BF BETTER FINANCE

The European Federation of Investors and Financial Services Users
Fédération Européenne des Épargnants et Usagers des Services Financiers

BETTER FINANCE's response to ESMA's Consultation on the review of the UCITS Eligible Assets Directive

-Date: 7 August 2024

-Ref: ESMA's UCITS Eligible Assets Directive Consultation (2024) - https://www.esma.europa.eu/press-news/consultations/call-evidence-review-ucits-eligible-assets-directive

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Executive Summary

BETTER FINANCE, the European Federation of Investors and Financial Services Users, welcomes the work undertaken by the European Securities and Markets Authority (ESMA) towards reviewing the UCITS Eligible Assets Directive (UCITS EAD). This Directive, which supplements the UCITS framework, was adopted seventeen years ago and has not kept pace with the rapidly changing capital markets, with potential negative consequences for investor protection in UCITS funds.

BETTER FINANCE strongly believes that the UCITS framework is a valuable vehicle for the European Union in its efforts to create a genuine "Savings and Investments Union" (or 'Capital Markets Union'). This framework must provide competitive, high-performance investment opportunities for European citizens by channelling funding to support the growth and green transition of European firms. In this context, it is important to preserve the focus of UCITS funds on assets that directly contribute to the real economy, with limited complexity and few intermediaries involved. Listed equity and fixed income securities should remain the core of UCITS investments, ensuring that investment policies are clear, transparent, and intelligible for the average individual investor.

Key Recommendations:

- **Focus on core investments:** BETTER FINANCE stresses that listed equity and fixed income securities should remain central to UCITS investments. These assets are well-understood by individual investors and align with clear, transparent, and straightforward investment policies. This focus is essential for maintaining investor confidence and ensuring that UCITS funds remain accessible to retail investors with varying levels of financial literacy.

- **Modernisation of rules:** BETTER FINANCE supports ESMA's initiative to update the UCITS EAD by replacing outdated rules with references to more recent legislative frameworks (securities financing transaction set out in the SFTR). These updates should enhance investor protection by addressing current market practices, particularly in areas like securities lending, where greater transparency and fairer returns for retail investors are needed.
- **Limitation of complex Instruments and securitisation vehicles:** BETTER FINANCE advocates for a conservative approach to UCITS investments in complex instruments, such as derivatives, delta-one products, and securities issued by securitisation vehicles. These investments should be strictly limited, aligned with the fund's core strategy, and subject to a mandatory look-through approach to ensure transparency. If permitted, they must include prominent warnings to retail investors about the associated risks.
- **Prudent approach to new Asset Classes:** BETTER FINANCE urges caution in expanding UCITS-eligible assets to include new asset classes. The strength of the UCITS framework lies in its simplicity and transparency. Introducing new, particularly complex or speculative asset classes could undermine these principles. Any new assets considered must be rigorously evaluated to balance innovation and protection, notably to ensure they do not compromise the UCITs framework's integrity and should include clear warnings/explanations to retail investors while being in line with the funds' policy.

BETTER FINANCE welcomes this opportunity to contribute to the review of the UCITS EAD and to share its views on investment policies that are appropriate for UCITS funds. As a popular vehicle for individual investors' engagement with capital markets, it is vital that UCITS funds continue to offer safe, transparent, competitive and easily understandable investment options. We remain at ESMA's disposal for further discussions on any of the issues raised in our response.

ESMA's Call for Evidence on the review of the UCITS Eligible Assets Directive

https://www.esma.europa.eu/press-news/consultations/call-evidence-review-ucits-eligible-assets-directive

General information about respondent

Name of the company / organisation	BETTER FINANCE
Activity	Consumer protection / Retail investors Federation
Country / Region	Europe / Belgium

Questions / Answers

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?

As ESMA rightly point out, market developments have created a wide range of new asset categories since the adoption of the UCITS EAD in 2007, and there is a crucial need to update the rules in order to clarify which of these new types of assets and securities are eligible as UCITS investments.

We consider that UCITS funds, being often the most common type of funds marketed to retail investors, should remain subject to a clear, straightforward framework, that has been the strength of the UCITS "brand" since the adoption of the first UCITS Directive. Since the adoption of the UCITS EAD, EU legislators and regulators have created the Alternative Investment Fund (AIF) category, which offers a more flexible framework for investors seeking more varied investment opportunities (in terms of asset types), and they have adopted rules on securitisation and securities lending that represent advances in terms of investor protection. We believe that, with the current momentum around the Capital Markets Union—or, as Enrico Letta suggests, Savings and Investments Union, it is opportune to update the UCITS EAD to streamline the overall investor protection framework.

The UCITS EA framework must be updated, but remain simple and attractive, as even today, UCITS funds are often not the most chosen product for retail investments within the EU.

The main - and rare - serious liquidity issues that occurred in the recent past on UCITS funds are more linked to breaches of maximum ratios for non-listed assets and/or of diversification rules.

Subsidiarily, and to ensure supervisory convergence for UCITs as the primary (almost only) relatively simple Pan-EU retail investment product, BETTER FINANCE believes a regulation could have been more appropriate than a Directive.

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.

Generally, the UCITS EAD rules regarding financial indices are sufficiently clear and straightforward. However, there is some uncertainty when it comes to indices tracking smaller national markets. In these cases, even if the index is as diversified as possible within that country's market, the main component(s) might still have too much weight for a UCITS fund replicating that index to comply with UCITS Directive diversification requirements. For example, the Lux General Index of the Luxembourg Stock Exchange includes only 19 components, with the largest company making up nearly half of the index. It should be clear that while the index design is not overly restrictive, the inherent structure of the market it represents makes it unsuitable as the basis for an index-replicating UCITS fund, which should constitute a diversification vehicle. Therefore, ratio-weighting shall be considered and appropriately managed for such restrictive index.

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.

Please see our comments below on the notions of “liquidity” and “negotiability”, as well as on the valuation criteria for eligible transferable securities.

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.

The presumption of liquidity and negotiability, as laid out in the current wording of the EAD, is too broad. There are various cases in which the admission to trading on a regulated market may not imply that a fund manager can effectively liquidate the fund's position in a timely manner.

One such case is that of microcaps, whose stocks may indeed be traded daily on a regulated market, yet for amounts that are smaller than a fund's position in this stock. The liquidity of such microcaps, therefore, should be monitored by the fund manager to ensure that the position can be liquidated over a relatively short period of time (e.g., five trading days). UCITS funds should be able to invest in small caps, and even make it a strategic investment policies to invest in small caps; nevertheless, managers of such funds should not assume that the securities issued by such small caps are always liquid and negotiable.

Real-world developments in recent years have shown that the liquidity of specific assets can dry up very quickly due to unforeseeable events. The Russian attack on Ukraine, for instance, created issues with regards to the liquidity and negotiability of both Ukrainian and Russian stocks and bonds, which, despite still being admitted to trading on a regulated market, might have become *de facto* illiquid and non-negotiable.

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.

Please, see our comments on Q4.

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.

We believe that it would be useful to specify further the notion of "ancillary liquid assets" in the UCITS framework, the purposes that such holdings serve and the categories of assets that can be used in relation to each purpose. Most retail investors will not find this wording intelligible, in breach of the MiFID rules on clear investor information.

Bank deposits at sight are not the only type of assets used as ancillary liquid assets. Money market fund shares can be as good and as liquid, sometimes even better, than some bank deposits at sight. The liquidity of these assets – both deposits and MMF shares –is contingent upon various factors that relate importantly to the solvency and liquidity situation of the credit institution where the UCITS makes a deposit or the MMF whose shares it buys. There may be cases in which deposits at sight become illiquid because of the bank's own lack of liquidity; similarly, there are differences amongst MMFs which may make some unsuitable as ancillary liquid assets.

Furthermore, we believe it would be justified that ancillary liquid assets could, in some cases, include bank deposits not only at sight but also short-term deposits (e.g., maximum three months), depending on the reason for the fund to hold these liquid assets. Indeed, recital 41 of the UCITS Directive mentions that UCITS funds may need to hold ancillary liquid asset "*when, because of unfavourable market conditions, the investment in transferable securities or money market instruments and in other financial assets is suspended*"; if the fund can reasonably expect such "unfavourable market conditions" to last for a certain period of time, it may be in the best interest of the fund – and, ultimately, of the fundholders – to make a term deposit rather than a deposit at sight.

In terms of limits to holdings of ancillary liquid assets, it may also be opportune to allow fund managers to increase the proportion of the fund's assets invested in highly liquid assets for a limited period of time – in case there is a reasonable expectation of market instability that may impair the ability of the fund to meet its obligation to redeem units at the request of fundholders. However, this possibility must be strictly limited in time and must be declared to the competent authorities, who must have the ability to order the fund manager to return to a normal allocation of his assets as soon as the conditions justifying this increase cease to exist. These safeguards are necessary to avoid fund managers to adopt overly conservative investment policies under normal market conditions.

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.

It may be opportune to allow UCITS, in certain limited cases, to invest a limited portion of their assets in a range of currencies with an established track record of rate stability with high liquidity. However, while the currencies / forex market is by far the biggest financial market in the world, it remains unregulated and includes risks.

Therefore, any such investment in a foreign currency should be in line with the investment policy of the fund: if the investment policy of a French fund is to invest in European equity, for instance, holdings of currency other than the Euro can hardly be justified beyond what might be necessary for the purchase and sale of equity in non-Euro area countries. Significant investments in foreign currency would indicate an investment policy that implies betting on foreign exchange rates, a policy that may be more indicated for an Alternative Investment Fund (AIF) than a UCITS fund.

Several UCITS fund managers can and already invest in foreign currencies by selecting short term foreign currency denominated instruments such as money market funds. Fundamentally, we believe that direct investments in the foreign currency markets (either spot or future) are quite speculative and do not translate into tangible investments into the real economy. They should therefore be strictly limited.

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.

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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.

The criterion on "reliable valuation" in Art. 2(1) of the UCITS EAD needs to be further specified, in particular as regards "other securities" (i.e., those not admitted or dealt in on a regulated market). The current requirement for a valuation "on a periodic basis" does not specify anything about the minimum frequency of said valuation: even though valuations of non-listed assets cannot be done as often as those of listed ones, we believe that the Directive should specify how many times per year, at minimum, such valuation of unlisted assets should be undertaken. Similarly, the requirement that this valuation be derived from information from the issuer "or from competent investment research" leaves too much room for interpretation as regards the source of the information: what is to be considered as "competent investment research"? We believe that the source of such information should be requested to be independent from the fund manager in order to avoid any conflicts of interest and be widely recognised as a reliable source of information for the asset and asset category in question.

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.

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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.

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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.

Our view on UCITS investments in derivatives, including instruments with embedded derivatives, is that such holdings should generally be limited to hedging purposes. Investments in these instruments enable speculative activities, which should be strictly avoided and instead follow specific investment purposes and follow clear efficient portfolio management. Therefore, they should only be allowed if they clearly align with the fund's investment policy. This policy must be clearly disclosed to all investors and formulated in a manner that makes the financial risks understandable to the average retail investor.

The disadvantages of such (often customised) embedded derivatives instruments include their potential limited liquidity and the complexity of managing rate and market risks. We have concerns that the average retail investor may not fully grasp the risks associated with the fund's exposure to derivatives, particularly those with embedded derivatives. Therefore, we advocate for a restrictive interpretation of the rules to limit fund managers' ability to invest in such derivatives products, unless accompanied by a prominent warning to retail investors.

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.

We urge for caution in the treatment of complex and opaque delta-one instruments and are generally opposed to UCITS funds making significant investments in such instruments.

First, as ESMA notes, such instruments may provide UCITS with exposures to asset classes that are not eligible for direct investment such as certain derivatives often under (risky) synthetic products. As such, investments into delta-one instruments should in no case be allowed without a proper look-through approach in place to ensure that such investments do not lead the UCITS to violate the rules on eligible assets and transparency, including valuation rules. Such look-through approach may in some cases be extremely difficult, considering the potential complexity of delta-one instruments (e.g. indirect exposure under synthetic or hybrid approaches, potentially including indirect exposure to commodity futures). This complexity leads us to conclude that such investments should be left for Alternative Investment Funds (AIFs), not for UCITS.

Second, unlike traditional transferable securities such as equity, delta-one instruments (e.g. including contracts for difference, futures, or swaps) expose the fund to additional counterparty and leverage risk, adding another layer of risk beyond that typically incurred by the fund. Adding to this the potential complexity of some such instruments, it may quickly become overwhelmingly difficult for a fund to meet some of the requirements of the UCITS directive, including that the fund manager should always be able to accurately calculate the net asset value of the fund, at all times.

Q14 Have you observed any recurring or significant issues with the interpretation or consistent application of the rules on UCITS investments in other UCITS and alternative investment funds (AIFs)? In this context, have you observed any issues in terms of the clarity, interaction and logical consistency between (1) the rules on investments in UCITS and other open-ended funds set out in the UCITS Directive and (2) the provisions on UCITS investments in closed ended funds set out in the UCITS EAD? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the relevant rules to improve investor protection, clarity and supervisory convergence. Where relevant, please distinguish between different types of AIFs (e.g. closed-ended, open-ended), investment strategies (real estate, hedge fund, private equity, venture capital etc.) and location (e.g. EU, non-EU, specific countries). In this context, please also share views on whether there is a need to update the legal

wording used in the UCITS EAD and UCITS Directive given the fact that e.g. they refer to 'open-ended' and 'closed ended funds', whereas it might seem preferable to use the notion of 'AIFs' by now given the subsequent introduction of the AIFMD in 2011.

We consider that the existing rules on UCITS investments in other funds are sufficiently clear and remain appropriate.

A closed-ended fund should indeed be an AIF. However, we oppose replacing the distinction between 'open-ended' and 'closed-ended' funds with the notion of 'AIFs', which refers to a very broad and diverse range of funds. We believe that open- vs. closed-ended distinction has specific regulatory implications that go beyond (or has nothing to do with) the classification of a fund as an AIF. Therefore, if the Directive was to be updated to use the notion of AIF in the context of closed-ended funds, it would have to be so in a way that maintains the existing criteria and leaves the current distinction untouched. This approach would likely lead to additional – and rather unnecessary – complexity.

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.

We believe the existing rules to be adequate.

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.

Article 11 of the UCITS EAD. As research from BETTER FINANCE on securities lending has shown[1], securities lending programmes implemented by UCITS fund managers – under the current UCITS EAD rules –vary greatly in terms of the share of the profits being effectively returned to the UCITS fund, most likely breaching in some cases the ESMA rule of attributing all the profit "net of operational costs" to the UCITS funds. Many funds bypass the requirement to return all net profits from securities lending to fundholders by

[1] BETTER FINANCE, 2022, "Securities Lending: Income Attribution & Conflicts of Interests in EU Retail Investment Funds", https://betterfinance.eu/publication/securities-lending-income-attribution-conflicts-of-interests-in-eu-retail-investment-funds/

allocating significant portions of this revenue to affiliated intermediaries as "agent fees." Additionally, they retain a substantial share for themselves under the guise of "other operational costs" – which often seem disproportionate compared to the actual expenses of running a securities lending programme. Indeed, in one case, a small player in the EU securities lending market, which uses a third-party lending agent, returned 92% of its securities lending revenues to the funds. In contract, another case of the market leader, using an "affiliate lending agent", returned only 62,5% of its securities lending revenues to the funds. This implies that the latter market leader would have incurred 4,5 times more operational costs for the same revenues than the former smaller player.

It has long been BETTER FINANCE's opinion that the legal requirements on securities lending by UCITS funds need to be updated; we would, therefore, strongly support an update of the UCITS EAD rules that impose more stringent requirements and enable a better enforcement of the obligation to transparently pass all revenues to the fundholders. More precisely, the "net profit" and "operational costs" notions must be evaluated in a consolidated manner, and any significant discrepancies with other market players who use only third-party lending agents be explained to the relevant supervisors.

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?

In line with our comments on Q16 above, BETTER FINANCE sees merit in replacing the current UCITS EAD rules on EPM techniques with references to the rules enacted in the SFTR. The SFTR, being much more recent than the UCITS EAD with more developed rules, better reflects current market practices. However, we emphasise that such reference must be introduced in a way that ensures that the revenue of securities lending by UCITS fund managers is passed to the fund with only actual consolidated (operational) costs being deducted. It is also crucial that such lending programmes do not unduly increase the risks borne by the fund. We believe the primary purpose of a UCITS fund is to invest mostly in transferable securities, not to lend them. Therefore, securities lending should remain a limited practice for UCITS funds, mostly applying to index funds and always under the safeguards and requirements outlined.

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.

We do not see any specific definition or concept other than those mentioned in our responses to the other questions in this consultation that may require update .

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.

We do not have a sufficiently clear view of national legislation transposing the UCITS Directive and UCITS EAD to offer specific insights on this question. However, we would like to stress that regulatory consistency is paramount to ensure that European citizens can fully reap the benefits of the Single Market and access investment opportunities offered by UCITS funds, regardless of where in the EU these funds are domiciled. Divergences (or 'gold-plating') across Member States should be strictly limited to what is absolutely necessary to adapt EU legislation to national specificities. Such divergences should therefore be minimal and not be used to create a captive market for the national asset management industry by blocking retail investors from accessing foreign UCITS funds from other Member States.

Notably, different EU Member States may have varying interpretations and enforcement of rules regarding compartments. Therefore, harmonising regulatory interpretations and practices across Member States is crucial to ensure smooth cross-border distribution and maintain investor confidence (such as transparency, segregation rules, and disclosure standardisation).

Besides cross-border distribution challenges, managing compartments across multiple jurisdictions can increase operational complexity and higher administrative/registration costs, which can affect the fund's efficiency and returns and accessibility. Safeguarding consumers and reducing regulatory arbitrage while enabling operational efficiency is crucial to ensuring fairer cross-border distribution and maintaining the integrity of UCITS structures EU-wide under a relative simplicity of funds structure. As mentioned in Q1, a regulation would have been more effective for supervisory convergence than a directive.

Q20 Please fill in the table in the Annex to this document on the merits of allowing direct or indirect UCITS exposures to the asset classes listed therein, taking into account the instructions provided in the same Annex. Please assess and provide evidence on the merits of such exposures in light of their risks and benefits taking into account the characteristics of the underlying markets (e.g. availability of reliable valuation information, liquidity, safekeeping). To substantiate your position, please fill the table with any available data and evidence (e.g. on liquidity or valuation of the relevant asset classes and underlying markets). ESMA acknowledges that the availability of data on direct/indirect exposures to some of the asset classes listed in this table is limited and would welcome receiving any

available data (whether on individual market participants and products or market-wide) and even rough estimates that help to understand the practical relevance of the relevant asset class for UCITS and the possible impact of any future policy measures.

BETTER FINANCE has limited data on the various asset classes listed in the annex table. Unfortunately, too often so does the financial industry, who, despite this lack of data, insists that these asset categories would sit perfectly in retail investors' portfolios.

Generally, we believe that the strength of the UCITS "brand", in Europe and beyond, comes from the fact that its framework makes for relatively simple, straightforward investment funds that even retail investors with limited financial literacy can trust to invest their savings into intelligible asset classes (such as stocks and bonds) – and labelled as such, if only to comply with MiFID rules on "clear" investor information.

The EU has created a very clear distinction between these UCITS funds and a broader category of Alternative Investment Funds, where the range of eligible asset categories is much wider, a category that is, in several cases, not accessible to retail investors precisely because this wider range of eligible assets requires more knowledgeable investors.

Beyond the dichotomy of "retail" and "professional" investors, BETTER FINANCE has long advocated for the creation of a third category of investors, "qualified" or "sophisticated" investors; individuals with sufficient knowledge and experience to appreciate the risks and opportunities of AIFs and other financial products normally not offered to retail investors. Rather than weakening the UCITS framework by allowing UCITS funds to expose retail investors to assets that may be too complex for them to understand the risk and opportunities, we believe such assets should remain the realm of AIF funds, and that "qualified" retail investors should have access to such AIFs.[2]

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.

Please see our comments on Q20 and in the annex table.

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

[2] As advocated in our position paper on the Retail Investment Strategy, p.23, https://betterfinance.eu/publication/better-finance-position-on-the-retail-investment-strategy/

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.

As a general rule, fund managers, particularly those of UCITS, should always have a clear understanding of the assets in which they are investing. Therefore, a look-through approach should be required before investing in any asset whose performance depends on an underlying asset – regardless of what that underlying asset is. Even a listed company may have investments in assets that are unsuitable for a UCITS, making the company's stock unsuitable as a UCITS asset. There are certain assets that are constructed in such a complex and costly way that conducting a proper look-through approach becomes impractical. The logical conclusion, therefore, should be that if the product is too complex to understand what risks it would expose the investing UCITS to, then the UCITS manager should refrain from investing in it. In other words, if it is too complex for you to understand it: do not touch it. We concur with ESMA's opinion that this is the only way to ensure that the list of eligible assets for UCITS funds remains effectively exhaustive.

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.

EU legislators and regulators have been quite active in the field of securitisation since the global financial crisis, and we acknowledge that there are securitisation vehicles which are regulated, quite transparent and relatively simple and therefore enabling an acceptably accurate and regular valuation. However, we cannot help but remark that securitisation vehicles, as a general category, may invest in a wide range of (potentially distressed) assets. Simply requiring that the securitisation vehicle has a banking liquidity line is not sufficient: as we could see in 2007-2008, a large-scale market collapse affecting securitised assets may make liquidity lines widely insufficient, leading to banking sector instability and/or heavy financial losses for investors in securitisation vehicles. In both cases, retail investors with skin in that game are liable to lose.

We, therefore, urge caution on the issue of allowing UCITS funds to invest in securities issued by securitisation vehicles. If such investments are permitted, then the following four conditions should at least be met:

- The ABS should be listed on a liquid market (like the US MBS market, for example);
- A sound look-through approach must be in place with the UCITS manager to ascertain the risks arising from the underlying assets and the structure of the securitisation;

- The UCITS framework should be amended to include reference to the Securitisation Regulation and to limit this possibility to the safest, simplest and most transparent type of securitisations;

- Additionally, such securitised assets must themselves be eligible to UCITS investments.

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.

Permitting UCITS to build short positions is very risky for retail investors, and may not contribute to fund the real economy, running counter the purported political objective of the Capital Market Union. Like for private assets, any such permission should be limited and include a prominent warning to retail investors in the KID and any other communication material, at the risks of otherwise eroding confidence in the UCITS brand.

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.

We do not have any other item to mention.