ALFI RESPONSE

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

association of the
luxembourg fund industry

Luxembourg, 6 August 2024

Executive summary

In its response, ALFI highlights the importance of maintaining a strong and competitive UCITS regime when envisaging changes to the UCITS EAD. Moreover, flexibility should be left in the Directive to be able to accommodate new market developments. ALFI suggests to enable broader access to private assets for retail investors, whilst providing the necessary robust safeguards. Finally, ensuring supervisory convergence across the EU is considered by our association as key in this context.

ALFI Position

Introduction and general considerations

We thank the European Securities and Markets Authority for the opportunity to participate in this call for evidence on the review of the UCITS Eligible Assets Directive (EAD).

Concerning ESMA's mandate to develop technical advice for the European Commission with regard to the UCITS EAD, we would like to bring forward the following general considerations.

UCITS can look back on many years of a success story as a truly global fund product, offering the highest possible levels of investor protection. They are widely sold to both retail and institutional investors across the world. Pension funds in particular rely on UCITS to diversify their portfolios with a well-regulated financial product. One should be mindful to maintain the strong position of UCITS when elaborating changes to the current EA regime. Changes may cover potential improvements of existing requirements as well as considerations of forward-looking strategies.

In this sense, whilst it is of utmost importance to ALFI that the UCITS regime remains strong and competitive as it is considered as a very robust financial product offering the highest possible levels of investor protection, and whilst careful consideration should be given when reviewing the UCITS delegated Directive on eligible assets as not to give rise to any market disruption which would impede the competitiveness of the UCITS system, it is our view that the eligible assets rules should be revisited with a view to adjusting it to the recent market developments, aligning definitions with other legal frameworks and ensuring supervisory convergence across the EU.

Moreover, one should be mindful not to put European investors and the European fund industry at a disadvantage as compared to US or other retail investors.

ALFI believes in particular that enabling broader access to private assets for retail investors would be important to bring them new investment opportunities. More illiquid assets such as private equity and credit, as well as commodities and real estate can offer higher performance and thereby ensure that UCITS remain one of the most attractive investment opportunities for retail investors. Recent developments in European regulation, such as the review of the ELTIF regime, showed that retail

investors can be offered alternative investments while ensuring at the same time a high level of investor protection. Investors should not be deprived of such opportunities under the UCITS regime either. Moreover, efficient diversification among traditional and alternative assets, while on the latter there is balanced access accompanied by guardrails that ensure less volatility, and thorough due diligence processes can lead to superior long-term investment results.

Response to the Questionnaire

Part I: Convergence issues and clarity of key concepts

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?

Response

In order to ensure that UCITS can remain an attractive product beyond the European market, it is necessary to maintain a stable and reliable product. This goal can be reached in particular with sufficiently harmonized requirements across Europe, e.g. on eligibility criteria. In this way, a level-playing field would be enabled, reducing potential areas for legal uncertainty due to misaligned interpretations and approaches.

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.

Response

To our knowledge the existing ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937) already provide appropriate requirements in regard of investor protection and their application is clear to a very high degree. However, we have been made aware of issues in the interpretation of the following criteria.

- Representativeness in the following cases:
  - Equally weighted index
  - Index with overweight on one component and other components with fixed weights
  - Strategy index
- Diversification:
  - When there are long and short components
  - When total weight is not 100%

- Publication:
  - When information is only available through a link to a website that cannot be found through internet search

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.

Response

No particular need for clarifications has been raised so far.

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.

Response

We do not see a need for adaptations in this respect.

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.

Response

The presumption of liquidity is an important concept that is to be assessed in conjunction with other existing investor protection tools within the UCITS framework. The presumption of liquidity at the compliance level is an effective and well-functioning tool when used in conjunction with more principle-based requirements relative to liquidity management. Against this background ALFI considers that the presumption of liquidity is still appropriate and future proof.

The more principle-based requirements above mentioned refer among others to:

- IOSCO - Recommendations for Liquidity Risk Management for Collective Investment Schemes - FR01/2018
- ESMA - Guidelines on liquidity stress testing in UCITS and AIF - ESMA34-39-897
- ESMA – Public statement presenting the results of the 2020 Common Supervisory Action (CSA) on UCITS liquidity risk management
- Other National Competent Authorities guidance[1]

For instance, the IOSCO eleventh recommendation establishes the need to consider the instrument liquidity and its effect on the undertaking for collective investments ("UCI") "before transacting". In this context, practices have been implemented by Management Companies to obtain reasonable assurance that the transactions are in line with the liquidity profile through an oversight of the policy (including controls) implemented by the investment manager for standard assets and individual checks on specific assets outside the scope of the mentioned policy.

In this context, the additional safeguards brought by the evolution of the liquidity management regulatory framework, together with the response of the industry, are now providing for a robust and updated framework addressing the concerns raised. As a consequence, it is believed that, conditional on these safeguards, the presumption of liquidity is appropriate and should be maintained. Furthermore, it has been estimated that removal of the presumption of liquidity would result in additional substantial costs due to the large impact on the data feed to be updated. The associated costs would be relating to the coverage of the large population of standard (more vanilla) assets rather than with the increased scrutiny and analysis on more "interpretable" assets. For a more efficient and appropriate approach, the mix between policy oversight and specific checks on specific (or new) assets is deemed a superior solution.

In conclusion, ALFI advocates that the presumption of liquidity is a critical concept that should be maintained. The effort should rather focus on the consistent application across jurisdictions of the liquidity management principle-based requirements (IOSCO Recommendation, ESMA Guidelines, ESMA Public statement) that are to be used in conjunction with the presumption of liquidity for an investor protecting, efficient and future proof framework. In addition, in line with the above argumentation regarding a complete removal of the presumption, it should be considered that also changing the presumption of liquidity may result in significant compliance burden to be implemented for the industry. This may lead to higher costs that would eventually be borne by the investor and may negatively impact the intention, e.g. as articulated under the European Commission proposal for a Retail Investor Strategy, to have greater retail investor participation.

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.

[1] 1 Such as the CSSF Feedback Report on ESMA Common Supervisory Action on UCITS.

Response

There are different interpretations of the term "ancillary liquid assets" among the EU Member States, which can lead to difficulties for Asset Managers on a cross-border basis, especially regarding the question whether cash current accounts fall under the definition and the resulting rules applicable to cash accounts. For example, we understand that certain NCAs do not qualify treasury assets as ancillary liquid assets and that others apply a limit of up to 30% of the NAV. Moreover, in some countries a distinction is made between liquid assets and bank deposits, and diversification rules applicable to bank deposits under UCITS rules or article 17 of the Money Market Fund Regulation (MMFR), do not apply to liquid assets, leading to easier monitoring of daily cash movements. Furthermore, there still seem to be some questions / different interpretations observed across the industry as to whether or not overnight Term Deposits should be included in the 20% ancillary liquid assets – this may need to be clarified.
The application of different limitations requires that international asset managers with funds in different countries establish different compliance systems for each country, which creates high costs and administrative burden.
Therefore, in order to avoid such costs and administrative burden, a harmonized approach on EU level and an alignment of NCAs' practices would be welcomed, not only in the interest of asset managers, but also in the interest of investors towards whom in our view only a European-wide approach would ensure transparency and comparability.

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.

Response

The possibility to invest in currency for investment purposes should be assessed and evaluated in accordance with the same principles as other assets. In this respect, the contemplated currency would be assessed in light of its capacity to meet the relevant liquidity requirements[2].

The FX market is the largest financial market in the world (Ranaldo and De Magistris, 2022) and therefore represents a significant portion of the investment opportunity set for investors. Some funds are dedicated to offer investors access to this investment opportunity by providing exposure to FX factors as per the investment objectives. Accordingly, as long as it is in line with the disclosed investment objectives, formalised in the prospectus, and captured by the risk profile of the fund, holding currency for investment purposes should be a possibility option for UCITS in order to allow investors to access a large and liquid market as well as the diversification benefits and investment features it may offer.

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[2] For a review of the liquidity on the FX market see Ranaldo, A., & de Magistris, P. S. (2022). Liquidity in the global currency market. *Journal of Financial Economics*, 146(3), 859-883.

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.

Response

We would like to provide similar considerations in this context of the 10% limit as in our response to Q5 regarding the presumption of liquidity. Also, here, we believe that the additional safeguards brought by the evolution of the liquidity management regulatory framework, together with the response of the industry, are now providing for a robust and updated framework addressing potential concerns with regard to the interpretation / use of the flexibility provided within the 10% limit. In this context, flexibility should be allowed when it comes to fixed income instruments that trade OTC (and therefore are considered in the 10%), but that otherwise are very much like other fixed income instruments that are considered fully eligible.

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.

Response

The existing 'transferable security' criteria set out in the UCITS EAD are functioning well and are sufficient. We are not aware of any significant difficulties in respect of the interpretation or consistent application of the eligibility rules for transferable securities.

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.

Response

Management Companies have implemented for many years processes related to the acceptance and onboarding of a "new instrument" or "new strategy". The semantic diverges across firms (e.g. "new product committee") but the overarching principles are generally aligned and evolve around the following concepts:

I. Standard instruments

- Standard instruments are covered by the risk management process and valuation policies.
- The effectiveness of the risk management process and valuation policies is periodically assessed and amended as needed.

II. New instruments

- New instruments are subject to a dedicated risk and valuation assessment also in view of the coverage by existing processes of the investment manager.
- The product is not integrated into the portfolio unless the risk and valuation process can adequately capture the instrument.

The process of identifying and onboarding new instruments, which goes beyond asset eligibility, is well established in terms of industry practice and regulatory requirements (such as in the Risk Management Circular in Luxembourg – Circular CSSF 11/512). The execution of this documented process allows to substantiate the criteria (risk and valuation) to be complied with for eligibility. Consistency should be ensured already at the stage of overarching risk and valuation requirements instead of specific EAD requirements.

Furthermore, when it comes to investor protection and in particular with respect to risk and valuation, while room for improvement exists, it is relevant to highlight that concerns remain moderate as no significant and recurring issues were observed. The following quotation from the ESMA Final report on the 2022 CSA on Valuation (ESMA34-45-1802) illustrates this general assessment.
"*Most NCAs considered that there is an overall satisfactory level of compliance of supervised entities with the applicable regulatory requirements, and did not identify any severe regulatory breaches, but rather a number of shortcomings and vulnerabilities.*"
Against this background, an evolution rather than a revolution would be favoured.

One aspect that could be mentioned in terms of possible improvements is that some further standards / clarifications at EU level would be welcomed in relation to the valuation and risk management-related requirements in respect of the definition / interpretation of "reliable" valuation/prices which may be deemed not clear enough.

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.

Response

The existing criteria have proven suitable.

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.

Response

We think that Article 10 in connection with Article 2 (3) of the UCITS EAD are clear regarding the concept.

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.

Response

- Many UCITS market participants and regulators have agreed that a UCITS may acquire transferable securities that provide delta-one exposure to alternative exposures like commodities (e.g. ETCs), on the basis that such instruments do not embed a derivative and therefore, do not require the look through approach to the underlying asset.
  This delta-one interpretation was first introduced by CESR in 2006.
  The German regulator BaFin then codified this so-called delta-one approach in its FAQs on The Commission Directive 2007/16/EC. Since then, this interpretation has become accepted within the UCITS investment and regulatory communities, with one main exception by an EU jurisdiction. We would suggest to apply this interpretation across all Member states.

- Delta-one notes offer UCITS a means to access assets that offer diversification advantages beyond the applicable UCITS guidelines. Generally speaking, delta-one instruments allow for a cost-efficient way to get exposure to an underlying asset/market/basket etc. They allow UCITS to build additional diversification and complement traditional asset classes.

- In practical terms, delta-one notes typically represent a portion of a UCITS portfolio, with these assets featuring return profiles that complement the rest of the investment portfolio. In such instances, the design of these delta-one securities incorporates sufficient transparency of the underlying positions, effectively mitigating associated risks. This approach extends beyond just delta-one notes and encompasses various instruments with similar characteristics.

- **Illustrative example 1:** A UCITS which holds delta-one notes written on deliverable commodity futures, which cannot be purchased by UCITS funds directly due to delivery-related limitations.

  The delta one note allows the UCITS to benefit from the return and diversification characteristics of the future position whilst being ring-fenced from the delivery at expiry. This feature contributes largely to the relevant UCITS investment strategy.

  This feature allows liquid alternative strategies on the relevant platform to invest in a diverse universe of investments.

- In addition, delta one notes allow UCITS to be managed more efficiently and reduce costs which are passed through to clients, to their advantage.

  - **Illustrative example 2:** A UCITS for which the entire portfolio is implemented via a portfolio swap using a delta-one note. In this case, the UCITS has exposure to a portfolio of UCITS eligible assets without actually holding them in its portfolio, meaning that the counterparty holding the portfolio can benefit from economies of scale on their trading.

    In the case of this UCITS, 70bps per annum is saved due to this and the ability to trade on intra-day prices rather than at "close of business" prices as the UCITS' portfolio manager may trade in volumes, which gives them a position on the relevant futures exchanges. These cost savings are passed on to the UCITS' investors.

- Finally, counterparty risk from delta-one certificates is limited. Those are generally issued by bankruptcy remote SPV entities, rather than by banks/brokers directly; delta-one certificate issuance can be conducted on a secured basis, whereby security is taken by a security trustee over substantially all of the assets of the issuing entity, with the certificate holder as the beneficiary of such security. Market standard provisions exist regarding the mechanism for enforcement, and events triggering enforcement of the security package.

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.

Response

The definition of closed-end fund vs open-end fund is not clear when it comes to funds with redemption possibilities. For example, in the case of certain Canadian REITs, where offering documentation describes the possibility of a redemption facility. These REITS are set up as "open-end mutual fund trust" which is a tax definition, however, the fund regulation in Canada prohibits mutual funds to invest in real estate which means that these REITS can thus not be qualified as mutual funds.

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.

Response

With regard to non-EU ETFs, it has been brought to our attention that there are cases in which they may not be eligible investments for UCITS, e.g. because of slightly different borrowing restrictions.
In 2013, changes were made to the prospectuses for many US ETFs to make them UCITS equivalent e.g. aligning the borrowing rule, short selling rule etc. However, due to the requirement for max 10% in other UCI to include both direct and indirect investment (e.g. through re-investment of cash collateral) many US ETFs would not qualify as eligible owing to their enrolment in securities lending programmes where cash collateral is mandated to be invested in US 2-a7 Money Market funds, which under SEC rules do not qualify as "CIS" for the purpose of their own max 10% in CIS rule but are open end funds and therefore subject to the UCITS max 10% in UCI requirement. This disparity between US and EU definition of max 10% in UCI plus the requirement to include indirect exposure, are the main reasons why non-EU ETF's are not eligible.
Our view is that US ETFs should qualify as eligible assets.

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.

Response

Regarding EPM, in particular the use of security lending, repos and reverse Repos, the UCITS regulations are very detailed in relation to EPM treatment and disclosures in funds' documentation. We are of the opinion that overall, no additional rules are needed, because the actual regulation provides enough clarity and protection to the investors.

However, we have been made aware by Members that the ESMA Guidelines on ETFs and other UCITS issues seem to be not clear with regard to the possibility for a UCITS being able to engage in securities lending transactions under collateral arrangements without transfer of title (i.e. with instead a pledge of collateral assets in favour of the lender).
While ESMA highlighted in their peer review report of July 2018 that NCAs such as CSSF interpreted the Guidelines in such a way that only title transfer arrangements are permissible, we also note that item 43.g) of the ESMA Guidelines on ETFs and other UCITS issues clearly refers to "Where there is a title transfer" and "For other types of collateral arrangement", which may potentially indicate that collateral arrangement without title transfer would also be accepted.
It can be noted that such an arrangement provides a way for lending funds to benefit from the premium pricing currently available for such transactions without materially increasing risk to investors, subject to appropriate eligibility checks performed in relation to the relevant pledged assets.
Consequently, the treatment concerning these collateral arrangements could be clarified. We would be pleased to provide further details to ESMA as needed.

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?

Response

We do not see a need to amend the rules on this aspect.

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.

Response

The EU Securitisation Regulation requires the completion of a detailed questionnaire for non-EU issuers, which creates an important hurdle to UCITS access to this asset class, as many US issuers are not seeking to comply with the Regulation. This is particularly problematic in the CMBS sector and non-agency residential space. We understand that the securitisation regime overall, including the reporting templates, are to be reviewed and we consider a balanced approach should be taken allowing UCITS to participate in the full investable universe and in particular to invest in securitisations from US issuers.

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.

Response

We would like to underline the importance of harmonizing the interpretation of existing rules across the EU in order to avoid any gold plating, to provide legal certainty, also in the best interest of investors, and to remove obstacles for cross-border distribution.

One example to draw attention to is the treatment of loans, where we see a divergent approach among national authorities.

<u>Part II: Direct and indirect UCITS exposures to certain asset classes</u>

Q20: 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 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.

Asset class	Merits of allowing direct UCITS exposures	Merits of allowing indirect UCITS exposures	Extent/ amount of existing UCITS exposures	Additional comments
1. Loans	Some promoters have raised that a discussion on the eligibility of bank loans for UCITS would be welcome and helpful, as these are still considered as eligible in certain jurisdictions, provided they qualify as transferable securities. The review of the Eligible Assets Directive is indeed a good opportunity to implement a European level playing field on this question. To manage risks associated with investments in bank loans, we are of the view that it would be appropriate to allow UCITS to invest in bank loans, subject to a predetermined maximum limit (e.g. 20% of the UCITS assets). Eligible loans can be restricted to the most liquid part of the market as well as high level loan specific settlement requirements. It is worth noting that the bank loans market, in particular those loans forming the broadly			

	syndicated loan market, exhibits features that are very similar to the corporate high yield market. Indeed, the borrowers of these loans are generally the same names issuing bonds in the corporate high yield market and are made through syndicates of large internationally recognized banks. The market has deep liquidity. Investor protection related concerns, such as the lengthy settlement, could be managed via e.g. allowing those exposures under the 10% bucket, possible redemptions twice per month or prior notice. We would like to point out in addition that any national divergence, not only in the treatment of loans as eligible assets, but also other asset classes in general, can weaken the position of UCITS as a strong cross-border product as a whole. Any amendments to the UCITS EAD should therefore be performed in light of harmonization.			
2. Catastrophe bonds ('Cat bonds')	Regarding Cat bonds, we note that investments by UCITS can be beneficial in order to increase performance. Typically, Cat bonds offer higher interest rates compared to similarly rated traditional corporate bonds. Cat bonds also provide portfolio diversification given			It must be noted that insurance-linked securities and more specifically Cat bonds are widely used in the financial ecosystem and have become an indispensable risk management tool, in particular in the reinsurance market.

	that the return from Cat bonds is largely uncorrelated with the return on other investments in fixed income or equity markets. There are Luxembourg domiciled funds dedicated to Cat bonds, as well as funds that invest in those funds getting an indirect exposure. There have been no particular issues raised by our Members with regard to Cat bonds. It was noted that the CSSF provides a detailed questionnaire covering Cat bonds which supports a clear overview and scrutiny on such investments.			
3. Contingent Convertible bonds ('CoCo bonds')	Similarly, to Cat bonds, some products have been developed with a focus on CoCos to address investors' demand. It is worth mentioning that this has been achieved with an important scrutiny of National Competent Authorities (e.g. specific stress-testing requests) to make sure that the Management Companies processes were capable to capture the risk profile of these instruments and strategies. Keeping this in mind, investments in CoCo bonds by UCITS can constitute a positive and robust feature, enabling broader diversification for investors. As for other asset classes, convergence in the treatment			

	at national level would be important to best leverage on the benefits for investors.			
4. Unrated bonds	Unrated bonds can serve as a good source of returns and therefore added value for investors. In our view, it would be beneficial to continue allowing a portion of UCITS' investments in such assets, while ensuring the proper mitigation of possible risks for investors.			
5. Distressed securities	We would like to refer to our reasoning under point 4 alike.			
6. Unlisted equities	Some specific consideration maybe given to IPO processes where a security can be temporarily unlisted. Equities that are unlisted, but planned to be listed or relisted could be considered as eligible as well, applying the 12-months exemption for temporary unlisted equities.			
7. Crypto assets	More flexibility regarding the eligibility of digital assets for UCITS could be a way to modernize the fund industry and to attract younger investors, whilst mitigating risks as UCITS managers would have to apply their due diligence processes to investments and trading platforms. In addition, with the increased transparency and rules proposed by MiCA, should a crypto-asset meet the EAD requirements and UCITS			

	requirements, it could be an option to provide a safer exposure to investors. If the UCITS regime would in the future not be open to offer the possibility of such exposures, investors may use riskier products to invest in crypto assets. Therefore, we believe, the review of the UCITS EAD would be the right moment to consider the provision of a certain, forward-looking and principle-based flexibility to enable the further assessment of their eligibility, once market practices and knowledge concerning these assets have been deepened and developed more broadly. In this context we would like to refer to the ALFI response to the ESMA consultation on the proposed guidelines on the qualification of crypto assets with regards to their classification as financial instruments under MiCA. In this response, ALFI also preferred a principle-based approach and supported the flexibility proposed in the consultation paper with regards to the criteria for qualification of crypto assets as financial instruments. As stated in the response, a principle-based approach is preferable, rather than a rule-based approach, because of the following rationale:			

	1. The individual instrument definitions with regards to crypto-assets still remain to be fully defined. 2. With regards to qualification and eligibility, various pieces of regulation are interconnected (MiFID in particular) and such flexibility allows to ensure consistency across the board. The same rationale can be used regarding crypto assets as eligible assets for UCITS in the future.			
8. Commodities and precious metals		Funds which gain indirect exposure to commodity markets by taking positions in diversified commodity indices are currently allowed on a case by case basis, subject to transparency and diversification. We believe it is important that this possibility should be maintained in the review of the UCITS AED. In case it would not be maintained and diversified commodity indices became ineligible, such funds would have to cease to exist, or move into a non-UCITS umbrella. There would be a further knock-on effect as this would also reduce the universe of investment available to investors, including funds of funds, some of which have their own		

		minimum/maximum 'Alternatives' exposure requirements. In addition, the exclusion of commodities exposure could have a considerable impact on trend-following strategies. A significant reduction of commodities allocation can result in fewer opportunities for UCITS investors to profit from trends. This has a particular impact when commodity markets move a lot, such as in 2022 when inflation was causing commodity markets to trend upwards, and gave rise to an underperformance of UCITS trend-following products. Multi-asset portfolio managers are also strongly in favour of retaining the ability to invest in commodity ETCs qualifying as transferable securities non-embedding a derivative element and in particular gold ETCs. In their views, not being able to invest in a (physically backed) gold ETC would reduce their ability to protect their investor's real returns from the key forward looking risk in the coming decades due to the increasing level of sovereign debts in various jurisdictions. In addition, it was highlighted by managers that investing in commodities through ETCs is a well-trodden path now for UCITS.		

		We would like to reference the ESMA Guidelines on ETFs and other UCITS issues which define a clear framework for exposures to commodity indices, including detailed requirements for diversification and the calculation of correlation observations (point 51). This shows that such exposures were already analysed in depth and that subsequent, adequate safeguards were put in place in order to protect investors. In turn, investors can benefit from a more diversified source of return. Such benefits for investors should in our view be preserved in the course of the review of the UCITS EAD.		
9. Exchange-traded commodities ('ETCs')		We would like to refer to our answer under point 8 above. In addition, we would like to raise the following advantages of investment in and exposure to ETCs. ETCs give investors the opportunity to invest in markets in which they usually don't have a direct access to, such as metals, energy, livestock and other commodities. ETCs invest in one commodity or in a basket of different commodities. The latter helps to diversify the portfolio between the different commodities. Besides ETCs can make a		

		positive contribution to portfolio diversification.		
10. Real estate	Real estate can offer higher performance and thereby ensure that also in a low-interest environment UCITS remain one of the most attractive investment opportunities for retail investors. Real estate often provides higher than average, consistent returns, that are independent from the stock market fluctuations. Correlations with traditional asset classes (stocks/bonds) have been low in the past, which would make real estate a very attractive asset class for UCITS to reduce the overall portfolio risk and to increase potential returns. Also, real estate can be considered as a hedge against inflation and investments in real estate are a dependable way to generate stable revenue and profits over time.			
11. Real Estate Investment Trusts ('REITs')	REITs are much more flexible than investing in physical properties. Buying and selling shares in a REIT takes much less time than buying and selling physical properties, which could take a long time and could incur high costs. REITs give investors access to property classes which are usually reserved for			

	investors with a significant capital stock as commercial real estate. By investing in REITs the managing cost are much lower than investing in physical properties directly. Usually REITs have a consistent and manageable income stream due to long-term leases associated with the managed assets.			
12. Special Purpose Acquisition Companies ('SPACs')	SPAC investments can be traded in the same manner as normal common stock when they are publicly listed companies on a stock exchange. The main difference being that they have no operations and are a vehicle which uses an IPO to raise capital to acquire another company down the line. Clarifying that investment in SPACs is allowed under the EAD, under similar conditions to those mentioned in the CSSF FAQ on the Law of 2010, point 13, p. 24 (in particular, that SPACs qualify, at any point of their life cycle, as transferable securities in reference to the CESR guidelines), would therefore be positive. In order to further limit any potential risks associated with SPACS, the percentage of possible investments into SPACS could also be limited under the Directive, e.g. as required in the CSSF FAQ, provided that such SPAC investments fulfil all applicable eligibility requirements, are appropriately disclosed			

	in UCITS prospectuses and are captured adequately by the risk management process of the UCITS.			
13. EU AIFs	As a general remark, AIFs meeting UCITS eligibility criteria should remain authorized for UCITS investments. Retail open-ended ELTIFs are eligible for retail investors as a direct investment but are not eligible for a UCITS to invest in. This makes sense to some extent as the investor who targets an ELTIF will be reminded that there is an expected time horizon for the redemption and will invest knowingly while the investor of a UCITS does not have this view and may redeem faster. Here again, we could consider putting the liquidity at the centre of consideration. If the redemption cycle of the UCITS is frequent enough to not jeopardize the overall liquidity of the fund, it could be considered as acceptable. Investments in AIFs give investors access to investments in large-scale projects such as real estate or infrastructure projects, what is due to the creation of the “ELTIF” now also possible for small investors and not just wealthy private individuals.			

	Due to the investment focus on real assets, AIFs generally offer investors a high degree of stability and profitability regardless of, for example, the current interest rate phase on the market. The funds are limited in time and have medium to long-term maturities. They are therefore particularly suitable for investors who are interested in a medium to long-term investment to build up assets. Furthermore, the statutory regulation of AIFs provides increased investor protection.			
14. Non-EU AIFs	A non-EU AIF makes it possible to invest in sectors outside the EU whose potential returns far exceed the investment opportunities of an AIF limited to the EU. In addition, they can be added to a portfolio heavily invested in the EU as a diversification or stabilization tool to reduce the risks that may arise in Europe. Although AIFs generally have a sectoral focus rather than a country focus, assets in one sector can develop differently in different countries. However, investing in countries outside the EU can also entail risks. NON-EU AIFs may be subject to authorities that do not			

	comply with European standards and may put investors at a disadvantage due to the lack of investor protection.			
15. Emission allowances				
16. Delta-one instruments	We would like to refer to our response under Q13.			
17. Exchange-traded notes ('ETNs')	We would like to refer to our answer to point 9 above and would suggest to apply a similar approach for ETNs.			
18. Asset-backed securities ('ABS') including mortgage-backed securities ('MBS')				
19. Other relevant asset classes (please specify)	**Sukuks** In line with the above, we understand that the industry would also welcome greater clarity and transparency regarding the eligibility of sukuks, with a focus on whether they can be considered as eligible			

	investments for UCITS, provided they meet the necessary liquidity requirements. Sukuks represent a growing segment within fixed income indices, and as such, they hold increasing significance in the fixed income investment landscape. Sukuks exhibit diverse structures, all designed to align with Sharia law principles. However, their bespoke structures currently prevent UCITS from investing in such an asset class. To illustrate a scenario where a UCITS should be permitted to invest in sukuks, but is currently restricted – consider the case of Sukuk al-Murabaha issued by the Malaysian Government. Upon initial issuance, sukuk investors very briefly hold ownership of palm oil before it is swiftly acquired by the Malaysian government, which subsequently repays the purchase price to the sukuk holders over the sukuk's term. The UCITS cannot take ownership of physical commodities, which leads to their avoidance of initial issuance. However, this situation appears somewhat illogical, as the true exposure is to the Malaysian government, not the palm oil itself. The very brief ownership (in practice less than a second) of palm oil serves as a mere Sharia law compliance mechanism.			

	Financial indices and OTC When it comes to financial indices, it would be highly advantageous to establish a centralized EU list of endorsed indices. The current practice of numerous managers individually scrutinizing indices for suitability appears inefficient and resource-intensive. A central repository of approved indices, encompassing widely utilized ones, would streamline the process, allowing managers to focus their attention on the more specialized and esoteric indices. Similarly, we believe that the revision of the UCITS EAD presents an excellent opportunity to re-evaluate the regulations governing eligible markets and take into account over-the-counter (OTC) fixed income markets. In terms of investor protection with regard to financial indices and OTC derivative exposures, reference is made to the ESMA Guidelines on ETFs and other UCITS issues (ESMA/2014/937) which contain dedicated requirements, such as liquidity, diversification and transparency requirements as well as the identification, mitigation and management of risks (points 41 ff. of the Guidelines).			

	Private credit As investments in private credit expand, it would be worth exploring their eligibility for UCITS, provided existing safeguards continue to be ensured.			

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.

Response

We would like to refer to our comments above.

In addition, we would like to highlight the following advantages: operational ease, regulatory security, cost as well as risk reduction borne by UCITS investors. This is based on the following considerations.
UCITS asset managers may not have the necessary expertise to operationally enabling direct investments and or doing so would require many resources (e.g., setting up custody for carbon allowances (union registry account), crypto assets (crypto asset custody account), precious metals) or access the liquidity venues for these assets. UCITS asset managers must of course perform detailed due diligence on the indirect access vehicles they invest in and confirm adequateness of the product setup (e.g., custody), which however is much easier than direct investment. Regarding ETCs in particular, it can be noted that they are a regulated, well-established transparent security form typically held within a regulated Central Securities Depository. ETCs are traded on regulated exchanges throughout the day and offer 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.

Response

We believe that there would be more merit to ensuring consistency of specific definitions and principles across Member States than requiring a look-through on each and every underlying investment. When assessing liquidity, focus should lie on the wrapper of the asset rather than on the underlying security, e.g. an index. In addition, risk management and adequate redemption frequencies play a key role and provide means to ensure a high level of investor protection.

Allowing UCITS to gain exposure to asset classes that are not directly investable while ensuring essential safeguards for liquidity and risk management would boost performance.

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.

Response

See our response to Q 18 above.

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.

Response

We refer to our answer under Q20, point 19.

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.

N/A

About ALFI

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.