Call for evidence on the review of the Commission Directive on UCITS Eligible Assets

February 2025

Between 7 May and 7 August 2024, the European Securities and Markets Authority (ESMA) collected data from stakeholders in order to answer to the European Commission's technical advice request to assess the implementation of the Commission Directive 2007/16/EC on Eligible Assets related to Undertakings for Collective Investment in Transferable Securities (EAD Directive).

Its main goals consist of assessing possible divergences in the Member States' implementation of the Directive, as well as reviewing the text in light of market developments. To this end, evidence-based opinions were collected from all levels of the Undertakings for Collective Investment in Transferable Securities (UCITS) chain, including investors, managers and depositaries, as well as their associations.

ESMA is currently working on said text, which will be published this year on its website including the results of said assessment along with the final proposal.

Pregunta

What are the main challenges identified since 2007?

Respuesta

UCITS are a *highly reputable brand* that offers a strong degree of investor protection. The UCITS[1] Directive requires investments in assets to ensure certain principles of liquidity and risk diversification, as well as the ability to fulfil redemptions and calculate the net asset value for units issuance or redemption.

While the UCITS Directive includes a list of assets eligible for investment in its Article 50, it uses general concepts such as "transferable securities" and "money market instruments". For the purpose of developing a common understanding of such concepts and provide clarity as to whether a given asset class is eligible for investment, the EAD Directive was published in 2007.

Since then, the number, type and variety of financial instruments traded in the markets has increased, leading to uncertainty as to whether some instrument categories are eligible and diverging interpretations and market practices.

ESMA has strived to provide market participants and national competent authorities with guidelines as well as carrying out supervisory convergence actions[2]. The latter have shown the difficulty in applying the EAD Directive's criteria under a scenario of assets' growing complexity and their corresponding specificities.

For example, questions have risen concerning the eligibility of direct or indirect exposure to asset classes such as structured/leveraged loans, catastrophe bonds, emission allowances, commodities, crypto-assets, and unlisted equities. The EAD Directive distinguishes between (1) instruments backed by or linked to the performance of others and (2) instruments embedding derivatives. Opinions differ regarding whether, in the aforementioned cases, the *look-through*[3] approach should be used and at what point in time to determine asset eligibility. This becomes especially relevant in the case of delta one[4] instruments and exchange-traded products that may lead to exposure to assets not eligible for direct investment by UCITS.

Doubts have also arisen about the concept of "liquidity" with regards to transferable securities in the EAD Directive. While, on the one hand, the regulation determines that UCITS must have sufficient capacity to meet redemptions or repurchasing of units obligations at the investors' request; on the other hand, its scope nor its application are clear.

Likewise, some issues were identified with regards to the presumption of liquidity and negotiability set out in the EAD Directive. In some cases, UCITS managers were overconfident when investing in listed securities (e.g.

instruments listed offshore with no significant trading volume) and, in other cases, applied liquidity presumptions to non-listed instruments.

[1] Worth noting: the UCITS Directive (Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009) is dated 1985. Nonetheless, it has been reviewed several times since then.

[2] For more information on said actions, please check the links of interest.

[3] The *look-through* approach involves verifying that indirect (underlying) investments, for example, through derivative instruments, instruments linked to the performance of other instruments, investment funds, etc, meet the same requirements as direct investments.

[4] "Delta-one" products are financial derivatives that have a one or near-one delta, which means that, for a given rapid movement in the price of an underlying asset, an identical movement in the price of the derivative is expected.

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What is the European Commission requiring?

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In its mandate, the European Commission requires ESMA the following:

1. To assess the implementation of the EAD Directive by Member States to detect potential divergences in its application, specifically indicating examples of provisions related to delta-one instruments, indices, efficient portfolio management techniques, the definition of money market instruments, as well as the notion of liquidity and the presumption of liquidity related to certain transferable securities.
2. To provide clarification on key definitions and criteria for asset eligibility assessment.
3. To assess whether cross-references can be carried out with other European frameworks (e.g. MiFID II, EMIR, Benchmark Regulation and Money Market Funds Regulation) that can contribute to clarity, legal certainty and cohesion.
4. To see how and to what extent UCITIS have gained direct or indirect exposure to certain asset classes that may have led to different interpretations and/or risk for retail investors and to assess the benefits and risks of UCITS gaining exposure to said asset classes.
5. As for efficient portfolio management techniques, to provide legislative clarifications in order to resolve shortcomings identified during ESMA´s supervisory convergence work[5].
6. When definitions and eligibility criteria suggested by ESMA allow for the exposure to the aforementioned assets, to assess whether such exposure is appropriate for the context of UCITIS considering the characteristics of underlying markets (availability of valuation, liquidity, safeguarding, etc.).
7. To suggest appropriate legislative changes, in the short, medium and long term, for both level 1 and 2 standards.

When conducting this analysis and providing potential recommendations, it is important to keep in mind the need to protect the brand's reputation and to preserve and reinforce the proper functioning of the framework, the managers' operations and the best interests of investors, along with the quality of investment products offered to retail investors.

[5] The 2018 peer review conducted on this matter, and its follow-up report of 2023, highlight uneven market practices on securities lending fees, and therefore seeks improving investor protection to avoid overcharging investors

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How was the consultation approached?

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ESMA divided its consultation into two sections:

1. *Convergence issues and clarity of key concepts*: In this section, questions are aimed at identifying the most urgent issues. To this end, specific questions were posed about each and every one of the aforementioned issues, as well as requesting improvement suggestions. Additionally, potential problems

about the so-called “trash-ratio” application were posed, that is, the 10 percent limit for investments in transferable securities or money market instrument other than those included in Article 50.1[6] of the UCITS Directive, along with possible interactions and divergences with national frameworks and the potential derived problems caused as a result.

2. *Direct and indirect UCITS exposures to certain asset classes:* This section aims to collect points of view, data and evidence to assess the risks and benefits of UCITS gaining direct, or indirect, exposure to assets[7] regarding which there are different views on their eligibility as UCITS investments. The following two questions included under the same section are also worth noting, among others: (a) the different impact that indirect exposure could have, in terms of investors’ risk and costs, as opposed to direct investments regarding said assets, and (b) the appropriateness of applying a “look-through” approach to determine asset eligibility (thereby, the list of eligible assets set out in the UCITS Directive would be considered exhaustive, and the risk of circumvention through indirect exposure to ineligible assets via instruments such as delta one, exchange-traded products or derivatives, would decrease).

ESMA aims to carry out a comprehensive analysis, therefore including questions related to other issues such as potential interpretation problems related to investments in EU or non-EU Exchange Traded Funds (ETFs), as well as risks and benefits that investments in securities issued by securitisation vehicles entail, or whether to allow UCITS to build up short positions through derivatives or delta one instruments. Details on these 25 questions, as well as several stakeholders’ answers, can be found in the links of interest below.

[6] The quoted article can be found in the following link: Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009.

[7] Loans, catastrophe bonds, contingent convertible bonds (CoCo), unrated bonds, distressed securities, unlisted securities, crypto-assets, commodities and precious metals, exchange-traded commodities, real estate assets, real estate investment trusts, SPACs, EU or non-EU alternative investment funds, emission allowances, delta one instruments, exchange-traded notes, asset-backed securities, including mortgage-backed securities, as well as other relevant assets for which including information is required.

Links of interest: Call for Evidence on the review of the UCITS Eligible Assets Directive **ESMA's supervisory convergence actions:** Peer review on ESMA's Guidelines on ETFs and other UCITS issues Follow-up of the peer review of the Guidelines on ETFs Guidelines and other UCITS issues Final report on the 2021 Joint Supervisory Action on Costs and fees