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Submitted by email to MARKT-UCITS-CONSULTATIONS@ec.europa.eu

European Commission
Directorate General Internal Markets and Services
Financial Markets and Asset Management
Brussels
B-1049

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RE: Consultation on Product Rules, Liquidity Management, Depositary, Money Market Funds and Long-term investments in the Undertakings for Collective Investment in Transferable Securities (UCITS)

Dear Sir/madam,

We appreciate the opportunity to provide comments on the consultation issued by the European Commission on product rules, liquidity management, depositary, money market funds and long-term investments under the Undertakings for Collective Investment in Transferable Securities (UCITS) framework (referred to hereafter as the “Consultation”).¹

ICI Global is a global fund trade organisation focused on regulatory, market, and other issues for global investment funds, their managers and investors. Our members include regulated funds publicly offered to investors in jurisdictions worldwide. We seek to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Our members manage total assets of over €750bn.

The importance of the UCITS framework for investors worldwide is clear. The Consultation raises a number of important questions that lie at the heart of ensuring the continued success of the UCITS framework and as such our members² and their investors consider these questions to be of the utmost importance. The Investment Company Institute (ICI)³, which established ICI Global in October 2011, has followed for many years the work undertaken by the European Commission (referred to hereafter as the “Commission”) to develop the UCITS framework from its origins in 1985.

¹ Consultation Document, Undertakings for Collective Investment in Transferable Securities (UCITS), Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments, 26 July 2012 (available at http://ec.europa.eu/internal_market/consultations/docs/2012/ucits/ucits_consultation_en.pdf)

² References in this letter to “ICI Global Members” or “Our Members” refer, as relevant, to the management companies and/or the funds themselves that ICI Global represents.

³ The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.4 trillion and serve over 90 million shareholders.

In its comment letter in response to the Consultation, the ICI has responded to a limited number of issues from the perspective of U.S. registered investment companies (RICs). We are pleased to comment in this letter from the perspective of fund managers operating publicly available regulated investment funds including UCITS⁴ that are managed, distributed and operated on a global basis.⁵

General Remarks

We consider the success of the UCITS framework since its creation over 25 years ago as testament to the balance that has been achieved by the Commission to ensure an appropriate level of investor protection and an appropriate level of investment freedom has been maintained as the environment within which UCITS funds are managed has evolved. The success of UCITS as a brand outside the European Union (EU), including particularly in the Asia Pacific (APAC) region, is further acknowledgement of the high regard in which regulators and investors hold the UCITS framework. Our members are quintessentially global in nature and use the UCITS framework to distribute funds around the world.

As the Consultation notes, the investment market continues to evolve both in terms of the needs and demands of investors and the instruments and techniques through which fund managers seek to meet those needs and demands. Any reforms adopted by the Commission⁶ aimed at reflecting this evolution should, as a matter of utmost importance, also endeavour to ensure that the success of the UCITS framework is maintained into the future.

The significant and very wide ranging reforms the Commission is examining through the Consultation occur against the backdrop of significant regulatory reform to all aspects of the financial system following the financial crisis. At international level, many reforms of relevance to the fund management industry remain subject to discussion including by the G20 and the Financial Stability Board (FSB) and in turn by the International Organisation of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision (BCBS). At European level the UCITS framework itself has been the subject of a recent Commission adopted proposal (commonly and hereafter referred to as "UCITS V") which remains subject to negotiation⁷. Other European legislative instruments of relevance to fund management are also either subject to reform, as is the case with the framework under the Markets in Financial Instruments Directive (MiFID), or significant components remain incomplete, as is the case with the technical standards under the European Market Infrastructure Regulation (EMIR) and the delegated acts under the Alternative Investment Fund Managers Directive (AIFMD).⁸

In short, key components of the legislative framework relevant to fund management remain subject to change. It is prudent for the Commission to raise the wide ranging questions posed in the Consultation to ensure the balance in the UCITS framework between investor protection and investment freedom that has been maintained hitherto remains going forward.

⁴ References in this letter to "UCITS" are used as relevant to refer to the investment company itself in the case of a self-managed UCITS or to the management company if the UCITS is not self-managed, for instance if it is set up in a contractual or unit-trust form or as in the case of the UK if the fund is an Open Ended Investment Company (OEIC).

⁵ References to "publicly available, regulated funds" in this letter refer to those funds that as a general matter are available for sale to the general public under an authorisation, licensing or other regulatory regime administered in their own domestic or regional jurisdiction.

⁶ We use the term "Commission" throughout this letter to refer as relevant to the college of Commissioners or the Commission Services

⁷ Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions, 3 July 2012 (available from http://ec.europa.eu/internal_market/investment/docs/ucits/20120703-proposal_en.pdf)

⁸ DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDEF>)

In many areas however the Commission has not been in a position to articulate concrete proposals for reform, in part because of the uncertainty in the outcome of the reforms already underway. We have therefore provided answers and comments in the subsequent sections of this letter to the questions posed by the Consultation, but in many areas our comments reflect our current understanding of the likely outcome of existing reforms and therefore are subject to change.

We would urge the Commission not to act in haste in areas of the UCITS framework that are subject to existing reform but instead, once these reforms are completed, to publish further targeted consultations on any concrete proposals under its considerable, on which we will be able to provide comments in a more substantive manner.

Eligible Assets

Section 2 of the Consultation raises questions that cover a range of broad topics concerning, at a high-level, the nature of the investment strategies pursued by UCITS funds and the assets into which they invest.

From a global perspective, we consider the existing UCITS architecture – comprising a “framework Directive” and implementing Directives and Regulations including the Eligible Assets Directive (EAD)⁹ – to work well. Overall this architecture achieves a good balance between the need for a strong level of harmonisation in the design of UCITS funds but an appropriate degree of flexibility to reflect important differences in domestic markets in Europe. Furthermore, given the success of the UCITS brand outside of Europe and, as the Commission Services acknowledged in the impact assessment accompanying UCITS V the fact that “fund portfolios are increasingly diverse and international”¹⁰, this framework also allows local differences in non-European markets to be reflected.

Box 1, Question (1) Do you consider there is a need to review the scope of assets and exposures that are deemed eligible for a UCITS fund?

At a high level we do not consider the need for a fundamental review of the scope of the assets and exposures deemed eligible for a UCITS fund. In our responses to specific proposals put forward in the Consultation, some of which would provide helpful clarity as to the interpretation of the eligibility of assets, we have identified particularly changes that could be made. These changes concern the measurement of exposures relating to certain instruments, including financial derivatives instruments (FDIs), and the nature of the assets into which certain “types” of UCITS invest, including particularly in the context of UCITS that are defined as money market funds (MMFs).

The scope of assets and exposures deemed eligible for a UCITS fund is distinct from, but related to, the question of whether a UCITS should be sub-classified based on some form of criteria including some measure of its complexity. The global development of the UCITS framework makes it imperative to frame such questions within the broader global context to ensure the ongoing success of the framework on a global stage.

⁹ COMMISSION DIRECTIVE 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions (commonly known and referred to hereafter as the Eligible Assets Directive) (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2007:079:0011:0019:EN:PDF>)

¹⁰ p17, Commission Staff Working Document, Impact Assessment accompanying the proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions (available from http://ec.europa.eu/internal_market/investment/docs/ucits/20120703-impact-assessment_en.pdf)

From this perspective, we note there is no single framework that establishes the characteristics of assets into which publicly available, regulated investment funds can invest or the way in which they are classified. Anecdotal evidence suggests that in the absence of such a definition and the absence of a single framework through which the characteristics, returns and risks of a particular fund are classified and communicated to investors, regulators are adopting different views on the suitability of such products for their local markets and in some cases are imposing additional requirements.

The broader issue of the complexity of funds, including how such a concept is defined are not discussed in detail in the Consultation and as such we have not offered detailed comments in this letter or commented on the relative merits of adopting such an approach over others. From a global perspective however, as we noted in our general remarks we consider it of utmost importance that in considering any reforms to the UCITS framework including the introduction of sub-classifications of funds or any changes to the eligibility of assets, the Commission should endeavour to continue to ensure a good balance is maintained between the need for a strong level of harmonisation in the design of UCITS funds but an appropriate degree of flexibility to reflect important differences in domestic and increasingly international markets.

Box 1, Question (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.

We have made a number of specific comments concerning the portfolio liquidity of the assets into which MMFs invest later in this letter but at a high level we do not consider there to be a need to fundamentally develop the rules concerning the eligibility of assets. As noted above, we consider that the current architecture comprising the UCITS framework including the EAD adopts a sufficiently principles based approach coupled with concrete examples to define the scope of eligible assets into which a UCITS is permitted to invest. It is notable that the concept of “transferable securities” which has been at the core of the UCITS framework since its creation has required relatively limited revision. We consider the introduction of the EAD in 2007 to have been an important step in harmonising the approach to defining the eligibility of assets across the internal market.

We also note that in addition to a number of instrument specific requirements in the EAD, UCITS managers are subject to a number of overarching obligations towards their investors under the UCITS framework including the ability for investors to redeem their units/shares directly or indirectly from the assets of the fund. This obligation requires that managers consider and manage the overall level of portfolio liquidity comprising consideration of the liquidity of each of the component assets in line with the expected redemption profile of investors in the fund.

Box 1, Question (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?

We do not consider it appropriate to distinguish or limit the scope of eligible FDIs based simply on the profile of their payoff. The current framework defining the eligibility of a particular FDI under the EAD is dependent on a number of different factors including liquidity and the criteria through which a derivative can be valued. We consider this framework to have served the UCITS framework well over the last few years since the EAD was introduced.

We consider that the payoff profile of an FDI may or may not, in and of itself, be illustrative of its complexity. If the Commission's purpose is to reflect concerns over the relative complexity of different types of FDIs, it should look well beyond the payoff profile of individual instruments and, instead, focus on the role of the investment in the fund's portfolio. Many portfolio management techniques involving FDIs combine multiple exposures to generate the desired outcome. The complexity or riskiness of the technique is a function of the combined effect, and the return generated by the fund will be a function of the combined returns of the instruments.

As noted above, the issue of complexity is a broader issue that remains under debate and one that is not discussed in detail in the Consultation. As a general comment, and as has been acknowledged by the Commission in its recent PRIIPS proposal¹¹, the key issue is that investors, particularly those who are retail in nature, are provided with clear and not overly-complex information that allows them to understand the risk of products. From a global perspective, we note that there is no single framework that establishes what such an understanding of risk should constitute. There is no globally accepted view as to the balance to be struck between ensuring that investors understand the characteristics, returns and risks of a particular fund (i.e. the outcome they expect to achieve) and the extent to which they must understand the underlying structure of a financial product including the techniques used to manage the investment portfolio.

Box 1, Question (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 multilateral platforms in accordance with the legislative proposal on MiFIR? What would be the consequences for different stakeholders of introducing such an obligation?

As acknowledged in the Consultation, the regulation of FDIs of all types is evolving at international, regional and domestic level following G20 commitments. These commitments include particularly those made at the G20 Pittsburgh Summit that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms and non-centrally cleared contracts should be subject to higher margin requirements.¹² The nature of the distribution of UCITS and their involvement in the global derivatives markets requires a global approach to the regulation of such markets to be adopted.

At European level the G20 commitments in respect of standardised OTC derivatives are being implemented through EMIR¹³ and MIFIR¹⁴ and at international level work is being undertaken by IOSCO and the BCBS on the margin requirements applicable to OTC derivatives that are not subject to central clearing.¹⁵ Whilst aspects of the framework under which OTC derivatives will be regulated have been finalised, a number of key elements remain subject to negotiation and finalisation.

¹¹ REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on key information documents for investment products, 3 July 2012 (available from http://ec.europa.eu/internal_market/finservices-retail/docs/investment_products/20120703-proposal_en.pdf)

¹² See Foreword of Implementing OTC Derivative Market Reforms, Financial Stability Board, 25 October 2010 (available from http://www.financialstabilityboard.org/publications/r_101025.pdf)

¹³ REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>)

¹⁴ Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0652:FIN:EN:PDF>)

¹⁵ Consultative Document on Margin Requirements for non-centrally-cleared derivatives, July 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf>)

In the context of EMIR, ESMA has only recently published its final proposals for technical standards¹⁶ which remain subject to adoption by the Commission following a consultation process to which we responded.¹⁷

Against the backdrop of reform to the regulation of FDIIs described above, we do not consider that it is appropriate at this stage to draw the conclusion that UCITS are only able to invest in those FDIIs traded on multilateral platforms under MiFIR. At a minimum such an obligation would need to take account of the broader global context in which UCITS funds invest. Furthermore, within the scope of assets eligible for investment by UCITS, there will be FDIIs that are not subject to mandatory clearing and not traded on multilateral platforms but will be entirely consistent with the required principles for eligibility under the EAD. The consequence of introducing a requirement would be to significantly limit the scope of instruments and therefore investment strategies that UCITS are able to pursue with material consequences for the choice of investors in such funds.

Efficient Portfolio Management (EPM)

The Consultation raises questions covering a very broad range of topics within the scope of EPM. Several of the “techniques” referred to within the Consultation are subject to discussion at international level or have been the subject of guidelines issued by ESMA. In particular, the Consultation refers to securities lending transactions and repurchase agreements (repos) as examples of EPM techniques and it is these transactions on which we have focused our comments.

As was acknowledged in the Consultation, securities lending transactions and repurchase agreements were addressed in the Commission’s Shadow Banking Green Paper and comprise part of the FSB’s shadow banking agenda¹⁸ under the auspices of which an interim report was published in April 2012¹⁹ to which we²⁰ and the ICI²¹ responded. Securities lending transactions and repurchase agreements have also been the subject of guidelines that have been recently finalised by ESMA.²²

Box 2, Question (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.

The techniques and instruments considered as EPM techniques cover a broad spectrum and include the use of instruments such as FDIIs, and techniques such as the lending of securities and the sale and repurchase of securities. Not all regulated investment funds undertake such transactions but for many funds they provide significant utility.

¹⁶ Final Report Draft technical standards under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories, ESMA, 27 September 2012 (available from http://www.esma.europa.eu/system/files/2012-600_0.pdf)

¹⁷ Letter from Karrie McMillan, General Counsel ICI and Dan Waters, Managing Director ICI Global, re Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories, dated 3 August 2012 (available from <http://www.ici.org/pdf/26368.pdf>)

¹⁸ Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, 27 October 2011 (available from http://www.financialstabilityboard.org/publications/r_111027a.pdf)

¹⁹ Securities Lending and Repos: Market Overview and Financial Stability Issues, Interim Report of the FSB Workstream on Securities Lending and Repos (referred to hereafter as the “FSB Securities Lending and Repo Interim Report”), 27 April 2012 (available from http://www.financialstabilityboard.org/publications/r_120427.pdf)

²⁰ Letter from Dan Waters, Managing Director ICI Global to Secretariat of the Financial Stability Board, Re FSB Interim Report on Securities Lending and Repos: Market Overview and Financial Stability Issues, 25 May 2012 (available from <http://www.ici.org/pdf/26190.pdf>)

²¹ Letter from Robert Grohowski, Senior Counsel ICI to Secretariat of the Financial Stability Board, Re FSB Interim Report on Securities Lending and Repos: Market Overview and Financial Stability Issues, 25 May 2012 (available from <http://www.ici.org/pdf/26196.pdf>)

²² Report and Consultation Paper, Guidelines on ETFs and other UCITS issues, ESMA, 25 July 2012 (available from <http://www.esma.europa.eu/system/files/2012-474.pdf>)

We note that the Consultation references securities lending and repo transactions as specific examples of EPM techniques which are also referred to in the Commission's Shadow Banking Green Paper. As such we have focused our comments below on these two types of transaction including a relevant referring to the comments we have made to the FSB.

As is outlined in the FSB Securities Lending and Repo Interim Report, there are a number of drivers for those investment funds that do undertake such securities lending and repo transactions including principally the ability for investment funds to earn incremental returns for their investors, the more efficient investment of collateral and, in the case of non-UCITS funds, the borrowing of securities including for the purpose of covering short positions.

Box 2, Question (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.

In the context of securities lending and repo transactions, we do not see a specific need to address particular issues or risks arising from the use of these transactions for EPM purposes. In Europe all market participants engaging in securities lending and repo transactions on behalf of investment funds are regulated through either MiFID or the UCITS Directive (or from July 2013 the AIFM Directive) in addition to a number of measures at Member State level.

The regulations governing investment funds in respect securities lending and repo transactions cover the nature and value of collateral that is received, including a combination of qualitative and quantitative rules governing the haircuts and margins that are applied to collateral, the reuse and rehypothecation of collateral and the due diligence that must be undertaken on borrowers and counterparties.

It is notable that a significant component of the FSB Securities Lending and Repo Interim Report, contains a description of the considerable variations between the secured finance markets²³ in different jurisdictions²⁴. As we have noted above, we do not consider there to be a need to fundamentally reform the framework governing secured finance markets. However, in the event that the FSB considers it appropriate to propose reforms, we strongly encouraged it to consider carefully the fundamental regional and jurisdictions differences that exist across markets to inform the development of its policy recommendations. We have considered that while there are some aspects of commonality between jurisdictions and any policy recommendations that emerge are coordinated, we believe that it is neither practical nor desirable to adopt a one-size-fits-all approach across the board to the regulation of the global secured finance market. At a European level we would encourage the Commission to adopt a similar approach if it sees a strong need to put forward proposals for reform.

²³ The "secured finance market" is a term used in this letter to collectively describe the market for securities lending transactions and repurchase ("repo") transactions as categorised in the FSB Securities Lending and Repo Interim Report

²⁴ In the UK for instance, what is commonly referred to as "stock lending" is in fact not a transaction which is a loan in a normal sense and as specified in the COLL 5.4.2G in the FSA's handbook, such a transaction is rather a transaction "under which the lender transfers securities to the borrower otherwise than by way of sale and the borrower is to transfer those securities, or securities of the same type and amount, back to the lender at a later date" (available from <http://fsahandbook.info/FSA/html/handbook/COLL/5/4>). In the U.S. on the other hand, the Master Securities Loan Agreement, under which many securities loans are undertaken does not refer specifically to the transfer of title.

Box 2, Question (3) What is the current market practice regarding the use of EPM techniques: counterparties involved, volumes, liquidity constraints, revenues and revenue sharing arrangements?

The FSB Securities Lending and Repo Interim Report identified four broad segments of the secured finance market, the broad categorisation of which we supported. As long-term investors in the financial markets, particularly in the cash securities capital market²⁵, our members engage in securities lending transactions primarily as lenders.

As noted above, securities lending and repo transactions are EPM techniques that can provide significant utility to many regulated investment funds. As we noted in our response to the FSB Securities Lending and Repo Interim Report, not all investment funds engage in these transactions, in some cases because they may not have the necessary types of securities to repurchase, lend or post as collateral. In other cases investment funds do not participate because entering into securities lending and repo transactions may not be appropriate to the techniques or strategies through which the portfolio of the fund's assets is being managed.

Some of our Members also engage in some "leveraged investment fund financing" as described in the second market segment of the FSB Securities Lending and Repo Interim Report and repo financing as described in the fourth market segment of that report. As managers of publicly available regulated investment funds, such financing is however usually limited, or in some cases prohibited, by the various regulatory regimes under which our members operate. In all cases, our members only engage in such financing to the extent that it supports the delivery of the investment objectives and is consistent with the investment fund's governing constitution and the laws to which they are subject.

Investment funds can enter into secured finance transactions with the purpose of enhancing the investment returns they can achieve for their investors. In addition to enhancing investment returns, income from secured finance can also be used to offset costs and fees arising from the management of assets or in the case of those funds tracking indices, to offset tracking error.²⁶

Box 2, Question (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?

Section 5.3 of the FSB Securities Lending and Repo Interim Report asserted that in addition to the potential for heightened procyclicality, there are other financial stability risks associated with the re-use of collateral including the potential for increased interconnectedness amongst firms and higher leverage.

Some of our members accept non-cash collateral in respect of secured finance transactions, to the extent that this is permitted under local or regional regulatory frameworks. In a considerable number of cases, even in instances where regulatory frameworks permit the acceptance of non-cash collateral, there are generally restrictions on the re-use of this collateral by fund managers and investment funds.

²⁵ The term "cash securities" is used in this context to represent financial securities that directly derive their value from underlying assets (e.g. stocks, shares and bonds) as distinct from derivative instruments which derivative their value indirectly with reference to an underlying cash or physical asset.

²⁶ Investment funds often face a number of challenges in seeking to replicate the return of a particular index resulting in some cases in a differential in return known as the "tracking error". This error can arise because of expenditure incurred by the fund (e.g. transaction costs), the need to hold some of the fund's assets as cash to meet liquidity requirements/redemption requests, difficulties in acquisition and disposal of the precise proportion/weight of assets that constitute the index and in the case of stocks and shares the effect of corporate actions. Revenue generated from secured financing can offset these costs and enable investors to more precisely achieve their investment objectives

Certain jurisdictions in Europe, including France, prohibit certain types of re-use in respect of non-cash collateral. We consider that it is appropriate to continue to permit the acceptance of non-cash collateral to cover exposures arising from secured finance transactions. Rather than focusing on the form of collateral, we believe it is appropriate to ensure that the necessary safeguards are maintained to ensure that the risks arising from re-use of collateral are adequately managed and disclosed to investors.

Box 2, Question (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.

In the context of securities lending and repo transactions, we believe that it is important to clarify the purpose and context within which haircuts and margins are set. This includes in the context of the regulatory requirements that govern minimum haircuts in certain jurisdictions.

In the first instance, it is important to acknowledge that while haircuts and margins are designed to collectively cover the exposure of one counterparty in a transaction (e.g. a securities lender) in the event of the other counterparty's default (e.g. the securities borrower), they serve distinct purposes. A haircut is set at the point a transaction is entered into. It represents the notional reduction in the value of the collateral posted against an exposure that could occur between the point of the counterparty's default and the point at which the collateral can be liquidated. Variation margin on the other hand reflects movements in the underlying value of the exposure and the associated collateral on an ongoing basis. As such it is progressive in nature throughout the period over which a transaction is outstanding.

In seeking to describe the characteristics of the secured finance market, Section 1.3 of the FSB Securities Lending and Repo Interim Report notes the various factors that affect the size of haircuts and variation margins that are applied to secured finance transactions. These factors include the type and maturity of assets and perceptions as to the creditworthiness of counterparties.

As a general comment, the type and maturity of assets accepted by our members as eligible collateral to cover exposures arising from secured finance transactions is typically set at the point at which a secured finance agreement is drawn up. In a considerable number of cases, collateral eligibility requirements are mandated by regulatory requirements, particularly in the case of jurisdictions that only permit cash collateral to be held.

Subject to these regulatory requirements, the restrictions on the eligibility of certain types of collateral or the haircuts that are applied may be adjusted at some future point. Such an adjustment is more typically made to reflect a change in the nature of the market for certain assets and would more typically be applied across a range of counterparties rather than to a specific sub-set of counterparties or borrowers.

In our view the more significant factor in managing the risk arising from secured finance transactions is the creditworthiness of counterparties. A number of our members have suggested that, in addition to the results of due diligence on counterparties to secured finance transactions, the quality of collateral that counterparties may seek to provide to cover exposures provides additional insight into their potential creditworthiness.

In some instances, our members manage concerns over the creditworthiness of counterparties through the reduction of the value of outstanding exposures (e.g. the value of loans in the case of securities financing).

In other cases, such concerns may be managed through an increase in the value of the margins that are posted against exposures as distinct from an adjustment to haircuts referred to above that would typically be applied in respect of a particular class of eligible collateral that would be applied across all counterparties.

Our members consider that the ability for lenders in secured finance transactions to vary the minimum haircuts applied at the initiation of a transaction, or to increase the progressive margin maintained during the outstanding period of the transaction, are important tools to manage risk on behalf of their investors. Importantly, while some regulatory frameworks under which our members operate specify minimum haircuts most, if not all, of these frameworks permit lenders to vary both initial haircuts and variation margins upwards. Furthermore, in many cases these frameworks do not specify mandatory minimum requirements for over-collateralisation (i.e. over 100%). In cases where minimums are applied, these are typically in cases where regulatory requirements mandate only the acceptance of cash collateral.

Box 2, Question (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?

There are a number of components of the UCITS framework that require the disclosure of information, as relevant, to investors regarding EPM techniques. These include principally the overarching requirements for the disclosure of the risks to which the UCITS is exposed in the prospectus²⁷ and the Key Investor Information Document.²⁸

In its recent guidelines, ESMA required additional components of disclosure in a fund's prospectus concerning EPM techniques including a detailed description of the risks involved in these activities, counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. Furthermore, ESMA required additional disclosure concerning direct and indirect operational costs/fees arising from EPM techniques, including a requirement that "all the revenues arising from efficient portfolio management techniques, net of direct and indirect operational costs, should be returned to the UCITS" which was the subject of further comment by the Chairman of ESMA in a recent speech.²⁹

We consider that the framework of disclosure under the UCITS Directive coupled with the recent ESMA guidelines is comprehensive from the perspective of investors. We strongly disagree with the assertion made by the Commission in the impact assessment that accompanied its UCITS V proposal that "the growing complexity of UCITS-eligible products all imply a series of hidden costs to investors" and furthermore "fees from stock lending and other transactions (including the re-use of collateral) involving the fund's assets are generally undisclosed." Our members have a duty under most, if not all, of the regulatory frameworks under which they operate, to not only assess the risks arising from such activities but also to ensure disclosure of these risks to investors.

²⁷ Article 69 of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

²⁸ Article 78 of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

²⁹ ESMA – Issues and Priorities, Speech by Steven Maijoor, ESMA Chair at EFAMA Investment Management Forum 2012, 25 September 2012 (available from <http://www.esma.europa.eu/system/files/2012-604.pdf>)

OTC Derivatives

The regulation of FDIs of all types is evolving at international, regional and domestic level in line with G20 commitments, including particularly the commitment made at the G20 Pittsburgh Summit that all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms and non-centrally cleared contracts should be subject to higher margin requirements.³⁰

At European level the G20 commitments in respect of standardised OTC derivatives are being implemented through EMIR³¹ and MIFIR³² and at international level work is being undertaken by IOSCO and the BCBS on the margin requirements applicable to OTC derivatives that are not subject to central clearing.³³ Whilst aspects of the framework under which OTC derivatives will be regulated have been finalised, a number of key elements remain subject to negotiation and finalisation.

In the context of EMIR, ESMA has only recently published its final proposals for technical standards under EMIR regulation on OTC derivatives, CCPs and Trade Repositories³⁴ which remain subject to adoption by the Commission following a consultation process to which we responded.³⁵

Box 3, Question (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?

As noted previously, work is being undertaken by IOSCO and the BCBS on the margin requirements applicable to OTC derivatives that are not subject to clearing through central counterparties. This work has included a consultation published in July³⁶ to which we have responded.³⁷

The proposals put forward by IOSCO and BCBS raise a number of questions concerning the exchange of margin, the forms of margin that would be permitted as eligible collateral and the use of thresholds above which the posting of margin is required and the treatment of provided margin (including the safekeeping of collateral).

It is appropriate to wait for the outcome of the work being undertaken an international level before drawing a formal conclusion on this question but we consider it highly likely for there to be a number of significant differences between the requirements for OTC derivatives not cleared through central counterparties that emerge from this work and the range of EPM transactions undertaken by UCITS.

³⁰ See Foreword of Implementing OTC Derivative Market Reforms, Financial Stability Board, 25 October 2010 (available from http://www.financialstabilityboard.org/publications/r_101025.pdf)

³¹ REGULATION (EU) No 648/2012 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2012:201:0001:0059:EN:PDF>)

³² Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on markets in financial instruments and amending Regulation [EMIR] on OTC derivatives, central counterparties and trade repositories (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0652:FIN:EN:PDF>)

³³ Consultative Document on Margin Requirements for non-centrally-cleared derivatives, July 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf>)

³⁴ Final Report Draft technical standards under the Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, CCPs and Trade Repositories, ESMA, 27 September 2012 (available from http://www.esma.europa.eu/system/files/2012-600_0.pdf)

³⁵ Letter from Karrie McMillan, General Counsel ICI and Dan Waters, Managing Director ICI Global, re Draft Technical Standards for the Regulation on OTC Derivatives, CCPs and Trade Repositories, dated 3 August 2012 (available from <http://www.ici.org/pdf/26368.pdf>)

³⁶ Consultative Document on Margin Requirements for non-centrally-cleared derivatives, July 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD387.pdf>)

³⁷ Letter from Karrie McMillan, General Counsel ICI and Dan Waters, Managing Director ICI Global to Wayne Byres, Secretary General BCBS and David Wright Secretary General of IOSCO, 27 September 2012 (available from <http://www.ici.org/pdf/26529.pdf>)

As set out in detail in our comment letter, we have made a number of recommendations to address or minimise the potential liquidity impact of the margin requirements including supporting the use of thresholds and encouraging IOSCO and BCBS to permit a broad list of eligible collateral.

Box 3, Question (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?

Investment funds contract with single or multiple counterparties depending on the nature of the transactions they undertake. In all cases the counterparty risk that arises from such transactions can be managed through measures such as the posting of collateral, the use of other counterparties and the appropriate disclosure to investors of the risks to which the fund is subject.

In some cases funds may enter into transactions with single counterparties because of the bespoke nature of the instrument to which the fund is seeking to gain exposure. In cases where such instruments are OTC derivatives, those that are subject to mandatory clearing will already be covered by the broad framework in EMIR. In cases where the bespoke nature of the instrument results in it falling outside the requirement to be centrally cleared, which in turn may subject the UCITS to bespoke risks including those that are operational in nature, it would be subject to the risk management requirements under EMIR in respect of the management of these risks and as implemented the work being undertaken by IOSCO and the BCBS.

Extraordinary Liquidity Management Tools

The Consultation raises a number of questions as to the tools that should be available to UCITS to deal with situations where the liquidity of assets in the fund is placed under pressure including in instances where the level of redemption requests made by investors increases over a short period of time.

The management of liquidity has been the subject of work at an international level including by IOSCO which published principles on the suspension of redemptions for collective investment schemes (CIS) in January this year³⁸, to which the ICI responded³⁹, and principles of liquidity risk management for CIS on which IOSCO consulted in April this year.⁴⁰

As a general comment, we consider it to be of utmost importance that the Commission participates fully in the work that is being undertaken at international level in respect of liquidity management and ensures to the greatest extent possible consistency between this and the framework at European level including as relevant the coordination of measures with non-European jurisdictions.

Rather than commenting specifically on all the questions raised in the Consultation, we have addressed certain aspects as they relate to particular types of UCITS including Exchange Traded Funds (ETFs) and MMFs in our comments below and in other sections of this letter. This includes comments related specifically to the ability for certain types of funds to temporarily suspend redemptions.

³⁸ Principles on Suspensions of Redemptions in Collective Investment Schemes Final Report, January 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf>)

³⁹ Letter from Susan Olson, Senior Counsel –International Affairs ICI to Mohamed Ben-Salem, General Secretariat, IOSCO, Public Comment on Suspensions of Redemptions in Collective Investment Schemes, 27 May 2011 (available from <http://www.ici.org/pdf/25243.pdf>)

⁴⁰ Principles of Liquidity Risk Management for Collective Investment Schemes Consultation Report, 26 April 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD378.pdf>)

A general comment we note that the Consultation raises a number of questions concerning the development of liquidity tools including side pockets and deferred redemptions (e.g. gates) and the criteria concerning when such tools might be used including in “exceptional circumstances”.

In certain jurisdictions UCITS funds make use of many of the liquidity tools noted in the Consultation. Generally such tools have hitherto been more commonly associated with non-UCITS investment funds that are characterised as investing in assets which have a higher degree of illiquidity or a greater propensity to become illiquid in certain market conditions. We note for instance that the AIFMD, including the technical advice provided by ESMA at the end of last year concerning delegated acts under that Directive, refer to a number of these concepts in the context of AIFs.

As we have discussed in our responses to questions in other parts of this letter, we consider that the use of many of the liquidity tools referred to in the consultation, including the ability for a fund to temporarily suspend redemptions, to be of value in enabling fund managers to effectively manage liquidity. We note however the significant differences that exist between UCITS funds and other types of funds including AIF, particularly in respect of the liquidity of the assets into which they are able to invest. As such we would not consider it appropriate for a direct copy across of those requirements concerning liquidity risk management from the AIFMD into the UCITS framework as such an approach would risk creating duplicative requirements.

Box 4, Question (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?

We support efforts, including by ESMA, to improve the understanding of the potential risks inherent in financial products and support status and rights with respect to purchasing and selling shares of UCITS ETFs, as well as efforts to seek ways to strengthen the ability of such investors to sell their shares. We do not support proposals to allow secondary market investors to redeem their UCITS ETF shares at any time during a day. As explained below, we do not understand how an ETF could operate from a management or operational perspective if it provided investors with the ability to buy and sell shares intra-day on the market, as well as the ability to redeem single shares at the end of each business day directly from the ETF.

The regulation of ETFs and the potential risks arising from their activities is subject to discussion at international level including through work undertaken by the FSB to examine potential financial stability issues⁴¹ to which the ICI responded⁴², and the development of principles for the regulation of ETFs on which IOSCO has consulted⁴³ and to which the ICI also responded.⁴⁴

ESMA also published its guidelines on ETFs and other UCITS issues in July⁴⁵ following a consultation⁴⁶ to which ICI responded⁴⁷ and the publication of a discussion paper⁴⁸ to which ICI also responded.⁴⁹

⁴¹ Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs), Financial Stability Board, 12 April 2011 (available from http://www.financialstabilityboard.org/publications/r_110412b.pdf)

⁴² Letter from Karrie McMillan, General Counsel ICI to the Secretariat of the Financial Stability Board, Regarding Potential Financial Stability Issues Arising from Recent Trends in Exchange Traded Funds, 16 May 2011 (available from <http://www.ici.org/pdf/25189.pdf>)

⁴³ Principles for the Regulation of Exchange Traded Funds, Consultation Report, March 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD376.pdf>)

⁴⁴ Letter from Karrie McMillan, General Counsel ICI to Mohamed Ben Salem, General Secretariat of IOSCO, Re: Principles for the Regulation of Exchange Traded Funds, 27 June 2012 (available from <http://www.ici.org/pdf/26275.pdf>)

⁴⁵ Guidelines on ETFs and other UCITS issues, ESMA, 25 July 2012 (available from <http://www.esma.europa.eu/system/files/2012-474.pdf>)

As set out in the comment letter submitted by the ICI in response to the Commission's Shadow Banking Green Paper⁵⁰ and its comment letters to ESMA, the ICI strongly supported ESMA's goals of improving secondary market investors' understanding of their status and rights with respect to purchasing and selling shares of ETFs, as well as seeking ways to strengthen the ability of such investors to sell their shares even during market disruptions. However, the ICI expressed concerns with ESMA's two proposed options for addressing the latter goal requiring:

- (i) UCITS ETFs to ensure that the market maker(s) of their shares continue to make markets whenever the market is open for trading; and
- (ii) the ETF to accept redemptions directly from shareholders.

In respect of option (i), the ICI expressed concern that practically speaking an ETF may not be able to ensure that market makers would continually make markets to enable investors to sell their shares whenever the market is open for trading, including in the event of a major market disruption. The ICI strongly opposed a requirement for ETFs to offer redemptions directly to secondary market investors and instead encouraged policy initiatives to be pursued to improve the overall market structure and prevent such disruptions altogether, and to enhance investor understanding of the nature and potential risks of secondary market trading.

In respect of option (ii), the ICI strongly opposed such an approach in light of the significant management and operational issues that would be faced by UCITS ETFs. ESMA acknowledged the practical operational challenges associated with individual investors redeeming directly with an ETF but has required that if the stock exchange value of the units or shares of the UCITS ETF significantly varies from its net asset value, investors who have acquired their units or shares on the secondary market should be allowed to sell them directly back to the UCITS ETF.

We do not consider it appropriate that ETFs accept direct redemption requests and instead recommend the Commission pursue initiatives designed to improve overall market structure and limit such disruptions, and to improve investor understanding of the nature and potential risks of secondary market trading.

Depository Passport

The question of whether a passport should be granted to enable depositaries based in one Member State to act for a UCITS fund established in another Member State has been raised by the Commission on two previous occasions.

⁴⁶ Consultation Paper on ESMA's guidelines on ETFs and other UCITS issues, 30 January 2012 (available from http://www.esma.europa.eu/system/files/2012-44_0.pdf)

⁴⁷ Letter from Karrie McMillan, General Counsel ICI to Steven Majoor, Chair, European Securities and Markets Authority, 30 March 2012 (available from <http://www.ici.org/pdf/26012.pdf>)

⁴⁸ Discussion Paper on ESMA's policy orientations on guidelines for UCITS Exchange-Traded Funds and Structured UCITS, 22 July 2011 (available from http://www.esma.europa.eu/system/files/2011_220.pdf)

⁴⁹ Letter from Karrie McMillan, General Counsel ICI to Steven Majoor, Chair, European Securities and Markets Authority, Regarding ESMA's Policy Orientations on Guidelines for UCITS Exchange-Traded Funds and Structured UCITS, 30 March 2012 (available from <http://www.ici.org/pdf/26012.pdf>)

⁵⁰ Letter McMillan, General Counsel ICI to European Commission, Re European Commission Green Paper on Shadow Banking, 8 June 2012 (available from <http://www.ici.org/pdf/26234.pdf>)

Firstly in the Consultation Paper on the UCITS Depositary Function published in 2009⁵¹, in response to which a “large majority of respondents viewed the harmonisation of the supervision of depositaries by national authorities and the harmonisation of the national supervisor's administrative powers, as necessary” and that “harmonisation of the status, role and liability regime of UCITS depositaries should be an unconditional pre-requisite for a UCITS depositary passport”.⁵²

Secondly in the Consultation Paper on the UCITS Depositary Function and on the UCITS Managers' Remuneration published in 2010⁵³, which although the Commission indicated it did not receive specific comments in respect of the feasibility or desirability of a depositary passport there was nevertheless a desire by respondents for the competencies of Member State supervisors to be harmonised including in respect of enforcement powers.⁵⁴

Rather than providing comments under all the specific questions raised by the Consultation, from a global perspective we have made a number of general remarks concerning the overall impact of introducing a depositary passport. We note that the obligations concerning the role and liability of UCITS' depositaries remain the subject of the Commission's UCITS V proposal that is currently subject to negotiation and as such the outcome of which remains unclear. We also note that in the context of the AIFMD, a transitional depositary passport already exists until 22 July 2017 for EU registered credit institutions acting as depositaries subject to the full application of the other depositary provisions⁵⁵ under the Directive.

Box 5, Question (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)?

The net impact arising from the introduction of a depositary passport remains unclear and as such we do not have a strong position on the net merit of its introduction at this stage. Instead we have set out below some comments on the potential advantages and drawbacks of the introduction of a depositary passport.

On the one hand, the introduction of a passport could increase the number of depositaries able to act for a UCITS fund and as such may increase competition resulting in lower costs and/or an increase in service.

A small number of depositary institutions currently act as depositaries for UCITS funds in Europe and in many cases these institutions already have established networks of operations across a number of Member States including the main fund domiciles. Therefore, on the other hand the introduction of a passport may further concentrate the provision of these services in a small number of large institutions which although offering the potential for economies of scale also raises the risk of a reduction in competition.

⁵¹ Q29, Working Document of the Commission Services (DG MARKET) Consultation Paper on the UCITS Depositary Function, 3 July 2009 (available from http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/consultation_paper_en.pdf)

⁵² Feedback Statement, Summary of Responses to UCITS Depositaries Consultation Paper (available from http://ec.europa.eu/internal_market/consultations/docs/2009/ucits/feedback_statement_en.pdf)

⁵³ Working Document of the Commission Services (DG MARKET) Consultation Paper on the UCITS Depositary Function and on the UCITS Managers' Remuneration, 14 December 2010 (available from http://ec.europa.eu/internal_market/consultations/docs/2010/ucits/consultation_paper_en.pdf)

⁵⁴ Feedback on public consultation on the UCITS V, (available from http://ec.europa.eu/internal_market/consultations/docs/2010/ucits/summary_of_responses_en.pdf)

⁵⁵ Article 61(5) of Directive 2011/61/EU on Alternative Investment Fund Managers (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF>)

Two additional factors may also be of relevance. Firstly, the extent to which the introduction of the requirement for an alternative investment fund (AIF) in the AIFMD to have a depositary results in new players entering the market to provide depositary services⁵⁶. Secondly, the impact of limiting the range of institutions eligible to act as depositaries for UCITS funds that has been proposed by the Commission under UCITS V and in turn that the Commission considers to be of limited economic impact.⁵⁷

It is common for a UCITS fund to invest in assets located or traded in a number of different Member States and/or to invest in multiple non-European jurisdictions. Therefore although the relative location of the depositary and the fund are of importance depending on the net economic impact arising from the introduction of a depositary passport, it is also the case that the custody of assets may be delegated by the depositary to entities established in other Member States or non-European jurisdictions.

The AIFMD and the Commission's adopted proposal for UCITS V both contain a significantly stronger framework for the standard of liability to which the depositary is subject in the event of the loss of those assets held in custody, or the negligent or intentional failure of a depositary to properly fulfil its obligations under the respect Directive. With the exception of a limited range of circumstances under which the depositary may be able to transfer elements of this liability through contractual means, this standard of liability applies to those assets held in custody by an entity to which the depositary has delegated including it cases where this entity is based outside the EU. The outcome of UCITS V remains unclear and as such a final proposal significantly different to that proposed by the Commission may constitute an important factor in the overall advantage or drawback of a depositary passport regime under UCITS.

Box 5, Question (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...)?

In the case of depositaries for AIFs the AIFMD⁵⁸ introduced additional obligations, and clarified the existing obligations, to which a depositary of a UCITS fund had hitherto been subject.⁵⁹ Furthermore ESMA proposed the further clarification and expansion of these obligations in the technical advice it provided to the Commission at the end of last year⁶⁰ in respect of the delegated acts under the AIFMD that the Commission is required to adopt.

In its adopted proposal for UCITS V the Commission acknowledged the support it received to clarify the functions of a depositary and simplify the regulatory landscape by aligning these functions with those of the AIFM Directive. The Commission also acknowledged the more critical stance taken by some respondents to its consultation as to whether the liability of depositaries should be aligned.

⁵⁶ Article 21 of Directive 2011/61/EU on Alternative Investment Fund Managers requires that for certain AIF, including those established in Europe and those that may be marketed under a third-country passport in the future, a single depositary is appointed.

⁵⁷ Section 7.1, Commission Staff Working Document, Impact Assessment accompanying the proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions (available from http://ec.europa.eu/internal_market/investment/docs/ucits/20120703-impact-assessment_en.pdf)

⁵⁸ Article 21(7) of Directive 2011/61/EU on Alternative Investment Fund Managers introduced more detailed requirements in respect of cash flow monitoring and Article 21(8) clarified the safe-keeping obligations for financial instruments that can be held in custody and other assets.

⁵⁹ Article 23-26 of Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) had hitherto specified the role and obligations of a UCITS depositary (available from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32009L0065:en:NOT>)

⁶⁰ Section V, Final Report, ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive, 16 November 2011 (available from http://www.esma.europa.eu/system/files/2011_379.pdf)

Notwithstanding our more general concerns regarding the liability to which depositaries will be subject to and the as yet unquantified cost of such liability, as a matter of principle we consider there to be merit in harmonising the requirements applicable to depositaries to avoid distortions in the internal market.

Box 5, Question (5) Are there specific issues to address for the supervision of a UCITS where the depositary is not located in the same jurisdiction?

The Commission has acknowledged that a large majority of respondents to the previous consultations it has undertaken have viewed the harmonisation of the supervision of depositaries by national authorities and the harmonisation of the national supervisor's administrative powers as being necessary (and from the perspective of some respondents as being a pre-requisite) for the development of a depositary passport.

We do not have any specific issues which we consider should be addressed concerning the supervision of a UCITS where a depositary is not located in the same jurisdiction but see considerable potential for differences in the interpretation of the overall framework applicable to the management and operation of a UCITS fund. Such differences might be exacerbated in instances where the distribution, management, establishment and location of the depositary for a UCITS fund are each in a different Member State resulting in the combined oversight of the value chain of the fund by four separate Member State regulators.

Money Market Funds

The regulation of MMFs is subject to discussion at the international level as part of the FSB's banking agenda⁶¹ under the auspices of IOSCO which has developed policy recommendations⁶² including through a consultation report published in April 2012⁶³, to which we⁶⁴ and ICI responded⁶⁵. At a European level, the European Systemic Risk Board (ESRB) has published an occasional paper discussing MMFs in Europe and Financial Stability⁶⁶ and the European Commission has included MMFs within the list of possible shadow banking entities in its Shadow Banking Green Paper ("Green Paper").⁶⁷

In our comment letter⁶⁸ in response to the Green Paper, we strongly objected to the assertion that MMFs are shadow banks. Instead we consider that MMFs are investment funds and not deposits and as such should not be subject to bank-like regulation which would fundamentally change their nature. Furthermore we asserted that MMFs are by design and by regulation highly liquid in nature, including through the requirements imposed by the UCITS Directive.

⁶¹ Shadow Banking: Strengthening Oversight and Regulation, Recommendations of the Financial Stability Board, 27 October 2011 (available from http://www.financialstabilityboard.org/publications/r_111027a.pdf)

⁶² Policy Recommendations on Money Market Funds, Final Report, IOSCO, October 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf>) (referred to hereafter as "IOSCO MMF Recommendations")

⁶³ Money Market Fund Systemic Risk Analysis and Reform Options Consultation Report, Technical Committee of IOSCO, 27 April 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf>)

⁶⁴ Letter from Dan Waters, Managing Director ICI Global to the Mohamed Ben Salem, General Secretariat, IOSCO, dated 26 May 2012, regarding Public Comment on Money Market Fund Systemic Risk Analysis and Reform Options (available from <http://www.ici.org/pdf/26205.pdf>)

⁶⁵ Letter from Karrie McMillan, General Counsel ICI to Mohamed Ben Salem, Regarding IOSCO Money Market Fund Systemic Risk Analysis and Reform Options, 25 May 2012 (available from http://www.ici.org/pdf/12_iosco_mmf_com_ltr.pdf)

⁶⁶ Money Market Funds in Europe and Financial Stability, Occasional Paper Series No.1/June 2012, European Systemic Risk Board (available from http://www.esrb.europa.eu/pub/pdf/occasional/20120622_occasional_paper.pdf?f7f3e2355c482eea0d3769dd2d63437b)

⁶⁷ Green Paper Shadow Banking, European Commission, 19 March 2012 (available from http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf)

⁶⁸ Letter from Dan Waters, Managing Director ICI Global to the European Commission, Re European Commission Green Paper on Shadow Banking, 15 June 2012 (available from <http://www.ici.org/pdf/26243.pdf>)

As set out in our joint response with ICI, EFAMA and IMMFA to IOSCO's working group on MMFs, the nature and extent of any liquidity transformation, is an order of magnitude less than performed by banks.⁶⁹

As is discussed in detail in our responses below, the response we provided to the Green Paper and the comment letter submitted by ICI, strongly refute the assertion that CNAV MMFs⁷⁰ give the impression to investors that they contain a capital guarantee and that they are structurally susceptible to "runs".

Box 6, Question (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.

As acknowledged in the Consultation and by IOSCO⁷¹ "MMFs are broadly used by retail and institutional investors (including non-financial corporations) as an efficient way to achieve diversified cash management".

IOSCO goes on to acknowledge in its consultation that the "health of MMFs is important not only to their investors, but also to a large number of businesses and national and local governments that finance current operations through the issuance of short-term debt" and as acknowledged by the ESRB MMFs fulfil a key role as "providers of short-term funding for banks, companies and governments".⁷²

MMFs provide a unique service to investors – providing money market rates of return on an equity based investment. As such whilst investors have alternatives to MMFs through which they are able to invest cash, including investing directly in the debt of banks, corporate and governments or placing cash on deposit including in other types of cash pools – such alternatives do not provide all of the benefits, features and characteristics of MMFs. In particular, investors may not be able to invest in certain instruments because of high minimum investment limits or easily be able to obtain the levels of diversification of exposure and/or counterparties they are able to obtain through MMFs.

Box 6, Question (2) What type of investors are MMFs mostly targeting? Please give indicative figures.

As noted in the comment letter submitted in response to IOSCO's MMF Consultation⁷³, the investor base of money market funds varies globally. Retail investors dominate in some markets while in others it is a mix of retail and institutional and still others may have primarily an institutional investor base. Many markets have only domestic investors but others have a geographically diverse group of investors.

⁶⁹ Joint letter from the European Fund and Asset Management Association (EFAMA), Institutional Money Market Funds Association (IMMFA) and the Investment Company Institute (ICI) to Patrice Bergé-Vincent regarding IOSCO working group on money market funds, 16 February 2012 (available from <http://www.ici.org/pdf/25936.pdf>)

⁷⁰ Constant Net Asset Value (CNAV) MMFs seek to maintain a constant (or stable) net asset value by accruing income (usually daily) and paying this out to investors or using this to purchase additional units/shares.

⁷¹ Policy Recommendations for Money Market Funds Final Report, IOSCO, October 2012 (available from <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf>)

⁷² Money Market Funds in Europe and Financial Stability, Occasional Paper Series No.1/June 2012, European Systemic Risk Board (available from http://www.esrb.europa.eu/pub/pdf/occasional/20120622_occasional_paper.pdf?f7f3e2355c482eea0d3769dd2d63437b)

⁷³ Letter from Dan Waters, Managing Director ICI Global to the Mohamed Ben Salem, General Secretariat, IOSCO, dated 26 May 2012, regarding Public Comment on Money Market Fund Systemic Risk Analysis and Reform Options (available from <http://www.ici.org/pdf/26205.pdf>)

The size of the money market fund sector also is highly variable with some countries having only a small sector and others a larger industry. The markets to which investors gain exposure through a money market fund also are very different, with some countries having smaller and less diverse markets than others. In our comment letter in response to the IOSCO consultation, we suggested that the variety of ways MMFs are used by different types of investors across jurisdictions must inform its goals when examining MMF regulation on a global basis. We consider the same to be true for the Commission in examining reforms to MMFs at a European level. The occasional paper published by the ESRB provides some preliminary analysis of the investor base of MMFs that follow the IMMFA code.

Box 6, Question (3) What types of assets are MMFs mostly invested in? From what type of issuers? Please give indicative figures.

As we also noted in the comment letter submitted in response to IOSCO's MMF Consultation, IOSCO has not analyzed the range or type of portfolio assets held by money market funds in different jurisdictions, including how portfolio composition may have changed since 2007. We believe that this type of detailed information would be extremely helpful in better understanding what instruments these funds actually hold in different jurisdictions rather than general information about what are funds' permitted investments. We believe regular, standardised MMF portfolio disclosure at a European level would greatly enable investors to better assess risk and facilitate regulators' ability to oversee MMFs.⁷⁴

Box 6, Question (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?

As noted in the FSB's Interim Report on Securities Lending and Repos⁷⁵, and in the comment letter submitted by ICI in response to that report, MMFs enter into repurchase agreements with high quality counterparties as a collateralised short term cash investment. As was also noted in ICI's comment letter and the letter submitted by us, such transactions are subject to a number of existing regulatory requirements the details of which were included in the FSB's report from the perspective of several European jurisdictions in respect of collateral management.

The FSB has indicated that it will develop policy recommendations covering securities lending and repo transactions by the end of the year which may be of relevance to financial institutions of all types including MMFs. As recommended by IOSCO any changes to existing regulatory frameworks for MMFs that are deemed necessary should take into account the outcome of current work on repo markets⁷⁶ and should not be progressed by the Commission before this work has been completed.

⁷⁴ FitchRatings, Sector Update, European Money Market Funds, September 2011

⁷⁵ Securities Lending and Repos: Market Overview and Financial Stability Issues, Interim Report of the FSB Workstream on Securities Lending and Repos (referred to hereafter as the "FSB Securities Lending and Repo Interim Report"), 27 April 2012 (available from http://www.financialstabilityboard.org/publications/r_120427.pdf)

⁷⁶ IOSCO MMF Recommendation 15

Box 6, Question (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.

We do not consider that either individually or collectively MMFs represent a source of systemic risk.

As we set out in our comment letter in response to the Commission's Green paper, a fundamental characteristic of all investment funds, not just MMFs, is that their shares are redeemable on demand. Indeed funds come and go in the investment market on a regular basis and this is not considered extraordinary nor is regulation focused on preventing the closure of funds in an orderly manner in the ordinary course of business. Fund investors know this and great pains are taken to disclose to fund investors, including MMF investors, the inherent risks of loss that investment funds can involve.

On the contrary, closures of banks are not considered routine or desirable and are in fact subject to significant regulatory intervention to deal with the crystallization of the inherent maturity and liquidity mismatches that underlie the banking model. No depositor is expected to comprehend or assess the underlying risk of failure of a bank, and apart from being provided a limit on deposit insurance, they are relieved of any responsibility to make such an assessment.

To speak therefore of 'runs' on MMFs or any other funds is to misapprehend the fundamental nature of such investment vehicles. Concerns among banking regulators about the over-reliance of banks on short-term funding vehicles such as MMFs are best addressed directly through regulation of banking activities rather than through attempts to re-engineer publicly traded funds to suit the underlying opacity and significant maturity and liquidity mismatches that lie at the core of the banking model.

Box 6, Question (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 definition?

We consider that MMFs are already subject to a strong framework of regulation at EU level through the UCITS Directive and the guidelines developed by CESR and subsequently by ESMA⁷⁷. We do not consider it necessary for the Commission to develop a more detailed and harmonised regulatory framework for MMFs at EU level. As we noted in our comment letter to IOSCO, we consider that an exercise should be undertaken to identify features that have improved the operation of MMFs, including national initiatives and the broader reforms to strengthen the financial system including money markets.

We consider that investors value many aspects of the UCITS framework under which the vast majority of MMFs that are established in the EU operate. A relatively limited proportion of MMFs have historically been established as non-UCITS funds (most if not all of which will be subject to the AIFM Directive in due course). In part this may have been a function of the differential framework to which funds were subject in each Member State and the absence of an internal market passport for the marketing and management of such funds, the latter passport having been introduced under UCITS IV.

⁷⁷ The most recent revision to "Questions and Answers – A common Definition of European Money Market Funds" was in February 2012 (available from <http://www.esma.europa.eu/system/files/2012-113.pdf>)

As we have commented in other parts of this letter, we consider it to be of the utmost importance that any reform to the UCITS framework endeavours to ensure that its success is maintained into the future. Historically the framework for the regulation of investment funds in Europe has comprised the UCITS framework and the various national frameworks that have been developed for those funds marketed on a domestic basis or on a cross-border basis outside the internal market passporting architecture. The development of the AIFM Directive coupled with the framework for European Social Entrepreneurship Funds (EuSEF) and the framework for venture capital funds has created a more complex and fragmented framework for fund managers and investors, particularly given the diverging nature of the management and operational requirements that exist across these Directives.

It would appear to be counter-intuitive and risk creating further complexity in the framework of European legislation for investors and fund managers, for the Commission to develop a separate regime for MMFs outside the existing UCITS framework.

Box 6, Question (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?

We consider the lack of a clear, global definition of a MMF to be highly problematic. As we noted in our comment letter in response to the IOSCO MMF Consultation, the substantial differences that exist among jurisdictions raise genuine and serious risks at a national, regional and global level. In particular, work undertaken by ICI shows the considerable extent of the differences in the definition and nature of MMFs across the globe.⁷⁸

As the IOSCO MMF Consultation noted, and as is discussed in some detail in a report produced by ICI, there are several different types of funds that co-exist within the European Union (EU). As the ICI noted in its comment letter⁷⁹ in response to the consultation published by CESR in 2010⁸⁰ it is important to foster a more consistent and common understanding of MMFs to reduce the risk that investors be misled about the exact nature of their investments. As such the ICI commended the efforts of CESR to harmonise the definition of MMFs in the EU including the way in which a short-term MMF had been defined to include strict limits on portfolio quality and maturity

We consider the update to the guidelines by ESMA in 2012 to have addressed the challenges faced by MMFs during the financial crisis. We consider that coupled with the framework that exists under the UCITS Directive, these address the concerns that have been expressed by regulators and meet the minimum recommendation set forth by IOSCO to have an explicit definition of MMFs in CIS regulation.⁸¹

⁷⁸ Investment Company Institute, Report of the Money Market Working Group, submitted to the Board of Governors of the Investment Company Institute, March 17, 2009, Appendix H, Survey of Select Offshore Jurisdictions' Regulation of Money Market Funds (available from http://www.ici.org/pdf/ppr_09_mmwg.pdf)

⁷⁹ Letter to Carlo Comporti from Susan Olson, Senior Counsel – International Affairs ICI, dated 23 December 2009, (available from <http://www.ici.org/pdf/24043.pdf>)

⁸⁰ CESR's Guidelines on a common definition of European money market funds, 19 May 2010 (available from http://www.esma.europa.eu/system/files/10_049.pdf)

⁸¹ IOSCO MMF Recommendation 1

Valuation and Capital

As set out in the comment letter we submitted in response to IOSCO's Consultation Report, we believe that the intense focus on amortized cost valuation, particularly as used by stable or constant NAV funds, is not ultimately helpful to addressing the risks identified by regulators.⁸² This valuation method is used by other funds, including both variable and stable NAV money market funds, as well as under international accounting standards. As described in the lengthy submissions of other public commenters in response to the IOSCO's Consultation Report and this topic, amortized cost valuation was not a cause of heavy redemptions in money market funds and its elimination would not have prevented the impacts on money market funds on either side of the Atlantic that occurred during the financial turmoil in 2007 and 2008.

As we have described in detail below, we are also strongly opposed to the introduction of capital buffers for MMFs of any type as we consider that these fundamentally change the nature of MMFs, are costly and in some cases are not feasible, and that they do not deal in an effective manner with the regulatory concerns that have been expressed.

Box 7, Question (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.

The terms Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV) refer to objective that a fund is seeking to pursue over time with respect to movements in its net asset value, including the way in which income received by the fund is treated. As such it is possible for CNAV and VNAV funds to have the same investment criteria and hold the same portfolio of assets.

There are a number of drivers for investors in determining the type of fund into which they invest. In many instances, as for example is the case in the US and in the UK, the existence and growth of the market for CNAV MMFs is historical and has developed over time as accounting and fiscal frameworks have evolved. As such, the use of one type of MMF over another has become embedded in the way in which corporate, governments and other institutional investors manage their cash or make investments into these funds.

As is acknowledged by IOSCO, many investors face investment restrictions or guidelines preventing them from investing in certain types of investment funds including VNAV MMFs and face significant operational obstacles including changes in IT and back-office systems in deciding to move from one type of fund to another.

⁸² We note that an analysis of variable NAV funds in Germany has illustrated that fluctuating NAVs do not prevent large shareholder redemptions. See Stephen Jank and Michael Wedow, *Sturm und Drang in Money Market Funds: When Money Market Funds Cease to Be Narrow*, Deutsche Bundesbank Discussion Paper, Series 2: Banking and Financial Studies, No. 20/2008 (available from http://www.bundesbank.de/download/bankenaufsicht/dkp/200820dkp_b.pdf)

Box 7, Question (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?

We do not consider there to be any case for CNAV MMFs to be singled out as being subject to additional regulation or for their activities to be reduced or phased out, for instance through eliminating the ability of such funds to use the amortised cost method of valuation and as such be required to mark all their portfolio assets to market on a daily basis. Survey evidence, including that undertaken by ICI in the US, shows an overwhelmingly negative reaction from investors to a mandatory move from CNAV MMFs to VNAV MMFs with c.79% of those investors surveyed suggesting they would decrease use or discontinue use of MMFs altogether⁸³.

There has been an intense focus on the use of amortised cost valuation in the international debate on MMF reform which, as we set out in our comment letter to IOSCO's MMF Consultation, we believe is neither an effective or constructive response to addressing the risks identified by regulators. We have expressed disappointment⁸⁴ that IOSCO's MMF Recommendations set out that CNAV MMFs should be subject to additional measures and/or safeguards and where workable they should be required to convert to VNAV. We consider this recommendation and the claim that CNAV funds are more susceptible to runs than VNAV funds as contrary to empirical evidence and analysis including the 2008 financial crisis.

The ICI has carefully examined the requirement for CNAV MMFs to convert to VNAV MMFs and has found this to be wholly unworkable and unlikely to reduce systemic risk, dampen the likelihood of a run, or serve investors and the economy.⁸⁵ Indeed, we believe it would cause a major restructuring and reordering of intermediation in the short-term credit market, causing assets to move to less regulated products or structures as a result.

Box 7, Question (3) Would you consider imposing capital buffers on CNAV funds as appropriate? What are the relevant types of buffers: shareholder funded, 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?

We strongly oppose the introduction of capital buffers for MMFs of any type as we consider that the introduction of a bank-like regulatory measure such as this would fundamentally transform the essential nature of a MMF away from being investment fund and to incorrectly imply to investors that their funds are guaranteed.

As set out in detail in the comment letter submitted by ICI in response to the Consultation, ICI has examined the likely outcomes of a capital buffer for the US MMF industry⁸⁶ in response comments that the SEC was considering such a proposal. The study considered several variations on the capital buffer concept including requiring MMF advisers to commit capital, requiring the funds themselves to raise capital in the market or requiring funds to build a capital buffer from fund income.

⁸³ Money Market Fund Regulations: The Voice of the Treasurer, April 2012 (available from http://www.ici.org/pdf/rpt_12_tsi_voice_treasurer.pdf)

⁸⁴ ICI and ICI Global Disappointed with IOSCO Report on Money Market Fund Regulation, 9 October 2012 (available from http://www.ici.org/pressroom/news/12_news_final_iosco_stm)

⁸⁵ See ICI's IOSCO Submission at Section III.A and ICI Letter to IOSCO at Section III.A.

⁸⁶ The implications of Capital Buffer Proposals for Money Market Funds, May 2012 (available from http://www.ici.org/pdf/ppr_12_mmfs_capital_buffer.pdf)

The conclusions from the study were that the costs of requiring MMF advisers to commit capital were significant, it was not a feasible option for funds to raise capital in the market and building a capital buffer from fund income would take a significant period of time and at the levels mooted by the SEC would not be sufficient in any cases to absorb large credit losses.

Box 7, Question (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?

As set out in detail in the comment letter submitted by ICI in response to the Consultation, it is incorrect to assert that the amortised cost valuation method allows MMFs “to disregard the gap between the real value and the book value of assets”. In the US, Rule 2a-7 requires that funds using the amortised cost valuation method must periodically compare the amortised cost NAV of the fund’s portfolio with the mark-to-market NAV of the portfolio. In cases where there is a material difference the fund’s board of directors must consider promptly what action, if any, should be taken including whether the fund should discontinue the use of the amortised cost method of valuation and re-price the securities of the fund.

Liquidity and Redemptions

Box 8, Question (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?

We consider there to be two primary components of the effective management of liquidity applicable to any type of investment fund. Firstly the management of liquidity profile of the assets into which a fund invests (sometimes referred to as “asset liquidity”) and secondly an understanding of the liquidity profile of the investors in a fund (sometimes referred to as “investor liquidity”).

As noted previously, the broader issue of liquidity management for all types of investment fund including the instances under which a fund should suspend the redemptions, has been considered at international level particularly by IOSCO. Specifically in relation to MMFs, some jurisdictions and industry codes already have explicit requirements for asset liquidity and investor liquidity as discussed below.

In the context of asset liquidity, as is discussed in detail in the comment letter submitted by ICI in response to the Consultation, the amendments introduced by the SEC in 2010 to its Rule 2a-7 impose daily and weekly liquidity requirements. In simple terms this rule requires a MMF to hold 10% in liquid assets that can be converted to cash within one business day and 30% in liquid assets that can be converted to cash within five business days. The IMMFA Code of Practice followed by some MMFs in Europe has similar requirements.⁸⁷

In the context of investor liquidity, as is also discussed in ICI’s comment letter, the amendments made to Rule 2a-7 by the SEC also require funds, as part of their overall liquidity management responsibilities to have “know your investor” procedures to help fund advisers anticipate the potential for heavy redemptions and adjust their funds’ liquidity accordingly and to have procedures for periodic stress testing of their funds’ ability to maintain a stable NAV.

⁸⁷ Institutional Money Market Funds Association Code of Practice (available from <http://www.immfa.org/About/CodeOfPractice2012.pdf>)

IOSCO has proposed several recommendations relevant to the management of asset and investor liquidity which we support when tailored to local market circumstances. These include limitations on the types of assets in which MMFs may invest⁸⁸, requirements for MMFs to establish policies and procedures to know their investors⁸⁹, minimum liquidity asset levels⁹⁰, requirements for MMFs to periodically conduct appropriate stress testing⁹¹, and the development of tools for use by MMFs to deal with redemption pressures⁹².

Box 8, Question (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?

We strongly oppose the introduction of any sort of redemption restriction that would permanently alter the ability of MMF investors to redeem all of their shares⁹³ on a daily basis through a redemption holdback⁹⁴. As it set out in detail in the comment letter submitted by ICI, and as described in a recent ICI study⁹⁵ redemption restrictions that would deny investors full use of their cash on a daily basis would not only make the MMF product unattractive for investors, but would require extensive and expensive operational changes across a myriad of systems and processes at funds, intermediaries, and service providers.

As is also noted in the comment letter submitted by ICI, the amendments made by the SEC in 2010 to its Rule 2a-7 gave MMF boards of directors, for the first time, the ability to suspend the redemptions of a fund under certain circumstances. This power is similar in many respects to the derogation that as is acknowledged in the Consultation already exists under the UCITS Directive.

Investment Criteria and Rating

Box 9, Question (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?

We consider that at a European level that the UCITS framework coupled with the guidelines published by CESR in 2010, and updated by ESMA in 2012 – including standards relating to portfolio quality and maturity that addressed the challenges faced by MMFs during the financial crisis – to represent a comprehensive framework of principles through which EU MMFs are defined.

We consider that this framework is consistent with the recommendations proposed by IOSCO that MMFs should be explicitly defined in CIS regulation⁹⁶ and furthermore should be subject to specific limitations as to the types of assets in which they may invest and the risks they may take.⁹⁷

⁸⁸ IOSCO MMF Recommendation 2

⁸⁹ IOSCO MMF Recommendation 6

⁹⁰ IOSCO MMF Recommendation 7

⁹¹ IOSCO MMF Recommendation 8

⁹² IOSCO MMF Recommendation 9

⁹³ We use the term “share” throughout this letter to represent the pro-rata equity ownership interest of an investor in an investment fund and for these purposes consider the term synonymous with the other concepts of ownership in collective investment vehicles including the concept of “units” in the context of a fund structured as a unit trust.

⁹⁴ We use the term “redemption holdback” as including the variety of possible approaches that effectively require a proportion of an investor’s holding in a MMF to be escrowed on an ongoing basis.

⁹⁵ Operational Impacts of Proposed Redemption Restrictions on Money Market Funds (available from http://www.ici.org/pdf/ppr_12_operational_mmf.pdf)

⁹⁶ IOSCO MMF Recommendation 1

Box 9, Question (2) Should it be still possible for MMFs to be rated? What would be the consequences of a ban for all stakeholders involved?

IOSCO has set out its view that it should be possible for MMFs to be rated subject to the recommendation that “CRA supervisors should seek to ensure credit rating agencies make more explicit their current rating methodologies for money market funds”.⁹⁸

As IOSCO also acknowledges, the use of ratings can comprise a component of investor’s diligence in the selection of funds but that investors should be clear about the risk related to the funds and the meanings of the ratings they employ. This is consistent with the principles published by the FSB on reducing reliance on ratings provided by Credit Rating Agencies (CRA) in October 2010⁹⁹ which included the two principles directed specifically at institutional investors:

“Investment managers and institutional investors must not mechanistically rely on CRA ratings for assessing the creditworthiness of assets. This principle applies across the full range of investment managers and of institutional investors, including money market funds, pension funds, collective investment schemes (such as mutual funds and investment companies), insurance companies and securities firms. It applies to all sizes and levels of sophistication of investment managers and institutional investors.”

and

“Senior management and boards of institutional investors have a responsibility to ensure that internal assessments of credit and other risks associated with their investments are being made, and that the investment managers they use have the skills to understand the instruments that they are investing in and exposures they face, and do not mechanistically rely on CRA ratings. Senior management, boards and trustees should ensure adequate public disclosure of how CRA ratings are used in risk assessment processes.”

The FSB furthermore acknowledged that the way in which investors in any investment fund use or rely on ratings provided by credit rating agencies varies depending on their size and sophistication but that in all cases such investors should “understand the risks in the strategy which they are following and that they understand the appropriate uses and limitations of CRA ratings.”

We consider that consistent with the recommendations of IOSCO and the principles adopted by the FSB, it should still be possible for MMFs to be rated but for investors to understand the use and risks arising from such ratings.

Box 9, Question (3) What would be the consequences of prohibiting investment criteria related to credit ratings?

The principles published by the FSB for reducing reliance on ratings provided by CRAs noted in our response to the previous question also specified that references to such ratings in laws and regulations should be removed or replaced only once alternative provisions have been “safely” implemented. In addition to the first of the principles noted previously, the FSB also include the following principle applicable to investment managers.

⁹⁷ IOSCO MMF Recommendation 2

⁹⁸ IOSCO MMF Recommendation 12

⁹⁹ Principles for Reducing Reliance on CRA Ratings, Financial Stability Board, 27 October 2010 (available from http://www.financialstabilityboard.org/publications/r_101027.pdf)

Investment managers should conduct risk analysis commensurate with the complexity and other characteristics of the investment and the materiality of their exposure, or refrain from such investments. They should publicly disclose information about their risk management approach, including their credit assessment processes.

As was correctly identified by the FSB, ratings provided by Credit Rating Agencies can play a useful role within the overall management of credit risk but in many jurisdictions investment managers are subject to additional obligations including fiduciary duties.¹⁰⁰ Furthermore, as recommended by IOSCO¹⁰¹ and in a proposal adopted by the Commission for amendments to the AIFMD and UCITS Directives¹⁰² it is appropriate that fund managers do not mechanistically rely on external credit ratings.

Long-term Investments

The Consultation acknowledges the role played by long-term investment as a factor for economic growth and channelling funds towards socially responsible projects but furthermore that access to long-term investments has historically been reserved for institutional investors, in part because of the low level of liquidity of such investments.

As long term investors in the financial markets, our members in principle support the development of a framework through which investors can invest on a longer-term basis. The precise design of such a framework is complex. In part because of the need to resolve a number of the inherent issues identified in the Consultation concerning the generally lower level liquidity of long-term assets as compared to the generally short-term liquidity preference of retail investors. Furthermore, as is also noted in the Consultation the characteristics, risk and return of longer-term investments are often significantly different in nature to those investments of a more conventional UCITS with which retail investors have become familiar. As such a key challenge in any such framework will be to clearly communicate these features of such a fund to investors.

Rather than responding to all the questions raised by the Consultation we have set out a number of comments in specific areas below.

Box 10, Question (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?

Box 10, Question (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?

The Commission should examine carefully the way in which a framework for long-term investment, if developed, is to be incorporated into the existing architecture of domestic and pan-European fund legislation.

¹⁰⁰ The term “fiduciary duties” refers to an obligation that is placed on investment managers in a number of jurisdictions globally to act in the best interest of investors. The precise nomenclature associated with this obligation varies (in some jurisdictions this is more commonly known as an “agency duty”) as does the origin of the obligation (this obligation is applied through English common law in jurisdictions adopting such a legal regime).

¹⁰¹ IOSCO Recommendation 11

¹⁰² Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings of collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings, 15 November 2011 (available from http://ec.europa.eu/internal_market/securities/docs/agencies/COM_2011_746_en.pdf)

There are a number of possible approaches including the creation of a distinct legislative instrument, as was the case in respect of the AIFMD, or the use of a framework of designations, as was the case in respect of the European Social Entrepreneurship Fund Regulation¹⁰³ and in the case of the European Venture Capital Fund Regulation.¹⁰⁴

We consider it to be of the utmost importance that the designation the framework be as clear as possible to investors to avoid confusion. We have concerns about the incorporation of such a framework under the existing UCITS umbrella because of the significant differences that may exist between the characteristics, risk and return of longer-term investments when compared to traditional UCITS investments which, by definition, are shorter in tenure. We also have concerns about the extent to which it would be wise to further complicate the purpose and nature of the UCITS framework to avoid to the greatest extent possible confusion for investors.

Box 10, Question (7) - Should the use of leverage or financial derivative instruments be banned? If not, what specific constraints on their use might be considered?

The extent to which leverage or FDIs should be used in a long-term investment framework is an important question and one that needs to take account of a number of multi-faceted considerations. At a principal level we do not consider the use of leverage of FDIs should be subject to an outright ban. The use of such investment techniques for the efficient management of fund portfolios including for hedging purposes, can reduce the degree of risk to which investors are exposed and enhance investment returns to investors. However such techniques can entail a number of risks which require management and must be understood by investors in the context of the overall risk and return characteristics of fund.

We would be happy to comment further on the way in which leverage and FDIs could be used, including any constraints to which they should be subject, as the design principles for a long-term investment framework are developed by the Commission.

Box 10, Question (8) Should a minimum lock-up period or other restrictions on exits be allowed? How might such measures be practically implemented?

The Consultation discusses the possible creation of a framework to support long-term investment in a range of different asset classes and for a variety of different purposes, including for infrastructure projects, real assets and unlisted companies. The breadth of these asset classes and the significant differences in the nature of trading on capital markets and their liquidity requires that fund managers to have at their disposal a sufficiently broad range of tools. These tools are necessary to enable fund managers to seek to ensure the best possible alignment between the liquidity of the underlying assets into which they have invested on behalf of the fund and the terms on which investors are able to redeem their holdings.

As such we would consider it appropriate for fund managers under a long-term investment framework to have available a range of liquidity tools including the ability to lock-up investors for a minimum period and impose other restrictions on redemptions, as appropriate to the nature of the assets into which they are investing and the nature of the investor based of the fund.

¹⁰³ Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON European Social Entrepreneurship Funds, 7 December 2011 (available from http://ec.europa.eu/internal_market/investment/docs/social_investment/act_en.pdf)

¹⁰⁴ Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON European Venture Capital Funds, 7 December 2011 (available from http://ec.europa.eu/internal_market/investment/docs/venture_capital/act_en.pdf)

UCITS VI Improvement

Box 11, Question (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.

The Consultation raises a number of questions concerning the treatment of self-managed investment companies, the rules developed in UCITS IV in respect of master-feeder structures and fund mergers and the way in which notification procedures operate. As a general comment, UCITS IV remains a relatively new legislative framework having only been comprehensively finalised following the adoption of implementing measures by the Commission in July 2010 which in turn applied from July last year. Rather than addressing each of the points raised in the Consultation in turn we would make two general comments.

Firstly, the number of transactions that have been undertaken under the master-feeder and merger rules remains limited and as such limited concrete experience exists as to how the changes made under UCITS IV have operated. Anecdotal evidence suggests that differences in the tax treatment of funds and the tax liabilities that can be incurred at the point at which transactions are executed remains a potential barrier.

Secondly, in the context of notification procedures whilst some arrangements under UCITS IV have been improved through the development of the electronic means of such communication the arrangements that require a network of communications to and between regulators continue to present operational challenges and present barriers to the way in which such notifications can be made in a timely manner.

Alignment with the AIFM Directive

Box 11, Question (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.

The UCITS and AIFM Directives both regulate the “collective portfolio management” of harmonised investment funds¹⁰⁵ including the ability to manage and market such funds across the internal market.

On the one hand the UCITS Directive can be characterised a “product” framework that defines the investment powers of UCITS funds and the way in which their risk characteristics are disclosed to investors. The AIFMD on the other hand can be characterised a “management” framework defining the terms under which funds are managed and administered.

¹⁰⁵ The term “investment funds” is used in this letter to refer to the various vehicles that exist for the purposes of collective investment, including as relevant those vehicles falling within the definition of a “collective investment undertaking” as defined in various European Directives including the AIFM and UCITS Directives.

While there are common features of the investment funds that fall under the directives, including their legal structure and the “collective” nature of investment, we consider there to be a number of fundamental differences between the two types of fund. We consider it to be entirely appropriate for aspects of the regulatory frameworks governing the funds to reflect these fundamental differences. In particular we see significant differences in the nature and type of assets into which the funds are permitted to invest, the size and nature of their investor base, and the investment strategies they follow. On the one hand, UCITS funds are generally characterised as being subject to a regulatory framework that is more restrictive in respect of the assets into which the funds can invest and generally characterised as having an investor base with a stronger retail bias. AIFs on the other hand are generally characterised as having a stronger professional biased client base and have a greater degree of flexibility as to the assets in which they invest.

As we have discussed in other responses throughout this letter, the framework under which UCITS funds operate contain at their core a range of requirements governing the assets into which they invest and the management of risks including limits on the concentration of such risks through diversification. In all cases UCITS funds are required, through the various channels of disclosure mandated under the framework of the Directive, to communicate these risks to investors at time of investment and on an ongoing basis including through the KIID, prospectus and periodic reports. We disagree therefore with sweeping statements such as that made by the Commission in the context of the remuneration rules under UCITS V that “inconsistency between the UCITS and the AIFM directives would encourage the managers to implement risky and complex strategies in UCITS funds in order to increase the fund potential returns”.¹⁰⁶

As such we do not consider it appropriate for the provisions under the AIFMD to be copied across in an indiscriminate manner but instead we consider it to be appropriate for due consideration to be given the purpose of each provision and the rationale or otherwise of harmonising the requirements. This consideration should include the costs of the additional burden that imposing additional and duplicative requirements on UCITS would lead to balanced against any operational benefits that might be released by management companies operating funds subject to both sets of requirements, albeit such the relative benefits of harmonising the requirements would be less significant for the management companies of one type of fund.

We appreciate the opportunity to provide comments on the Consultation. If you have any questions about our comments or would like additional information please contact me (dan.waters@ici.org or +44 203 009 3101) or Giles Swan, Director of Global Funds Policy (giles.swan@ici.org or +44 203 009 3103).

Yours faithfully,

/s/

Dan Waters
Managing Director

¹⁰⁶ Commission Staff Working Document, Impact Assessment accompanying the proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions (available from http://ec.europa.eu/internal_market/investment/docs/ucits/20120703-impact-assessment_en.pdf)