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CONSULTATION DOCUMENT

Undertakings for Collective Investment in Transferable Securities (UCITS)

Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments

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1. INTRODUCTION

The UCITS rules¹ have constituted Europe's regulatory framework for asset managers and investors since 1985. UCITS funds have attracted all types of investors, coming even from several geographic regions outside of Europe, especially Asia. UCITS has created a safe and transparent environment and the brand is now considered by both professional and retail investors to represent one of the highest standards in the asset management industry.

Recent international work on shadow banking, coordinated by the Financial Stability Board (FSB), has identified certain areas in the area of investment funds that require closer scrutiny: money market funds and the use of securities lending or sale-and-repurchase arrangements (repos). The latter are frequently used as part of an investment fund's efficient portfolio management (EPM). Although Europe already has a comprehensive regulatory system for funds in place – UCITS and the Alternative Investment Fund Manager Directive² (AIFMD) – issues under discussion by international bodies, such as IOSCO or the FSB, might require updates to relevant EU rules.

This consultation is complementary to and coherent with the work the European Securities and Markets Authority (ESMA) did over the last two years that resulted in the publication of ESMA "Guidelines on ETFs and other UCITS issues".³ This holds in particular with respect to section 3 "Efficient portfolio management techniques" below where the guidelines have provided an important first response to the issues raised by certain EPM techniques in the context of UCITS. ESMA has also launched a consultation on guidelines on repo and reverse repo agreements.⁴

Other issues, more specific to the aim of keeping the UCITS framework topical and in line with the evolution of investment markets, are also part of this consultation. These comprise the treatment of OTC derivatives once the central clearing requirements for derivatives are in place, liquidity and redemption management by UCITS funds, the potential benefits of a depositary passport and a more conceptual section on how to foster a culture of long-term investment in Europe.

While the Commission's Green Paper on Shadow Banking⁵ published on 19 March 2012 gathered first stakeholder comments on issues related to the fund industry, this targeted consultation aims to follow on and deepen the Commission's understanding of the following eight topics:

¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF>.

² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>.

³ <http://www.esma.europa.eu/content/Report-and-consultation-paper-guidelines-ETFs-and-other-UCITS-issues>

⁴ This consultation will be open until 25 September 2012. Readers are encouraged to participate in this consultation as well.

⁵ http://ec.europa.eu/internal_market/bank/shadow_banking/index_en.htm.

1. **Eligible assets and use of derivatives:** evaluation of the current practices in UCITS portfolio management and assessment of certain fund investment policies;
2. **Efficient portfolio management techniques:** assessment of current rules regarding certain types of transactions and management of collateral;
3. **Over the counter (OTC) derivatives:** treatment of OTC derivatives cleared through central counterparties, assessment of the current framework regarding operational risk and conflicts of interest, frequency of calculation of counterparty risk exposure;
4. **Extraordinary liquidity management rules:** assessment of the potential need for uniform guidance in dealing with liquidity issues;
5. **Depository passport:** assessment of whether or not to introduce a cross border passport for the performance of the depository functions set out in the UCITS Directive;
6. **Money Market Funds (MMF):** assessment of the potential need to strengthen the resilience of the MMF market in order to prevent investor runs and systemic risks;
7. **Long term investments:** assessment of the potential need for measures to promote long term investments and of the possible form of such measures (including investments in social entrepreneurship);
8. **Addressing UCITS IV:** assessment of whether or not the rules concerning the management company passport, master feeder structures, fund mergers and notification procedures might require improvements.

The current consultation addresses different issues and is separate from the proposals concerning the UCITS depository, remuneration and sanctions which have been adopted by the Commission on 3rd July 2012.

The responses to this consultation will provide important input for the Commission services future policy in the field of asset management. The Commission's services would appreciate replies following the sequence of this questionnaire. Please also indicate clearly in your replies to which question you are responding; you do not need to respond to all questions if this is not relevant for you.

In replying to these questions, please indicate the expected impact of potential changes described in each section of this consultation on your activities or on the activities of firms in your jurisdiction. Please also assess possible impacts on other stakeholders. For stakeholders other than firms or competent authorities, please indicate as far as you can the impact of different options on you.

You are invited to send your contributions by the **18th of October 2012** to:

MARKT-UCITS-CONSULTATIONS@ec.europa.eu

In your contribution, you are also invited to give views on whether there are any other aspects of the current UCITS framework that need to be addressed.

Responses will be published on the following European Commission's website http://ec.europa.eu/internal_market/consultations/2012/ucits/index_en.htm

It is possible to request that a submission remains confidential. In this case, the contributor should explicitly indicate on the first page of their response that they do not want their contribution to be published.

2. ELIGIBLE ASSETS

Under the UCITS framework, UCITS funds are required to invest in instruments that are sufficiently liquid. For this purpose, Article 50 of the UCITS Directive provides a list of eligible assets. This list comprises transferable securities, money market instruments, units of collective investment schemes, bank deposits and financial derivative instruments (FDI). It is also possible for a UCITS to gain exposure to an index through the use of FDI provided that the index complies with a defined set of criteria, e.g. diversification, publication or benchmark adequacy (Article 9 of the Commission Directive 2007/16/EC).

The UCITS Directive currently permits UCITS funds to gain exposure to non-eligible assets in a number of ways: e.g. FDI based on financial indices, closed-ended funds, or structured transferable securities⁶.

UCITS may use derivative instruments to gain exposure to eligible assets as long as the global exposure relating to financial derivative instruments does not exceed 100 percent of the total net value of the UCITS portfolio and complies with the UCITS risk spreading rules. Currently the global exposure is measured by leverage (commitment approach) or by the value at risk (VaR). However, VaR does not measure leverage. Regarding the FDI itself, the manager is free to choose the most appropriate structure, ranging from plain vanilla to exotic payoffs.

The emergence of UCITS adopting highly sophisticated investment strategies that provide access to highly complex risk profiles has raised several questions as to the appropriateness of these strategies and profiles in a UCITS context.

Furthermore, the regulatory framework regulating derivatives, in line with G20 commitments, is evolving at EU level, both with respect to trading and post-trading (e.g., the legislative proposals on Markets in Financial Instruments Regulation (MiFIR) and the European Market Infrastructure Regulation (EMIR)). The legislative proposals for the review of MiFID introduced the general obligation to trade derivatives on multilateral trading platforms (regulated

⁶ Article 2(2)(c) of Directive 2007/16/EC qualifies as transferable securities certain financial instruments that are backed by, or linked to the performance of, other assets, which may differ from those referred to in Article 19(1) of Directive 85/611/EEC provided that the other criterion set out in art. 2(2)(c)(i) has been complied with.

markets, multilateral trading facilities or organised trading facilities) provided that they are subject to the clearing obligation under EMIR and are sufficiently liquid.⁷

Box 1

- (1) Do you consider there is a need to review the scope of assets and exposures that are deemed eligible for a UCITS fund?
- (2) Do you consider that all investment strategies current observed in the marketplace are in line with what investors expect of a product regulated by UCITS?
- (3) Do you consider there is a need to further develop rules on the liquidity of eligible assets? What kind of rules could be envisaged? Please evaluate possible consequences for all stakeholders involved.
- (4) What is the current market practice regarding the exposure to non-eligible assets? What is the estimated percentage of UCITS exposed to non-eligible assets and what is the average proportion of these assets in such a UCITS' portfolio? Please describe the strategies used to gain exposure to non-eligible assets and the non-eligible assets involved. If you are an asset manager, please provide also information specific to your business.
- (5) Do you consider there is a need to further refine rules on exposure to non-eligible assets? What would be the consequences of the following measures for all stakeholders involved:
 - Preventing exposure to certain non-eligible assets (e.g. by adopting a "look through" approach for transferable securities, investments in financial indices, or closed ended funds).
 - Defining specific exposure limits and risk spreading rules (e.g. diversification) at the level of the underlying assets.
- (6) Do you see merit in distinguishing or limiting the scope of eligible derivatives based on the payoff of the derivative (e.g. plain vanilla vs. exotic derivatives)? If yes, what would be the consequences of introducing such a distinction? Do you see a need for other distinctions?
- (7) Do you consider that market risk is a consistent indicator of global exposure relating to derivative instruments? Which type of strategy employs VaR as a measure for global exposure? What is the proportion of funds using VaR to measure global exposure? What would be the consequence for different stakeholders of using only leverage (commitment method) as a measure of global exposure? If you are an asset manager, please provide also information specific to your business.
- (8) Do you consider that the use of derivatives should be limited to instruments that are traded or would be required to be traded on

⁷ Article 24 of the legislative proposal for a Regulation on markets in financial instruments and amending Regulation (EMIR) on OTC derivatives, central counterparties and trade repositories.

multilateral platforms in accordance with the legislative proposal on MiFIR? What would be the consequences for different stakeholders of introducing such an obligation?

3. EFFICIENT PORTFOLIO MANAGEMENT (EPM)

According to Article 51(2) of the UCITS Directive, Member States are empowered to authorise UCITS to employ certain techniques and instruments for the purpose of EPM subject to conditions laid down by Member States. EPM techniques may for example include securities lending and repurchase agreements (repos). Commission Directive 2007/16/EC lays down criteria that must be fulfilled for techniques and instruments to be considered for the purpose of EPM: risk reduction, reduction of cost or generation of additional capital or income, provided that the level of risk is consistent with the risk profile of the UCITS and risk diversification rules. The ESMA guidelines mentioned above set out requirements on UCITS that use certain EPM techniques.

EPM techniques are widely used and potentially involve a substantial proportion of any given UCITS' portfolio. Several questions have been raised regarding: (1) the transparency of EPM techniques; (2) counterparty risk assumed by those funds using EPM; (3) the quality of collateral or the reinvestment of collateral. Regulators around the world are currently assessing the systemic risk inherent in the use of EPM techniques.

The Commission Green Paper on Shadow Banking also addressed certain aspects of some of these topics. Many responses highlighted the important role of securities lending and repos in facilitating financing and liquidity in the capital markets. Some were in favour of introducing criteria on the type of collateral that may be received in EPM while others suggested introducing limits on reinvestments. A number of industry respondents cautioned against imposing mandatory haircuts or minimum margin requirements but most respondents were in favour of increasing the level of transparency and consolidating current best practices in the industry.

According to Article 83(1) of the UCITS Directive the UCITS cannot borrow⁸ and according to Article 88(1) of the UCITS Directive the UCITS cannot grant loans. However, the economic substance of certain EPM transactions is equivalent to borrowing or granting loans by the UCITS.⁹

Box 2

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

⁸ According to Article 83(2), Member States may authorize a UCITS to borrow a limited amount under the conditions set out in that article.

⁹ Certain EPM transactions are required to be treated as borrowing or granting loans for the purpose of accounting according to the international financial reporting standards (IFRS 9 and the IAS 39).

- (2) Do you consider there is a specific need to further address issues or risks related to the use of EPM techniques? If yes, please describe the issues you consider merit attention and the appropriate way of addressing such issues.
- (3) What is the current market practice regarding the use of EPM techniques: counterparties involved, volumes, liquidity constraints, revenues and revenue sharing arrangements?
- (4) Please describe the type of policies generally in place for the use of EPM techniques. Are any limits applied to the amount of portfolio assets that may, at any given point in time, be the object of EPM techniques? Do you see any merit in prescribing limits to the amount of fund assets that may be subject to EPM? If yes, what would be the appropriate limit and what consequences would such limits have on all the stakeholders affected by such limits? If you are an asset manager, please provide also information specific to your business.
- (5) What is the current market practice regarding the collateral received in EPM? More specifically:
 - are EPM transactions as a rule fully collateralized? Are EPM and collateral positions marked-to-market on a daily basis? How often are margin calls made and what are the usual minimum thresholds?
 - does the collateral include assets that would be considered as non-eligible under the UCITS Directive? Does the collateral include assets that are not included in a UCITS fund's investment policy? If so, to what extent?
 - to what extent do UCITS engage in collateral swap (collateral upgrade/downgrade) trades on a fix-term basis?
- (6) Do you think that there is a need to define criteria on the eligibility, liquidity, diversification and re-use of received collateral? If yes, what should such criteria be?
- (7) What is the market practice regarding haircuts on received collateral? Do you see any merit in prescribing mandatory haircuts on received collateral by a UCITS in EPM? If you are an asset manager, please provide also information specific to your business.
- (8) Do you see a need to apply liquidity considerations when deciding the term or duration of EPM transactions? What would the consequences be for the fund if the EPM transactions were not "recallable" at any time? What would be the consequences of making all EPM transactions "recallable" at any time?
- (9) Do think that EPM transactions should be treated according to their economic substance for the purpose of assessment of risks arising from such transactions?
- (10) What is the current market practice regarding collateral provided by UCITS through EPM transactions? More specifically, is the EPM

counterparty allowed to re-use the assets provided by a UCITS as collateral? If so, to what extent?

- (11) Do you think that there is a need to define criteria regarding the collateral provided by a UCITS? If yes, what would be such criteria?
- (12) What is the market practice in terms of information provided to investors as regards EPM? Do you think that there should be greater transparency related to the risks inherent in EPM techniques, collateral received in the context of such techniques or earnings achieved thereby as well as their distribution?

4. OTC DERIVATIVES

The obligation in EMIR that a variety of OTC derivatives must be cleared through central counterparties raises the question of how OTC derivative transactions should be dealt with when assessing UCITS limits on counterparty risk.

UCITS rules permit management companies to reduce UCITS exposure to a counterparty of an OTC derivative transaction through the receipt of collateral.¹⁰ Therefore, should a counterparty provide sufficient collateral (covering more than 90% of the UCITS' exposure to this counterparty), even an investment strategy where the entire UCITS portfolio consists of an exposure to a single counterparty does not breach the counterparty risk exposure limits contained in Article 51(1) of the UCITS Directive. Exposure to a single counterparty, even if highly collateralised, raises concerns relating to insolvency or potential conflicts of interest.

Management companies are required to calculate UCITS global exposure on at least a daily basis.¹¹ There is no corresponding requirement with respect to the calculation of the OTC counterparty risk and issuer concentration. This discrepancy could lead to different market practices with inherent risks to investor protection.

The counterparty risk limit is set as a percentage of UCITS assets. In order to apply this percentage, both the value of the counterparty exposure (mark-to-market value of the derivative minus mark-to-market value of the collateral) and the value of the UCITS assets must be up-to-date (or calculated on a daily basis).¹² However, this requirement may be difficult to reconcile with the fact that UCITS are permitted to value certain eligible assets on less frequent intervals, such as units in closed-ended funds or securities that are not traded on regulated markets.¹³

¹⁰ Article 43(3) of the Commission Directive 2010/43/EU.

¹¹ Article 41(2) of the Commission Directive 2010/43/EU.

¹² EMIR provides for daily mark-to-market of outstanding contracts that are not cleared.

¹³ Article 2(1)(c)(ii) of the Commission Directive 2007/16/EC.

Box 3

- (1) When assessing counterparty risk, do you see merit in clarifying the treatment of OTC derivatives cleared through central counterparties? If so, what would be the appropriate approach?
- (2) For OTC derivatives not cleared through central counterparties, do you think that collateral requirements should be consistent between the requirements for OTC and EPM transactions?
- (3) Do you agree that there are specific operational or other risks resulting from UCITS contracting with a single counterparty? What measures could be envisaged to mitigate those risks?
- (4) What is the current market practice in terms of frequency of calculation of counterparty risk and issuer concentration and valuation of UCITS assets? If you are an asset manager, please also provide information specific to your business.
- (5) What would be the benefits and costs for all stakeholders involved of requiring calculation of counterparty risk and issuer concentration of the UCITS on an at least daily basis?
- (6) How could such a calculation be implemented for assets with less frequent valuations?

5. EXTRAORDINARY LIQUIDITY MANAGEMENT TOOLS

Article 84 of the UCITS Directive provides that a UCITS shall redeem units on request by investors. The Directive does not specify how in practice such a right must be applied. For example, it does not set time limits for the execution of redemption orders.

During the financial crisis some UCITS were confronted with liquidity bottlenecks such that they were unable to redeem units on request. The temporary suspension of redemptions is the only derogation from the general right to redeem units of UCITS on request. Such suspensions are allowed only in "exceptional cases where circumstances so require and where temporary suspension is justified having regard to the interests of the unit-holders". Article 84 of the UCITS Directive does not provide guidance as regards the meaning of "exceptional cases" which has led to different interpretations among the Member States. Some take the view that more developed rules on a European-wide basis may help fund managers facing liquidity bottlenecks, better ensure high-levels of investor protection and support a better functioning of the single market. Any framework should seek an appropriate balance between the interests of investors who are redeeming their investments and those investors remaining invested in the fund.

Deferred redemptions aim at preventing a situation in which a UCITS would be obliged to sell a large part of its portfolio in a short period of time and at a potentially deflated price because it is confronted with an unusual amount of

redemption orders. The mechanisms involve postponing the execution of all or part of the redemption orders.

Side-pockets can be applied in situations where a part of the assets in the UCITS portfolio becomes illiquid. In such case liquid assets are separated from illiquid assets and a new fund is created. It must be noted, however, that according to Article 1(5) of the UCITS Directive, Member States shall prohibit UCITS from transforming themselves into non-UCITS funds.

Attention has also been drawn to secondary markets for Exchange Traded Funds (ETFs). Situations may arise when the authorized participant providing liquidity ceases to perform its duty. Specific measures may be necessary to guarantee liquidity for ETF investors.

Box 4

- (1) What type of internal policies does a UCITS use in order to face liquidity constraints? If you are an asset manager, please provide also information specific to your business.
- (2) Do you see a need to further develop a common framework, as part of the UCITS Directive, for dealing with liquidity bottlenecks in exceptional cases?
- (3) What would be the criteria needed to define the "exceptional case" referred to in Article 84(2)? Should the decision be based on quantitative and/or qualitative criteria? Should the occurrence of "exceptional cases" be left to the manager's self-assessment and/or should this be assessed by the competent authorities? Please give an indicative list of criteria.
- (4) Regarding the temporary suspension of redemptions, should time limits be introduced that would require the fund to be liquidated once they are breached? If yes, what would such limits be? Please evaluate benefits and costs for all stakeholders involved.
- (5) Regarding deferred redemption, would quantitative thresholds and time limits better ensure fairness between different investors? How would such a mechanism work and what would be the appropriate limits? Please evaluate benefits and costs for all the stakeholders involved.
- (6) What is the current market practice when using side pockets? What options might be considered for side pockets in the UCITS Directive? What measures should be developed to ensure that all investors' interests are protected? Please evaluate benefits and costs for all the stakeholders involved.
- (7) Do you see a need for liquidity safeguards in ETF secondary markets? Should the ETF provider be directly involved in providing liquidity to secondary market investors? What would be the consequences for all the stakeholders involved? Do you see any other alternative?

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

6. DEPOSITARY PASSPORT

At present, UCITS depositaries have no European passport. This is because Article 23(1) of the UCITS Directive requires that a depositary shall either have its registered office or be established in the UCITS' home Member State. The fund industry has already for some time been debating whether UCITS should be limited to the services of depositaries located in the same jurisdiction as the fund.

The AIFMD and the proposal on UCITS V aim to harmonize the rules governing entities eligible to act as depositaries, the definition of safekeeping duties and oversight functions, the depositary's liability, and the conditions for delegation of the custody function. The introduction of a depositary passport is sometimes seen as the capstone to this wide-ranging harmonisation.

Box 5

- (1) What advantages and drawbacks would a depositary passport create, in your view, from the perspective of: the depositary (turnover, jobs, organisation, operational complexities, economies of scale ...), the fund (costs, cross border activity, enforcement of its rights ...), the competent authorities (supervisory effectiveness and complexity ...), and the investor (level of investor protection)?
- (2) If you are a fund manager or a depositary, do you encounter problems stemming from the regulatory requirement that the depositary and the fund need to be located in the same Member State? If you are a competent authority, would you encounter problems linked to the dispersion of supervisory functions and responsibilities? If yes, please give details and describe the costs (financial and non-financial) associated with these burdens as well as possible issues that a separation of fund and depositary might create in terms of regulatory oversight and supervisory cooperation.
- (3) In case a depositary passport were to be introduced, what areas do you think might require further harmonisation (e.g. calculation of NAV, definition of a depositary's tasks and permitted activities, conduct of business rules, supervision, harmonisation or approximation of capital requirements for depositaries...)?
- (4) Should the depositary be subject to a fully-fledged authorisation regime specific to depositaries or is reliance on other EU regulatory frameworks (e.g., credit institutions or investment firms) sufficient in case a passport for depositary functions were to be introduced?
- (5) Are there specific issues to address for the supervision of a UCITS where the depositary is not located in the same jurisdiction?

7. MONEY MARKET FUNDS

MMFs are widely used by all types of investors, e.g. households, corporate treasurers, pension funds or insurance companies, who regard MMFs as a "safe" short term liquid asset class for investing cash. In this case they are close substitutes to deposits. MMFs are themselves key lenders to issuers of short dated high quality money market instruments. They provide an important source of funding for a variety of institutions such as sovereigns, banks, or companies. Active trading by MMFs is vital for liquid markets for commercial paper, short-term bank debt and sovereign debt. Increased liquidity is in turn beneficial to market efficiency and leads to a reduction in the cost of capital for firms.

The potential systemic importance MMFs, including their susceptibility to runs, have been analysed in the context of the shadow banking work stream of the FSB. In the EU, CESR (the predecessor of ESMA) has already adopted guidelines¹⁴ on a common definition of European MMFs. These non-binding guidelines are addressed to both UCITS and non-UCITS MMFs.

The responses to the Commission Green Paper on Shadow Banking focused to a large extent on MMFs. Stakeholders are generally supportive of enhancing their liquidity profile in order to better accommodate redemption requests. The proposed solutions to prevent massive redemptions (runs) vary ranging from light touch approaches to measures requiring structural changes.

Box 6

- (1) What role do MMFs play in the management of liquidity for investors and in the financial markets generally? What are close alternatives for MMFs? Please give indicative figures and/or estimates of cross-elasticity of demand between MMFs and alternatives.
- (2) What type of investors are MMFs mostly targeting? Please give indicative figures.
- (3) What types of assets are MMFs mostly invested in? From what type of issuers? Please give indicative figures.
- (4) To what extent do MMFs engage in transactions such as repo and securities lending? What proportion of these transactions is open-ended and can be recalled at any time, and what proportion is fixed-term? What assets do MMFs accept as collateral in these transactions? Is the collateral marked-to-market daily and how often are margin calls made? Do MMFs engage in collateral swap (collateral upgrade/downgrade) trades on a fixed-term basis?
- (5) Do you agree that MMFs, individually or collectively, may represent a source of systemic risk ('runs' by investors, contagion, etc...) due to their central role in the short term funding market? Please explain.

¹⁴ CESR Guidelines on a Common Definition of European MMFs CESR/10-049

- (6) Do you see a need for more detailed and harmonised regulation on MMFs at the EU level? If yes, should it be part of the UCITS Directive, of the AIFM Directive, of both Directives or a separate and self-standing instrument? Do you believe that EU rules on MMF should apply to all funds that are marketed as MMF or fall within the European Central Bank's definition¹⁵?
- (7) Should a new framework distinguish between different types of MMFs, e.g.: maturity (short term MMF vs. MMF as in CESR guidelines) or asset type? Should other definitions and distinctions be included?

7.1. Valuation and capital

The low or almost non-existent fluctuation of the net asset value (NAV) of so-called Constant NAV MMFs (CNAV MMFs) and regular sponsor support to maintain a stable NAV may give the impression to investors that CNAV MMFs contain a capital guarantee. This has been held to give rise to a run once investors fear that the CNAV MMF is prone to 'break the buck' and no longer be able to offer redemption at par (e.g. the "Reserve Primary Fund" in the US).

There is also a concern that the amortized cost valuation method (used by CNAV MMFs) allows MMFs to disregard the gap between the real value and the book value of assets. Variable NAV MMFs (VNAV MMFs) value their assets on the basis of the mark-to-market model, therefore they allow for changes in the NAV. It is estimated that in Europe 60% of the MMFs follow a VNAV model whereas 40% follow the CNAV model.

As CNAV MMFs are sometimes considered as substitutes to bank deposits, some argue that they should be subject to equivalent capital requirements. Capital buffers are sometimes envisaged but their practical implementation remains an unresolved issue. Possibly, buffers would serve to absorb first losses and maintain a stable NAV thus limiting the downside risk.

Box 7

- (1) What factors do investors consider when they make a choice between CNAV and VNAV? Do some specific investment criteria or restrictions exist regarding both versions? Please develop.
- (2) Should CNAV MMFs be subject to additional regulation, their activities reduced or even phased out? What would the consequences of such a measure be for all stakeholders involved and how could a phase-out be implemented while avoiding disruptions in the supply of MMF?
- (3) Would you consider imposing capital buffers on CNAV funds as appropriate? What are the relevant types of buffers: shareholder funded,

¹⁵ The European Central Bank defines a MMF as a collective investment undertaking whose units are close substitutes for deposits and that primarily invest in money market instruments, shares or units in money market funds, and/or other transferable debt instruments with a residual maturity of up to and including one year; and/or bank deposit, cf. Council Regulation (EC) 2423/2001 of 20/11/2001, Annex 1, Part 1, Section 1, paragraphs 6 and 7.

sponsor funded or other types? What would be the appropriate size of such buffers in order to absorb first losses? For each type of the buffer, what would be the benefits and costs of such a measure for all stakeholders involved?

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

7.2. Liquidity and redemptions

MMFs allow investors to withdraw on demand, with almost immediate execution and a relatively stable principal value. At the same time, MMFs invest in assets that mature in the future and which do not necessarily display daily liquidity. This situation might impede MMF's ability to face large redemption requests from investors.

Different options are possible to increase the stability of MMFs. For instance, liquidity fees might reduce incentives for investors to redeem first, because first redeemers would have to compensate remaining investors that might thereby be disadvantaged. Redemption restrictions might serve to limit the number of shares that a manager has to repurchase, thus limiting the risk and size of asset fire sales. Liquidity constraints may be imposed (in addition to the existing CESR guidelines) so managers hold highly liquid assets to be able to face redemptions.

Box 8

- (1) Do you think that the current regulatory framework for UCITS investing in money market instruments is sufficient to prevent liquidity bottlenecks such as those that have arisen during the recent financial crisis? If not, what solutions would you propose?
- (2) Do you think that imposing a liquidity fee on those investors that redeem first would be an effective solution? How should such a mechanism work? What, if any, would be the consequences, including in terms of investors' confidence?
- (3) Different redemption restrictions may be envisaged: limits on share repurchases, redemption in kind, retention scenarios etc. Do you think that they represent viable solutions? How should they work concretely (length and proportion of assets concerned) and what would be the consequences, including in terms of investors' confidence?
- (4) Do you consider that adding liquidity constraints (overnight and weekly maturing securities) would be useful? How should such a mechanism work and what would be the proposed proportion of the assets that would have to comply with these constraints? What would be the consequences, including in terms of investors' confidence?
- (5) Do you think that the 3 options (liquidity fees, redemption restrictions and liquidity constraints) are mutually exclusive or could be adopted together?

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

7.3. Investment criteria and rating

The MMF industry relies extensively on credit ratings in order to assess credit risk associated with their assets. On the one hand MMFs may be rated and on the other hand the assets in which they are authorized to invest have to follow credit ratings criteria (CESR MMF guidelines) in many cases.

Most of the funds that are rated are awarded an AAA credit note. A downgrade of one of these AAA-rated MMFs may have the consequences that investors may want to switch their positions quickly to another AAA-rated fund. Such a sharp decline in the fund's assets might have systemic effects. It is argued that banning the rating of MMFs would force investors to assess for themselves the risk / reward profile of the funds instead of relying on credit rating agencies' opinions. This would increase their monitoring and reduce the potential for systemic overreactions to sudden new developments.

MMF managers are required to invest only in assets that are awarded top quality credit ratings. If a downgrade in these assets were to happen, the manager would be forced to sell these assets in order to continue complying with the rules. The managers are already currently required to assess the credit quality of their investments but a purely internal assessment without reference to ratings is also sometimes discussed.

Box 9

- (1) Do you think that the definition of money market instruments (Article 2(1)(o) of the UCITS Directive and its clarification in Commission Directive 2007/16/EC¹⁶) should be reviewed? What changes would you consider?
- (2) Should it be still possible for MMFs to be rated? What would be the consequences of a ban for all stakeholders involved?
- (3) What would be the consequences of prohibiting investment criteria related to credit ratings?
- (4) MMFs are deemed to invest in high quality assets. What would be the criteria needed for a proper internal assessment? Please give details as regards investment type, maturity, liquidity, type of issuers, yield etc.

8. LONG-TERM INVESTMENTS

Investing on a long-term basis is generally perceived as a factor for growth for the economy. Although long term investing only offers returns over the long term, such investing may better contribute to the financing of new projects and expansion plans that normally require longer time horizons for completion.

¹⁶ Article 3 of Directive 2007/16/EC, "Instruments normally dealt in on the money market".

Besides the banks that provide borrowing facilities, private companies may also seek other sources of money in order to strengthen their capital. Investment funds can play a key role in channeling investor's money toward such financing.¹⁷

Long-term investments can also contribute to financing infrastructure projects such as in the areas of transportation, energy, health or education. Often financed with public money, infrastructure projects could benefit from new sources of financing, including private money. This could increase the number and scale of projects launched, boosting growth and job creation. Such investments can offer investors stable and steady returns that can be uncorrelated with financial markets.

Long-term investments share one common feature: a low level of liquidity. They are generally associated with long lock-up periods. This is why access to this type of investments is normally reserved for institutional investors only. Nonetheless, some EU Member States have sought to develop ways of facilitating access to long-term investments for retail investors, though a common approach to this has not emerged. Long-term investing remains therefore segmented along national lines, with barriers to the free movement of capital across borders.

A variety of asset types have been characterised as 'long-term', including direct investments into unlisted companies (early or mature stage), infrastructure projects, 'real' assets (real estate, other physical assets), and third-party managed funds making investments in unlisted companies. Since socially responsible investments are typically long-term in perspective, these represent a major category. In the future, such investments could include channeling money to the European Social Entrepreneurship Funds (EuSEF) envisaged in the recent proposal by the European Commission¹⁸.

Long-term investment funds open to retail investors may be an effective enhancement to the internal market. They could create new opportunities for deepening the European asset management industry and its contribution to growth, while offering new investment opportunities for investors. Steps towards encouraging long-term investment could also help reduce cyclical pressures in the capital markets. Promoting such funds could take several forms, including different legislative options; access to retail investors would of course entail high standards of investor protection, as is already the case for UCITS.

Box 10

- (1) What options do retail investors currently have when wishing to invest in long-term assets? Do retail investors have an appetite for long-term

¹⁷ This consultation is one of the initiatives taken by the Commission in this area. With regard to small and medium enterprises, it is worth mentioning the improved regime for SME markets (so called SME growth markets) proposed in the context of the review of MiFID (Proposal for a directive on market in financial instruments repealing Directive 2004/39/EC).

¹⁸ http://ec.europa.eu/internal_market/investment/social_investment_funds_en.htm

investments? Do fund managers have an appetite for developing funds that enable retail investors to make long-term investments?

- (2) Do you see a need to create a common framework dedicated to long-term investments for retail investors? Would targeted modifications of UCITS rules or a stand-alone initiative be more appropriate?
- (3) Do you agree with the above list of possible eligible assets? What other type of asset should be included? Please provide definitions and characteristics for each type of asset.
- (4) Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced? Please give details.
- (5) What proportion of a fund's portfolio do you think should be dedicated to such assets? What would be the possible impacts?
- (6) What kind of diversification rules might be needed to avoid excessive concentration risks and ensure adequate liquidity? Please give indicative figures with possible impacts.
- (7) Should the use of leverage or financial derivative instruments be banned? If not, what specific constraints on their use might be considered?
- (8) Should a minimum lock-up period or other restrictions on exits be allowed? How might such measures be practically implemented?
- (9) To ensure high standards of investor protection, should parts of the UCITS framework be used, e.g. management company rules or depositary requirements? What other parts of the UCITS framework are deemed necessary?
- (10) Regarding social investments only, would you support the possibility for UCITS funds to invest in units of EuSEF? If so, under what conditions and limits?

9. UCITS IV IMPROVEMENT

9.1. Self-managed investment companies

Article 31 of the UCITS Directive lays down general requirements on administrative procedures and internal control mechanisms for investment companies. It mirrors, to a great extent, Article 12 of the UCITS Directive, which applies to management companies. However, it does not provide for an empowerment for the Commission to adopt delegated acts specifying the administrative procedures and internal control mechanisms. As a result, the Level 2 measures developed for Article 12 do not apply to investment companies.

9.2. Master – feeder structures

Article 64(1) of the UCITS Directive requires UCITS to provide information to investors in the following two cases: where an ordinary UCITS converts into a

feeder UCITS, and where a master UCITS changes. However, this article does not cover a third possible scenario, that is, where a feeder UCITS converts into an ordinary UCITS. Such conversions lead to a significant change in the investment strategy. It can be argued that similar information standards should apply across all three scenarios.

9.3. Fund mergers

The merger of two UCITS is subject to prior authorisation by the competent authorities of the merging UCITS home Member States. These authorities must inform the merging UCITS about their decision within 20 working days from the date of the receipt of the complete application.

Before the authorities communicate their decision, they need to consult the competent authorities of the receiving UCITS. The competent authority of the receiving UCITS must consider the potential impact of the merger on the investors of the receiving UCITS. They must assess whether the information to be provided to investors is sufficient. The authorities of the receiving UCITS can ask the fund, within 15 working days, to modify the information to be provided to investors.

One of the possible readings of these provisions is that, after the receipt of the modified version of the information to investors, the competent authorities of the receiving UCITS have 20 working days to inform the competent authorities of the merging UCITS whether they are satisfied with that modified version of the information.

Given such an interpretation practical problems can arise. It is not clear how to reconcile the general 20 working day time limit for the competent authorities of the merging UCITS for their decision on the authorisation of the merger with a 20 working day time limit for the competent authorities of the receiving UCITS for their assessment of the modified version of the information to investors.

Revision of the provisions on the timelines for the mergers of the UCITS could therefore be considered so as to increase legal certainty.

9.4. Notification procedure

UCITS IV has introduced a new electronic regulator-to-regulator notification procedure. However, Article 93(8) of the UCITS Directive requires that any change to the information on marketing arrangements in a host Member State or marketing of a new share class should be notified to the UCITS host Member State in a written form. Two improvements could be considered:

- Introduction of the notification of the update to the UCITS host Member State in electronic form;
- Clarification that information on a share class is limited to share classes marketed in a host Member State.

It can be also considered whether to introduce a regulator-to-regulator notification for any changes to the notification file including the information on arrangements for marketing or marketing of a new share class.

9.5. Alignment with the AIFM Directive

The AIFM Directive, which will apply as of July 2013, has been adopted to cover alternative investment funds. In order to prevent systemic risks and to create a safe environment for investors, many important provisions have been introduced. Some of these provisions are more detailed in the AIFM Directive than comparable ones in the UCITS Directive, including measures on organisational rules, delegation, risk and liquidity management rules, valuation, reporting or calculation of leverage.

Box 11

- (1) Do you think that the identified areas (points 1 to 4) require further consideration and that options should be developed for amending the respective provisions? Please provide an answer on each separate topic with the possible costs / benefits of changes for each, considering the impact for all stakeholders involved.
- (2) Regarding point 5, do you consider that further alignment is needed in order to improve consistency of rules in the European asset management sector? If yes, which areas in the UCITS framework should be further harmonised so as to improve consistency between the AIFM Directive and the UCITS Directive? Please give details and the possible attached benefits and costs.