FESE response to the ESMA Call for Evidence on the review of the UCITS Eligible Assets Directive

Brussels, 5th August 2024

Q5: The 2020 ESMA CSA on UCITS liquidity risk management identified issues with respect to the presumption of liquidity and negotiability set out in UCITS EAD. In light of the changed market conditions since 2007, do you consider such a presumption of liquidity and negotiability still appropriate? Where possible, please provide views, data or estimates on the possible impact of removing the presumption of liquidity and negotiability set out in the UCITS EAD

FESE considers that the presumption of liquidity and negotiability is still appropriate. This is an important enabler for listing activities of exchanges, and removing it would also present considerable higher costs for UCITS, since liquidity assessments would need to be made prior to any investments, and on a continuous basis thereafter.

Q8: Have you observed any recurring or significant issues with the interpretation or consistent application of the 10% limit set out in the UCITS Directive for investments in transferable securities and money market instruments other than those referred to in Article 50(1) of the UCITS Directive?

FESE appreciates the discussion around the limits set out in the UCITS Directive and would like to use this question as an opportunity to provide insights on issues associated with the "5/10/40 Rule" for investments in transferable securities and money market instruments as set out in the UCITS Directive under Article 52. In our view, the limits are detrimental to issuers and investors and the vitality of capital markets at large.

Many issuers have expressed dissatisfaction with the UCITS limits, arguing that it negatively impacts the performance of their shares. The ceiling imposed by the rule often leads to underperformance as it restricts the potential for higher capital inflows from UCITS funds. In Germany, it contributed to the delisting of Linde, the largest issuer in the DAX, from the Frankfurt Stock Exchange. Due to its dual listing, Linde has only been listed in New York since then. This once again underlines the competitive disadvantages of the European capital markets compared to the United States. Although Deutsche Boerse adjusted its DAX capping rule from 10% to 15%, the underlying issue with the UCITS Directive remains unresolved.

Some asset managers exceed the 10% threshold temporarily but then engage in strategic selling around certain dates to comply with the limit. This behavior induces artificial selling pressure on the securities, leading to market distortions and volatility. Furthermore, some passive investment strategies, including non-UCITS funds, are not bound by the 10% limit. This discrepancy raises questions about the fairness of restricting active managers, who are ostensibly better positioned to make informed investment decisions based on their expertise.

Although exchanges could adjust the capping rules of their indices, they would have to take the UCITS rules into account to ensure a proper benchmarking for the funds. It is important to note that capping index components also impacts the market capitalisation of the index, as positive price developments are undermined, which negatively impacts market liquidity and attractiveness for investors.

FESE recommends a review and potential adjustment of the “5/10/40 Rule” in the UCITS Directive to align with market realities and the needs of both issuers and investors. The preferable approach would be to align with the rules applicable to passive investments (replicating the composition indices) under Article 53, according to which a single security may account for up to 20% or 35% of a portfolio under certain conditions. Therefore, the "5/10/40 Rule" should be developed further in the direction of a new "20/40 Rule ". A more flexible approach would prevent the unintended consequences currently observed, promote market stability, and help retain major issuers, thereby enhancing the overall attractiveness and competitiveness of its financial markets.

Q18: Apart from the definitions and concepts covered above, are there any other definitions, notions or concepts used in the UCITS EAD that may require updates, further clarification or better consistency with definitions and concepts used in other pieces of EU financial legislation, e.g. MiFID II, EMIR, Benchmark Regulation and MMFR?

If so, please provide details on the issues you have observed and how you would propose to clarify or link the relevant definitions or concepts.

For more than 20 years, European financial institutions have voluntarily cleared securities financing transactions (SFTs such as repurchase agreements or repo) in order to reduce counterparty risk, improve settlement efficiency and lower capital costs. Under EMIR, CCPs have designed new membership models for the voluntary clearing of SFTs – models that offer a new balance of responsibilities between banks and their clients. The aim of these new models is to provide an additional option for buy-side firms to access liquidity and for banks additional capacity to serve their clients.

Whilst banking regulation has enshrined clear rules on the treatment of exposures of a bank towards the CCP in a traditional clearing model, funds regulation has not applied similar rules for other types of market participants when facing a CCP. As a result, there are inconsistencies between banking, clearing and EU funds regulation, unintentionally disincentivising buy-side entities to make use of central clearing, notably for SFTs, and to benefit more from the new access models that were specifically developed to meet the needs of the buy-side. While EMIR 3.0 provides some welcomed reliefs to counterparty and cash limits in the MMFR and UCITS Directive, more holistic changes to address those inconsistencies and recognise the specific risk-reducing nature of centrally cleared transactions and the efficiencies of access models have been deferred to the review of the UCITS framework. To provide a viable option to all market participants to centrally clear SFTs and other financial instruments, further targeted amendments to the UCITS and MMF frameworks could be helpful.

In particular, the strict collateral concentration and diversification rules applied to UCITS could be further adapted risk-adequately for CCP-cleared reverse repos. While those rules have been put in place with the intention to address funds’ vulnerabilities and protect them from risks associated with OTC markets; with its strong lines of defence, the CCP guarantees the fulfilment of the contract so that the diversification of received collateral becomes insignificant for the safety of the MMF or UCITS fund.

UCITS rules still unintentionally disincentivise central clearing with respect to counterparty limits for centrally cleared SFTs. These provisions do not recognize that a CCP becomes the buyer and seller to all centrally cleared transactions and would thereby hit the limit much faster than in a bilateral context, despite the risk-reducing nature of clearing. To ensure consistency with the recent changes that exempt centrally cleared derivatives transactions from counterparty limits, a targeted addition to Art. 52 paragraph 2 UCITS Directive could exclude all centrally cleared transactions, including SFTs, from the current counterparty limits, making the use of central clearing for the buy-side more attractive without restricting the use of bilateral markets. Such an exclusion should apply to both direct and indirect clearing models.

Further, other regulatory constraints exist which equally impact the viability of centrally cleared transactions and efficient collateral management for the buy-side. To facilitate more voluntary clearing and efficiencies for the buy-side for stronger EU capital markets, targeted changes to the UCITS Directive, the MMFR and ESMA Level 3 measures could be considered as well to ease the constraints on the re-use of received collateral through SFTs to meet CCP margin requirements.

Specifically, in order to protect funds from risks associated with non-centrally cleared repos, they are currently restricted to pledge collateral received in a reverse repo transaction to meet CCP margin requirements, even if this collateral would be held bankruptcy remote from the pledge. Consequently, for CCP-cleared transactions, additional assets would need to be sourced by the fund to meet the mandatory CCP margin requirements, making central clearing economically less attractive and keeping the buy-side locked in bilateral markets. Through a targeted amendment to Art. 15(2) MMFR and the related provisions in UCITS Guidelines, UCITS funds could be explicitly allowed to pledge securities to a CCP if received by the fund by way of a transfer of title in a cleared reverse repo transaction with that CCP.

Also, according to Article 14(b) MMFR as well as according to Q6J of the ESMA UCITS Q&A, funds are currently not explicitly permitted to raise or re-use cash collateral received through a repo transaction to meet mandatory CCP margin requirements. Through a targeted amendment to Art. 14(b) MMFR as well as Art. 52 UCITS Directive, it could be added that cash collateral received from centrally cleared securities financing transactions may be used by UCITS to meet CCP margin requirements. The respective ESMA Guidelines reinforcing the current restriction should be amended accordingly.