levels, raising operational difficulties for managers who may operate cross-border.

We believe ESMA's coordination of responses to this topic has been positive in driving a more convergent approach. We encourage ESMA to continue these discussions.

<ESMA_QUESTION_EADC_6>

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.

<ESMA_QUESTION_EADC_7>

Our primary use of FX instruments relates to hedging currency risk, either at portfolio or share class level. Any exposure for pure investment purposes would need to be consistent with both the investment objectives of the fund and the overarching liquidity requirements of UCITS.

<ESMA_QUESTION_EADC_7>

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.

<ESMA_QUESTION_EADC_8>

We have observed divergent practices across jurisdictions as to what qualifies as a "transferable security and money market instrument other than those referred to in Article 50(1) of the UCITS Directive".

We note that some investors are keen to increase their exposure to private markets within a UCITS wrapper, given the often-attractive risk-return profiles and diversification benefits, which can contribute to efforts to build up long-term savings. We acknowledge that UCITS as a framework rightly prioritises liquidity and the ability to redeem units at an investor's request and believe facilitating (restricted) access to private assets through the 10% limit does not contravene these principles, if properly adhered to with appropriate risk management and liquidity management.

One such private asset class in this category is unlisted equities. Jurisdictions differ on the length of lock up periods permitted for unlisted equities post IPO, ranging from no mention of the timeframe whatsoever, up to a one-year cap. Permitting a lock up period of at least one year for unlisted equities (on a pre-IPO basis) could help facilitate the ability of UCITS investors to build up starting positions in promising unlisted companies at lower costs, which may then grow and potentially list at an attractive valuation. Such access to private assets, even contained to 10%, can help to deliver stronger, less correlated returns in the long term.

The range of alternative investment funds (AIFs) has expanded significantly since the publication of the EAD. We encourage ESMA to reassess the eligibility of those AIFs which do not comply with Article 50(1)(e) (i)-(iv) of the UCITS Directive within the 10% ratio. Appropriate guardrails could include an assessment of the AIF's impact on the UCITS' overall liquidity profile, the liquidity profile of the AIF itself and whether those AIFs are constituted in a regulated fund format such as a European Long-term Investment Fund (ELTIF) or whether they are set up in a fund of funds format.

Secured bank loans (as opposed to direct lending where issues have been addressed in the recent AIFMD review) similarly have demonstrated clear value for investors, including typically higher return performance than other corporate debt categories, as well as diversification benefits due to their low correlation with other fixed income sectors. They are also part of a well-established market with deep liquidity and a very transparent secondary market, ensuring investors can benefit from fairer pricing and lower price volatility. However, we observe differences in interpretation regarding their eligibility within the 10% limit, and suggest harmonisation to permit access to these assets.

We are also conscious that in the absence of a formal name for the 10% limit, it has more commonly been known as the 'trash bucket', suggesting that the assets in this category are expected to be substandard in some way. In reality, these assets are still required to classify as a transferable security or money market instrument, and must still align with the best interests of unitholders of the fund.

We would encourage ESMA to formalise a name for these assets instead, such as the 'adjusted risk-allocation allowance' for instance, reflecting the function of this segment of assets as a means for UCITS investors to increase the diversification of their fund within a controlled environment. This would not necessitate re-opening the EAD, and could be communicated by means of an ESMA Opinion.

<ESMA_QUESTION_EADC_8>

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.

<ESMA_QUESTION_EADC_9>

We consider the transferable security criteria clear enough for NCAs and market participants to assess individual securities. We agree with the proposed clarification to MiFID II, put forward in ESMA's draft MiCA guidelines, which state that any asset which currently classes as a financial instrument under MiFID II should remain so if this asset is tokenised, and believe this principle should be extended to transferable securities under EAD. Such tokenised assets can enhance liquidity for a particular asset class, reduce costs and enable smoother and faster settlement, increasing efficiency and value for UCITS investors. FAQ from ESMA on how amendments to MiFID II should apply to UCITS and EAD could be helpful in ensuring a consistent approach across EU jurisdictions and improve the readability of the single rule book.

As discussed in our response to ESMA's consultation on the draft MiCA guidelines, we are conscious that crypto-assets which do not meet MiFID II criteria, such as bitcoin and ether, would not currently be considered transferable securities. Given the multi-faceted considerations around custody, valuation, liquidity, and diversity of this ecosystem, we believe this will require further detailed analysis on whether the UCITS framework is the most appropriate setting for facilitating retail access to these assets, or, whether another framework such as MiCA would be more appropriate.

Concerning the references to 'regulated markets' in Article 2(1) EAD, as defined by article 4(14) of MiFID, we believe that digital trading exchanges satisfy these criteria, and should be included in ESMA's database of all such listed markets. Similar to traditional stock exchanges, they provide a mechanism for trading and liquidity, playing an important role in the price discovery process, and are subject to regulatory controls under MiCA.

<ESMA_QUESTION_EADC_9>

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.

<ESMA_QUESTION_EADC_10>

In common with industry practice, BlackRock's management companies operate a governance process to ensure that all new asset types are captured by our risk management processes and that they can be valued in accordance with the terms set by our internal pricing committees with a process subject to review both internally and externally (e.g. as part of the depositary oversight process).

We also note that ESMA has recently reviewed relevant risk management and valuation practices and as part of its 2022 CSA on Valuation where certain recommendations were made to address short-comings and vulnerabilities. We believe this provides sufficient regulatory and supervisory guidance.

<ESMA_QUESTION_EADC_10>

Q11 Are the UCITS EAD provisions on investments in financial instruments backed by, or linked to the performance of assets other than those listed in Article 50(1) 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.

<ESMA_QUESTION_EADC_11>

Answering Questions 11 and 13 together.

We believe that the UCITS EAD provisions are generally adequate and there is a broad convergence around the steps needed to be taken to ensure compliance with the EAD. We have, however, observed differences in supervisory interpretation and we suggest that alignment along the lines set out below would be beneficial in delivering an appropriate balance of investor protection and investment diversification.

Indirect exposure to assets which cannot be directly held by UCITS funds can provide many benefits for investors, and has a long history of functioning well in a number of jurisdictions.

In this context, a recurring question relates to the eligibility of exchange-traded commodities (ETC), often in the context of precious metals ETCs. These products can offer investors exposure to commodities by means of a more reliable, more liquid, transparent and cost-effective structure. This means gaining access to investment benefits such as uncorrelated returns to direct UCITS holdings, free of the operational challenges of investing in precious metals themselves. The exchange-traded structure can also provide the benefit of protecting the assets through a custodian, and enhanced efficiencies inherent to an exchange-traded wrapper, such as increased liquidity, more transparent price discovery and more frequent trading (which will only improve with the adoption of a consolidated tape in Europe) – ultimately providing investors with more cost-effective exposure to commodities.

We consider ETCs linked to metals as somewhat distinct from other commodities, due to the intrinsic value these assets have, which allow them to be used as safe haven investments in times of stress, distinct from other commodities which may be more susceptible to volatility.

ETCs are typically structured as debt instruments which represent the monetary value linked to the price of the underlying precious metal, but do not represent the precious metal itself, ensuring compliance with Article 50 of the UCITS Directive. They are listed on a recognised stock exchange and designed to meet the requirements for treatment as “transferable securities”.

From a risk management perspective, managers consider the structural features of the underlying assets in their risk management processes, ‘looking through’ to these underlying assets in their regular monitoring, rather than just the exchange-traded product. This is a key consideration for UCITS investors, as it means risk management processes, such as liquidity stress testing, which require careful assessment of the potential impact of market sensitivities of the fund’s holdings, take into account the underlying assets as part of that process. The proportion of assets not directly investable by UCITS funds should of course remain limited within the fund’s holdings, and in our experience typically is, in keeping with the liquid and diversified nature of the UCITS framework.

As the underlying commodities are accessed by investors through a listed instrument, it does not raise the challenge of requiring a UCITS fund investor to receive physical settlement on an early redemption of the entire ETC series, but rather allows the investor to receive cash settlement on an early redemption. ETCs linked to precious metals, such as gold, that hold such precious metals physically, do not generally embed derivatives.

For investor protection purposes, it is important that investors have transparency regarding the nature of the assets held by the fund. UCITS which hold ETCs or indeed any other asset not directly investable, should disclose so both in pre-contractual disclosures such as the prospectus, to inform investor decision-making, and provide updates on an ongoing basis where relevant. Such transparency allows investors to build confidence and trust regarding key related elements such as the risk profile, expected returns, and costs. We believe the MiFID II product governance framework’s guidelines regarding the treatment of complex products such as ETCs, including the need to provide clear and comprehensive risk disclosures, and to ensure the manufacturing and distribution of such products is aligned with the needs and risk profiles of the intended investors, provides a robust layer of investor protection in this regard.

<ESMA_QUESTION_EADC_11>

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.

<ESMA_QUESTION_EADC_12>

We consider these articles to be sufficiently clear.

<ESMA_QUESTION_EADC_12>

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.

<ESMA_QUESTION_EADC_13>

See Question 11.

<ESMA_QUESTION_EADC_13>

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.

<ESMA_QUESTION_EADC_14>

Investment in non-UCITS funds

We believe there is merit in updating the eligibility of investment in non UCITS funds to better reflect the regulatory regime which covers AIFs, recognising that there are many types of AIFs with different asset allocation regimes, fund and regulatory structures and liquidity profiles. As such, we believe that in the future it may be beneficial to give a clear list of factors to take into account rather than attempting to provide a definitive list of eligibility.

The UCITS Directive provides a framework for investment into non-UCITS funds which have an investment universe equivalent to that of a UCITS under Article 50(1). While this can be a helpful framework in defining potential eligibility, the level of detail required in the assessment of equivalence is in practice very detailed, and retail AIFs such as US ETFs can fail the eligibility test due to operational differences in other jurisdictions, such as the way cash collateral is accounted and treated for.

For example, in 2013, changes were made to the prospectuses for many US ETFs to make them UCITS equivalent e.g. aligning them with UCITS rules on borrowing and the prohibition on short selling. However, due to the requirement for funds not to invest more than 10% in other collective investment schemes (CIS) – including both direct and indirect investment (e.g. through re-investment of cash collateral into MMFs) – many US ETFs were not able to qualify as eligible, owing to their enrolment in securities lending programmes where cash collateral is mandated to be invested in US 2-a7 MMFs. The SEC maintains a similar 10% restriction on investments in UCIs as in the EU, but MMFs do not qualify as "CIS" for this purpose. This disparity between the US and EU definitions of a CIS for the purpose of the 10% limit, and the requirement to include indirect exposure, are the main reasons why US ETFs are not treated as eligible. We do not think the intended consequence of the application of indirect CIS exposure to the maximum 10% CIS rule, nor the fund of fund cascade rule more generally, was to make it almost impossible for a US ETF to be an eligible UCITS investment. Therefore, where the overall investment universe is consistent with UCITS investment restrictions, we believe the diversification benefits are likely to outweigh differences in cash collateral reinvestment. More guidance on the where to draw the line on equivalence would be beneficial in this case.

Closed-ended / open-ended funds

The closed-ended / open-ended definition originally reflected an analysis that certain closed-ended vehicles were largely structured in the same way as listed trading companies – e.g. UK investment trusts or many types of Real Estate Investment Trusts (REITS) – and that therefore it was logical to assess the level of transferability and liquidity based on their listing on a regulated exchange and depth of trading. While we continue to agree with this analysis, we do not think this holds true for all closed-ended AIFs which may not be traded or offer any ongoing secondary market liquidity features. The distinction does not assist with assessing the eligibility of certain hybrid AIF structures which may offer periodic redemption facilities.

One example is that of Canadian REITs, some of which have offering documentation which describe the possibility of a redemption facility. These REITs are set up as “open-end mutual fund trust” for domestic tax purposes but do not qualify as mutual funds under domestic fund regulation leading to differing interpretations of eligibility by member states. Given the primary structure is a closed-ended listed vehicle, we would consider them as closed end funds and assess them against the criteria for such funds.

A further example relates to EU regulated ELTIF structures which may be closed-ended, or have regular liquidity windows in an evergreen structure, with a different asset allocation and liquidity profile from that of UCITS. Allowing UCITS to use the 10% ratio to allocate to the evergreen vehicles could provide a straightforward and effective way of allowing more private investors to allocate to private markets, in a restricted, regulated and controlled manner, dependent on a detailed assessment by the manager as to whether the ELTIF’s liquidity profile is consistent with the liquidity profile of the investing UCITS. While in the future a secondary market in closed-ended ELTIFs may develop, we do not see significant demand for this type of structure. However, we would welcome a broader assessment of the structural liquidity features of ELTIFs and their portfolio diversification benefits to UCITS portfolios.

We would also support further ESMA guidance to align member state interpretation of closed-ended AIFs, with a focus on assessing the primary operating structure of the fund.

<ESMA_QUESTION_EADC_14>

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? Please describe any 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.

<ESMA_QUESTION_EADC_15>

As noted in Question 14, investing in non-EU ETFs can be challenging under the current UCITS rules, particularly US ETFs, as the US rules on reinvestment of cash collateral mean that they would be considered to be in breach of the restriction on investing more than 10% of their assets in collective investment schemes.

While this rule is well-intended as a means of ensuring diversification, it can hinder the ability to gain exposure to highly liquid, diversified and cost-efficient US ETFs, potentially limiting investor choice.

We see two possible solutions, where future guidance from ESMA could be helpful:

- MMFs would not be considered as a CIS for the purpose of the maximum 10% that can be invested in CIS, to make them an eligible investment. This would be in line with the US ‘40

Act regulations, where 2a7 money market funds are not included in the '40 Act maximum 10% in CIS prospectus rule. Our proposal would be to amend the Prospectus wording to state "Maximum of 10% in aggregate in CIS, with the exception of MMFs", on the basis that this allows better risk diversfication when holding cash collateral and also that MMFs are highly unlikely to be used for a fund-of-fund strategy and so the cascade risk is minimal.

- Alternatively, the maximum 10% CIS rule could be disapplied from indirect reinvestments of cash collateral into a CIS.

If the self-imposed maximum 10% in CIS rule were to not apply to MMFs, there would be more same day liquidity options available to UCITS, introducing a more efficient process in the case of large subscriptions or redemptions and even in the case of settlement mismatches, the likelihood of which increased with the recent accelerated settlement changes of markets such as the US (T+1).

As it stands, UCITS with a larger short-term cash or collateral requirement effectively need to place cash with a less diverse and potentially less liquid (laddered investment rather than available same day / overnight) selection of MMIs and short dated debt securities. The ability to use MMFs in place, would reduce operational burden and increase both diversification and liquidity in heavily regulated short-term MMFs. <ESMA_QUESTION_EADC_15>

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.

<ESMA_QUESTION_EADC_16>

Securities lending transactions are undertaken by UCITS as part of their EPM strategies, which generates incremental revenues from their asset holding, thereby increasing returns for end-investors. These incremental returns can effectively offset a significant portion of the costs of investing.

Market practices regarding the operation of securities lending have evolved since the introduction of the EAD and the existing rules effectively limit the capacity of UCITS to generate additional revenue through securities lending. These relate to limitations on the use of pledge collateral in addition to title transfer, and the investment of cash collateral.

<u>Pledge collateral</u>

Traditionally, collateral in respect of securities lending is received on a title transfer basis, however, in recent years an alternative structure has emerged in the market whereby lenders take a security interest over, rather than title to, the collateral (commonly referred to as "pledge arrangements"). We believe this has a similar risk profile to the title transfer model.

While the UCITS Directive specifically permits for securities lending where "the transaction is covered by high-quality and liquid collateral received by the UCITS via a title transfer arrangement", the 2014 ESMA Guidelines on ETFs and other UCITS issues refers to "title transfer…[and] other types of collateral arrangements" which suggests that alternative collateral arrangements such as pledge may be permissible. ESMA's 2018 Peer Review on the ESMA Guidelines also acknowledged this perceived inconsistency and recommended that this be considered and addressed.

This uncertainty currently prevents UCITS from receiving collateral by way of pledge, meaning their lendable inventory is typically underutilized as compared to lenders that are not subject to the same limitation. We anticipate that this competitive disadvantage will likely be further exacerbated by the forthcoming changes to capital rules applicable to bank borrowers which, as things stand, could see borrowing from UCITS become prohibitively expensive.

In order to protect the competitiveness of UCITS in securities lending markets (and the incremental returns that lending generates for end investors, thus reducing the cost of investing for investors), ESMA could intervene to ensure consistent interpretation and application of the UCITS Directive across the EU by clarifying that collateral may be received under a pledge arrangement rather than only by way of transfer of title.

This would continue to preserve the high level of investor protection provided under title transfer collateral arrangements as security interest collateral arrangements have been structured such that they are legally akin to title transfer arrangements so that they are "capable of being fully enforced by the UCITS" for the purposes of paragraph 43(h) of the 2014 ESMA Guidelines on ETFs and other UCITS and can be appropriated and liquidated as quickly following a borrower default.

To this end, we note that the International Securities Lending Association (ISLA) has produced market standard documentation for pledge arrangements as well as supporting legal opinions on the enforceability of pledge arrangements and the extent to which they constitute "security financial collateral arrangements" for the purposes of the Financial Collateral Directive. Given the perceived inconsistency referenced above is borne out of the UCITS Directive and the ESMA Guidelines, it may be prudent for any changes in respect of UCITS' ability to utilise pledge arrangements be made in the UCITS Directive itself, rather than in the UCITS EAD.

Securities lending fees

Concerning the securities lending fees, the ESMA Guidelines on ETFs and other UCITS issues require disclosure of the EPM costs to investors, and that all "revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS".

The CSA on Costs and Fees also highlighted several issues relating to fee splits in securities lending agreements including:

- the extent to which UCITS managers use fixed fee splits without assessing if the revenue generated and the amount retained by the agent are competitive and in the best interest of investors,
- concerns regarding the risk of overcharging investors if not regularly reviewed and adjusted to market conditions, and
- the range of percentage of revenue returned to UCITS.

It is important to ensure transparency of costs associated with securities lending activity to end investors, and to assess and periodically review such costs to ensure that they are competitive and proportionate to the revenue generated. However, hard limits on security lending fees do not adequately recognise the variation in scale and operational sophistication of lending agents' platform offerings, and the subsequent differences that may result in in fee split arrangements.

We consider that it is the contractual and operational protection afforded to participants in agent lending programmes, and the net-of-fees return to UCITS that should be assessed when considering whether a particular fee split arrangement is justified and in the best interest of investors.

For example, indemnities offered to UCITS against borrower defaults or robust internal collateral management oversight functions can provide significant additional protection to UCITS, further reducing risks associated with securities lending. Further, a higher percentage of gross revenues being returned to UCITS may not necessarily result in a higher net return to UCITS if one agent's proficiency and scale means it is able to achieve higher loan fees, as illustrated in the hypothetical scenario below.

	Fee Split (UCITS/Agent)	**Annualised Gross Lending Return (basis points)**	**Net Return to UCITS (basis points)**
Agent 1	90/10	1.0	0.9
Agent 2	70/30	3.0	2.1

As such, rigid parameters such as fee caps are not an accurate means of ensuring maximum protection and returns for UCITS. Instead, they could have the opposite effect by reducing the investment by lending agents in their platforms and/or reducing the number of lending agents that are prepared to offer this service, thus reducing market competition and robustness.

It is therefore important to refocus on the issues highlighted by the CSA by articulating for UCITS managers how performance and lending agent offerings should be assessed, and ensuring that such assessments are sufficiently frequent and robust. Initiatives such as [ISLA's Securities Lending Performance Measurement – Industry Guidance](), which seeks to develop a robust and transparent framework around certain performance metrics, should assist with such assessments.

Investment of cash collateral

Issues around cash collateral arise because a number of borrowers prefer to provide cash as collateral against securities lending transactions, which the lending agent can then reinvest conservatively into money market funds. However, due to the requirement that no more than 10% of the assets of a UCITS, including reinvested cash, be invested in other UCITS or other UCIs, taking cash collateral is usually not commercially viable. Most UCITS investors are therefore disadvantaged by this rule, as they do not experience the financial benefit of the demand to borrow securities, from borrowers who want to utilise excess cash. Establishing clear rules around this scenario would enable UCITS participation, protecting this diversified income stream for investors.

.<ESMA_QUESTION_EADC_16>

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?

<ESMA_QUESTION_EADC_17>

We do not see benefits to investors from linking the notions of EPM and SFT.

The existing concepts are each well understood and able to be reflected clearly within fund prospectuses, and we see no reason to alter them: in fact, this could cause confusion to investors as EPM techniques, which are used by UCITS funds to optimize their performance and reduce costs in a number of ways, are not limited to securities financing transactions (SFTs), but also include the use of derivatives and other instruments.

<ESMA_QUESTION_EADC_17>

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? If so, please provide details on the issues you have observed and how you would propose to clarify or link the relevant definitions or concepts.

<ESMA_QUESTION_EADC_18>

The EAD currently makes reference to much of the now repealed Directive 85/611/EEC and updating these references to the current version of the consolidated UCITS Directive would improve clarity and readability.

We also note that the definitions of MMFs across EMIR, MiFID, PSR, and MiCA do not align, and we would welcome ESMA adding a definition that would make MMFs eligible for use under the EAD and these regulations. This could relieve operational challenges in cases such as where repurchase agreements (repo) are used by Electronic Money Institutions (EMIs) as a means of safeguarding customer funds, or for CCPs, for whom Public Debt Constant Net Asset Value (PDCNAV) funds often play an important role as part of their collateral reinvestment strategies.

<ESMA_QUESTION_EADC_18>

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.

<ESMA_QUESTION_EADC_19>

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<ESMA_QUESTION_EADC_19>

Q20 Please fill in the table in the Annex to this document on the merits of allowing direct or indirect UCITS exposures to the asset classes listed therein, taking into account the instructions provided in the same Annex. 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 market-wide) 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.

<ESMA_QUESTION_EADC_20>

We comment on a selected number of asset types highlighted by our investment teams.

1. Loans	
Merits of allowing direct UCITS exposure	• **Higher yields and diversification**: Loans, especially loan participations and CLOs, can provide higher returns than other corporate debt categories, as well as diversification benefits due to their low correlation with other fixed income sectors. • **Low interest-rate sensitivity and inflation hedge:** Collateralized Loan Obligations (CLOs) in particular are typically structured as floating-rate instruments. The loans tend to adjust their yields according to a designated benchmark rate. This means that they have lower interest-rate sensitivity and can protect investors from rising rates and inflation. • **Loans have an attractive risk profile and credit quality**: Loans have lower default rates, higher recovery rates, and stronger credit quality than most corporate bonds, as they are secured by first-lien collateral and backed by covenants. CLOs also have a robust structure that mitigates the risks of the underlying loans. • **Market with deep liquidity**: Loans are part of a large and still growing market. They have well-established liquidity, with high average daily trading volumes both for investment grade and non-investment grade CLO debt. CLOs also have observable secondary transactions and full transparency into the underlying collateral. • **Supporting real economy:** Provides capital to enterprises that may be looking to expand, make acquisitions or undergo other growth initiatives, which can contribute to economic growth.
Merits of allowing indirect UCITS exposure	• Could gain access to even higher liquidity if loans are invested in through exchange traded products rather than directly.
Extent/amount of existing UCITS exposures	
Additional Comments	
2. Catastrophe Bonds ("cat bonds")	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
3. Contingent Convertible Bonds ("CoCo bonds")	

Merits of allowing direct UCITS exposure	• **Higher yields with diversification benefits:** These hybrid securities can convert into equity or be written off when the issuer's capital ratio falls below a certain threshold. In the UCITS context, we would recommend that only those with terms which specify the CoCo bond converts into equity be permitted as UCITS-eligible. CoCo bonds typically offer higher yields than traditional bonds and can help improve asset diversification within a portfolio. • **Reliable liquidity and valuations:** CoCo bonds have similarly comparable liquidity to other corporate bonds, and are priced in the same way as traditional bonds. • **Issued by regulated entities with transparent reporting**: CoCo bonds are predominantly issued by banks and insurers, who are subject to robust regulatory regimes and stress testing. The reporting of capital ratios has become more transparent and standardised over the years, and the terms and conditions of each issuance are clearly specified and widely available. • **Can reduce credit risk and offer capital appreciation potential**: CoCo bonds can reduce credit risk for investors by strengthening the resilience of the issuer in instances of stress, as the conversion to equity can improve the issuer's capital position. Moreover, the conversion to equity can offer a potential for capital appreciation if the issuer's situation improves and the equity value increases.
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	• **CoCo bonds can be volatile and subject to extension risk**: CoCo bonds are subject to volatility and uncertainty, as the conversion or write-off trigger depends on the issuer's capital ratio, which can fluctuate due to market conditions or regulatory changes. CoCo bonds are also subject to extension risk, as the issuer may decide not to call the bond at the expected date, which can affect the bond's price and yield.
4. Unrated bonds	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
5. Distressed securities	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	

Extent/amount of existing UCITS exposures	
Additional Comments	
6. Unlisted equities	
Merits of allowing direct UCITS exposure	Access to private markets for UCITS investors, selectively, can help to deliver stronger, less correlated returns in the long term, an attractive consideration for investors using UCITS to save for the future. In detail: • **Higher return potential:** Unlisted equities can be purchased pre-IPO, providing investors the opportunity to build up starting positions in these promising companies at lower costs, which may then grow and potentially list at an attractive valuation. • **Exposure to innovation:** Investors can gain access to innovative and disruptive businesses, supporting growth in new sectors, and gaining insight into potential future economic drivers. • **Risk diversification:** Unlisted equities are not subject to the same market fluctuations as listed companies, which can sometimes provide a more stable investment environment.
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	Reliable liquidity and valuation can be more challenging for unlisted equities than their listed counterparts, and we support limiting holdings in alignment with the 10% rule.
7. Crypto assets	
Merits of allowing direct UCITS exposure	The issue of direct eligibility of crypto-assets, as an instrument so distinctive to those originally considered in the UCITS Directive, raises issues around the extent to which the rigorous UCITS framework could or should adapt to such innovations. Given the multi-faceted considerations around custody, valuation, liquidity, and diversity of this ecosystem, we believe this will require further detailed analysis on whether the UCITS framework is the most appropriate setting for facilitating retail access to these assets, or, whether another framework such as MICA would be more appropriate. Noting though, that not all digital assets are alike, we support the general principle in the MiCA regulation not to change the regulatory treatment of financial instruments which already qualify as transferable securities, just because they have been tokenised. Such tokenised assets can enhance liquidity for a particular asset class, reduce costs and enable smoother and faster settlement, increasing efficiency and value for UCITS investors.
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	

Additional Comments	
8. Commodities and precious metals	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	See below.
Extent/amount of existing UCITS exposures	
Additional Comments	
9. Exchange-traded commodities ('ETCs')	
Merits of allowing direct UCITS exposure	• **Enables simplification and cost reduction:** There are currently many ways that investors can gain direct exposure to commodities, but these impose unnecessary costs on investors, can lack transparency and often tend to have higher counterparty risk. However, accessing commodities through exchange traded products increases liquidity, enables more transparent price discovery and more frequent trading – ultimately providing investors with more cost-effective exposure to commodities. • **Increased protections and higher returns:** ETCs have historically displayed low correlation to stocks, providing increased return potential and diversification. The exchange-traded structure also provides the benefit of protecting the assets through a custodian, and provide the investor the ability to receive cash settlement on an early redemption, rather than physical settlement.
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	We have observed divergent approaches across NCAs, with many, but not all, NCAs recognising ETCs as UCITS-eligible, and for the reasons mentioned above, we see this as an opportunity for harmonisation across Member States.
10. Real estate	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	

Additional Comments	
11. Real Estate Investment Trusts (‘REITs’)	
Merits of allowing direct UCITS exposure	• **Traded on regulated markets:** As publicly traded assets, REITs can provide liquidity and transparency for investors. The valuations of REITs are based on the market prices of their shares, which reflect the underlying value of their real estate assets. • **More efficient than real estate, but with access to the associated benefits:** REITs are tax transparent vehicles that invest in real estate and distribute most of their income as dividends to investors. They allow investors to access different sectors and locations of real estate without requiring direct ownership or high capital. They are also easier to buy and sell than physical real estate, which can take a long time and incur high costs. REITs also provide economies of scale, as they can manage large portfolios of properties with lower expenses and leverage. As noted in our response to Q14 we note some interpretative issues regarding the status of UCITS in some jurisdictions and how to resolve these.
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
12. Special Purpose Acquisition Companies (‘SPACs’)	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
13. EU AIFs	
Merits of allowing direct UCITS exposure	The range of alternative investment funds (AIFs) has expanded significantly since the publication of the EAD. We encourage ESMA to reassess the eligibility of those AIFs which do not comply with Article 50(1)(e) (i)-(iv) of the UCITS Directive within the 10% ratio. Appropriate guardrails could include an assessment of the AIF’s impact on the UCITS’ overall liquidity profile, the liquidity profile of the AIF itself and whether those AIFs are constituted in a regulated fund format, such as a European Long-term Investment Fund (ELTIF), or whether they are set up in a fund of funds format.

Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
13. Non-EU AIFs	
Merits of allowing direct UCITS exposure	Permitting access to non-EU ETFs, which would currently classify as non-EU AIFs for the purpose of UCITS, can provide investors exposure to a variety of industries that may be performing well in their respective regions, in a highly liquid, diversified and cost-efficient way. Markets can differ in the stages they are in with regards to economic cycles, regulatory regimes, and sectoral balances and such exposure provides UCITS investors the opportunity to take advantage of growth opportunities across regions. While we agree that the eligibility of these funds should consider how equivalent the investment universe is to that of a UCITS, we note challenges with the eligibility test due to operational differences in other jurisdictions, such as the way cash collateral is accounted and treated for, which appear to be an unintended barrier. See our answer to Q15 for further detail on the obstacles to investing in non-EU AIFs.
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
15. Emissions allowances	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
16. Delta-one instruments	

Merits of allowing direct UCITS exposure	
Merits of allowing direct UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
17. Exchange-traded notes ('ETNs')	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	
18. Asset-backed securities ('ABS') including mortgage backed securities	
Merits of allowing direct UCITS exposure	• **ABS / MBS offer yield and diversification through securitized loans**: ABS / MBS are securities that are backed by pools of loans, such as mortgages, consumer credit, or corporate debt. They offer investors a steady stream of income from the interest and principal payments of the underlying loans, and a diversification benefit from exposure to different types of borrowers and sectors. • **ABS / MBS are liquid and transparent assets with reliable valuations**: ABS / MBS are traded in large and active markets, especially in the US, where they have standardised features and high credit ratings. The information on the underlying loans and collateral is readily available from market data providers, and the liquidity and pricing of the securities can be tracked from the TRACE database and other sources. • **Offers lower duration risk**: ABS / MBS are usually floating rate and have shorter maturities than other fixed-income securities, which reduces the duration risk and the sensitivity to interest rate changes. As long as they meet certain criteria of credit quality, diversification, and liquidity, ABS / MBS should be able to be included in UCITS funds.

Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	Some sectors of Asset-Backed Securities trade daily but require a lead time to gather quotes so mangers may require more preparation when trading these securities The inclusion of notice periods, for example prior day notice rather than same day notice, can give time to do so.
19. Other relevant asset classes	
Merits of allowing direct UCITS exposure	
Merits of allowing indirect UCITS exposure	
Extent/amount of existing UCITS exposures	
Additional Comments	

<ESMA_QUESTION_EADC_20>

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.

<ESMA_QUESTION_EADC_21>

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<ESMA_QUESTION_EADC_21>

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.

<ESMA_QUESTION_EADC_22>

As noted in our answer to Question 11, there are several benefits to investors having limited exposure to assets not permitted to be directly held by the UCITS fund, which we believe should be preserved. They permit investors to access higher returns which are less correlated to the traditional fund holdings, without the higher costs and complexities related to custody, settlement, and operational risk management, which typically come with investing directly in commodities.

To maintain the benefits of wider portfolio diversification, we do not support extending the look through approach beyond that currently applicable to investment in derivatives. Rather we recommend focussing on the risk management assessment by the manager of the relevant investments. As discussed in Question 11, fund managers already incorporate this approach when assessing and monitoring the risks that any underlying assets may have on the broader fund and are required to take action to manage such risks. These holdings and any associated risk considerations should also be communicated to investor by means of both the pre-contractual disclosures such as the prospectus and the Key Information Document (KID), which can outline either the detailed holdings information or the risk indicators, and ongoing disclosures such as updates on the fund manager's website. The combination of managing the risks of the underlying assets as well as communicating these to investors help to maintain transparency and accountability, without impacting returns.

Generally speaking, as long as a security meets the requirements for a transferable security under the EAD and is therefore an eligible asset for a UCITS fund, there should not be look through to the underlying investment exposure of that transferable security to determine whether the underlying investment exposure can also be directly held by a UCITS fund, save where the EAD currently requires a look through.

As part of the focus on risk management, ESMA may also consider guidelines on looking through to the risk profile of the underlying where the lack of liquidity in the relevant asset could significantly increase the likelihood that investor redemption requests cannot be easily met, for instance, where liquidity could be severely constrained. Conducting this principles-based test would ensure that one of the core features of a UCITS fund, the ability for the fund to meet investor redemptions, is protected. This also reinforces the fiduciary duty of the investment manager to justify how the investment and risk management decisions they are making are truly aligned with the investor's best interests.

<ESMA_QUESTION_EADC_22>

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.

<ESMA_QUESTION_EADC_23>

The ability for UCITS to invest in securitisations could provide access to a number of potential benefits which are currently hindered by onerous administrative requirements. UCITS could gain access to returns that have typically proven higher than other fixed income products, a source of diversified liquidity that can prove prudent in times of market stress, and a market which can contribute to real economy growth in Europe for all member states.

Conducting due diligence is an important part of the risk assessment process for securities of this kind, and indeed should be performed as part of a manager's fiduciary duty to investors. However, we see opportunities to make this process more efficient for both issuers and investors in this market, given there are currently significant disincentives on both sides. This could involve simplifying the report process by consolidating the different reporting templates into a single template and considering limiting the level of detail required in these reports, particularly for private securitisations or those of a very high investment grade.

Separately, we see opportunity to enhance clarity around the way securitised assets are considered for the purpose of the 'significant influence rule', which prevents more than 10% of debt in issue to be held (Article 56 (2) (b)). It is inevitable with a securitised vehicle that the total deal size will reduce as the tranches are paid down. Therefore, the denominator used for the max 10% (current deal size) will decrease, resulting in a growing % held by the UCITS.

See example below:

Point A in time:

UCITS investment in junior class of securitisation = €1m

Original deal size (all the classes added together) = €100m

% of deal held = 1%

Point B in time:

UCITS investment in junior class of securitisation = €1m

Current deal size (all of senior classes now paid down) = €10m

% of deal held = 10% (Breach)

This then requires a sale to be made at the time when most performance can be accrued and in non-economic (in size) lots, which causes additional transaction costs and is a deterrent for UCITS to invest in junior classes.

We have experienced supervisory divergence in whether this sale should take place and the passive breach be corrected, or whether the UCITS can continue to hold until it's fully paid down.

The proposal is to use the original deal size as the denominator throughout, for securities issued by securitisation vehicles. As there is no "influence" that can be made by owning more than 10% of the deal, by using the original deal size as denominator UCITS could still make sure that they do not take more than 10% of the deal but then can continue to hold the junior classes as the senior ones paydown. This will result in less transaction costs to reduce the exposure and allow the UCITS to obtain the optimum return from holding the junior class from the start.

We note that this is a layered and technical issue, and as such should be considered holistically, and look forward to discussing these elements in more detail in the Commission's upcoming consultation on the securitisation market this Autumn.

<ESMA_QUESTION_EADC_23>

Q24 What are the risks and benefits of permitting UCITS to build up short positions 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.

<ESMA_QUESTION_EADC_24>

UCITS requirements restrict physical shorting. Since the introduction of the ability to invest in derivatives in UCITS III, UCITS funds with appropriate disclosed objectives such as long short strategies or absolute return funds have been able to take synthetic short position through a variety of derivative instruments such as contracts for differences. Provided the fund's investment objective clearly sets out how the fund intends to execute its strategy, discloses relevant counterparty risk and the fund has a comprehensive risk management programme covering relevant strategies we see no need to change the current regulatory position. Such funds typically measure their risk positions using the UCITS VaR methodology.

<ESMA_QUESTION_EADC_24>

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.

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