International
Capital
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Association

ASSET MANAGEMENT AND INVESTORS COUNCIL

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European Commission
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Sent by email

Dear Tilman,

European Commission consultation on Undertakings for Collective Investment in Transferable Securities (UCITS): Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments.

The ICMA Asset Management and Investors Council ('AMIC') was established in March 2008 to represent the buy-side members of the ICMA membership. ICMA is one of the few trade associations with a European focus having both buy-side and sell-side representation.

The AMIC composition embraces the diversification and the current dynamics of the industry – representing the full array of buy side interests both by type and geography. The AMIC's focus is on issues which are of concerned to its broad membership, rather than having a specific product focus.

The AMIC welcomes the opportunity to respond to the European Commission consultation on UCITS: Product rules, Liquidity management, Depositary, money market funds, Long-term investments.

General comments on the specific themes highlighted in the consultation paper

3. EFFICIENT PORTFOLIO MANAGEMENT (EPM)

AMIC Council members highlighted that ESMA has explained in its consultation issued in January 2012 (ESMA 2012/44) on guidelines on ETF and other UCITS issues that EPM encompasses securities lending and repos. Securities lending brings extra revenues to the funds and their holders. Reverse repos and repos are largely used as means to adjust cash position of the funds in a safe, flexible and profitable way. In that respect they are closer to common investment tools than to EPM techniques. Revenue sharing agreements provide that UCITS holders get the extra revenues through securities lending or repo and that the intermediary receives an appropriate reward for providing this activity and cover its costs. As part of the service it is expected that fund managers carefully monitor the counterparty risk of the funds they manage and follow counterparty's credit worthiness on a continuous basis. No other types of transaction should be considered as EPM.

EPM techniques do not create specific risks that would not be analysed and properly monitored by the risk control systems of an asset manager. In fact UCITS have a strict limit on the exposure resulting from derivatives. Thus EPM techniques are indirectly but strictly limited and there is no need to further regulate this activity.

Therefore it is key for AMIC Council members that consistency throughout European regulations is respected and takes into account that ESMA has expressed definitive views on a topic which is open for comments in the present consultation initiated by the European Commission. Members believe that risks relating to EPM are properly addressed in ESMA's guidelines through transparency and disclosure requirements, risk control and liquidity management. However some rules should be revisited : §29 is unclear and not economically justified if it views fees splitting agreements as unsuitable; § 40-e on diversification, §40-i and j on use and investment of collateral and §42 on stress testing create real operational concerns particularly with the introduction of EMIR and the Dodd Frank Act in mind. These concerns were already raised in our response to the ESMA consultation paper on recallability of repo and reverse repo arrangements.

As noted in the aforementioned response, there should not be any direct link between collateral and eligible assets. Collateral is a tool to mitigate counterparty risk, and not an investment decision. Therefore the main criteria for collateral are quality and liquidity. Introducing any other rule would be counterproductive. It would be detrimental to inappropriately limit eligible collateral or require excessive cash margins. As suggested in ESMA's guidelines a broad definition of eligible collateral is necessary to avoid liquidity and market impact. Haircut is a very efficient way to protect investor and to adapt to the evolution of market conditions and a key instrument in its risk management.

UCITS funds comply with specific rules to protect investors. This has been key to the success of the brand. UCITS funds provide regular information to investors including on the use of EPM techniques and the recent ESMA's guidelines go a step further in terms of transparency. Apart from the different paragraphs highlighted earlier, the ESMA guidelines should be the regulatory text of reference.

4. OTC DERIVATIVES

The introduction of mandatory clearing through CCPs will have an impact on how counterparty risk for OTC derivatives will be assessed - and thus the legal structure of CCPs as well as monitoring of the time sequence of successive bookings and associated risks (executing broker, clearing member, CCP) will be key. However members are concerned that mandatory or recommended clearing could lead to a difficulty in complying with counterparty risk limits of UCITS. Since clients accounts will be legally segregated, CCPs should not create a counterparty risk. CCPs should also have access to central bank's money and be strictly regulated and monitored by authorities to ensure their solvency.

In the context of this theme, members also raised an issue related to counterparty limits of OTC derivatives and central clearing. In short, the counterparty limits included in the UCITS Directive reflect the bilateral world of OTC derivatives, but are not drafted in anticipation of new legislative measures encouraging derivatives being executed on an OTC basis but subject to clearing. UCITS funds have a regulatory 5% limit on their exposure to a single counterparty on OTC derivatives (raised to 10% for exposures to a credit institution). Under Article 52 of the UCITS Directive OTC derivatives that are subject to clearing are not distinguished from those which are not. Clarity is needed as to which counterparty will be taken into account as regards the 5% (raised to 10% for exposures to a credit institution) limit, and in fact this limit should be removed for any exposure to a clearing house. AMIC members believe that exposures should not be subject to a 5% (or 10%) limit and that provided that the fund is insulated against clearing member risks (e.g. perhaps by some form of proper segregation of client assets or by effective porting arrangements etc).

5. EXTRAORDINARY LIQUIDITY MANAGEMENT TOOLS

AMIC members are in favour of a common framework for dealing with liquidity bottlenecks in exceptional cases, provided that terms are general not to be too limited for asset managers. Therefore time limits and thresholds regarding deferred redemption should be left at the discretion of asset managers. Communication with investors should be done through the prospectus.

Some elements that could be considered as an "exceptional case" may include:

- a weakening of the compensation between subscription and redemption with a regular outflow of redemptions,
- important redemptions which might lead to difficulties in the management of the portfolio and produce a deterioration of liquidity management ratios,
- market shock that the asset manager considers as a threat to the liquidity of the market or the segments of the market where the fund is engaged.

However time limits regarding liquidity of funds once they are breached should not be part of the common framework and in fact should be considered only on a case by case basis in coordination with national supervisor. Moreover rules for the execution of redemption order are defined in the prospectus of each fund and therefore should not require common rules set by the European Commission.

6. DEPOSITARY PASSPORT

In theory the introduction of a depositary passport would foster competition which should lead to higher service or lower cost and ultimately benefit to retail investors. However, it is not advisable to introduce a depositary passport now when UCITS V rightly mentions that this option should only be considered after the full harmonisation of the role and responsibilities of depositaries throughout Europe. Moreover it remains to be seen how depositaries reach a common minimum level in their practice after the implementation to come of AIFM and UCITS V directives. In the case of the supervision of UCITS, and specific issues when the depository is not located in the same jurisdiction as the UCITS, one may consider conflicts of law regarding exchange of information and communication to investors.

7. MONEY MARKET FUNDS

MMFs are used by all types of clients and especially corporate treasurers and institutional investors. They provide them with a very effective tool to invest cash, in large of small amounts, in a highly liquid product that offer risk diversification and a higher return than that available for cash. There is no comparable alternative for treasurers since deposits or certificates of deposit will increase counterparty or credit risk and management of a diversified portfolio would require time and expertise that the MMF manager offers at a low cost. In times of crisis, we have seen some investors require accrued transparency on the portfolio of MMFs, some have switched to MMFs invested solely in government securities but globally assets under management of MMFs have not declined over the last years, even when short term interest rate drastically declined. The AMIC had produced in fact two reports specifically on money market funds that you may find useful in this context.

If MMFs considerably participate to the financing of the economy on the short term side, their role should not be overestimated as in Europe banks keep a far more important role in that respect. The risk of run leading by contagion to a systemic crisis is a scenario which is unthinkable with Variable NAVs ('VNAM') MMFs. Although some issues regarding Constant NAV ('CNAV') MMFs are still outstanding, their small market share in Europe does not present a systemic risk that needs addressing.

- **Coherence and reference to the CESR's Guidelines on a common definition of European money market funds**

AMIC members have called for transparency and supported the MMF common definition exercise led by CESR at the time – providing clear distinction between short-term and regular MMFs. This set of rules could be revisited if needed, but no additional regulation concerning MMFs should be introduced in the UCITS Directive. Even if most MMFs are UCITS in Europe some are not and must nevertheless comply with CESR/ESMA's guidelines to be labelled as MMF. In fact the recently published IOSCO policy recommendations set reasonable common standards for the regulation and management of MMFs, consistent with CESR's rules. Therefore the present architecture of the regulation seems therefore appropriate.

Liquidity is a key element of MMFs. Investors like the possibility to invest or divest instantly in MMFs for large or small amounts. The current flexibility is one of the major drivers of the success of MMFs. Of course, return in line with short term interest rate and proper credit selection to avoid capital losses are also expected from MMFs managers. Liquidity fees or redemption restrictions of any kind would be damageable for the future of MMFs: their possibility of subscribing to or redeeming them at any time for any type of amount is what is key for investors.

Fund managers should be able to choose appropriate investments in terms of credit quality, maturity, liquidity, yield and instruments. In all these areas the manager will be of course assisted by credit analysts and risk controllers who check the compliance with the investment process and criteria. CESR's guidelines have appropriately defined the framework for an efficient fund management though reactive and adjustable to market conditions.

It is however confusing to use the label MMF for funds that are not compliant with CESR/ESMA's guidelines and it is the case for MMF established under the regulation of third countries.

- **CNAV and VNAV**

From a commercial point of view there is a major difference between CNAV and VNAV funds in the way they are perceived. CNAV are viewed as deposit like instruments with a stability of the value that refers to the accounting of a deposit. This is probably the way MMFs are marketed in the USA. VNAV MMFs are on the contrary understood to be investment schemes and probably present the smallest risk of all offered funds. But of course risk is inherent to any fund, including MMFs.

Moreover some investors prefer CNAV funds for accounting reasons (and the interpretation of "cash equivalent" is important in that respect) or because they are better rated (usually triple A). Therefore instead of eliminating CNAV better transparency should be encouraged – the focus should be not on regulating liquidity, but on dealing with the possibility of a discrepancy between official and shadow NAV.

- **The UCITS Directive definition**

The current definition of money market instruments (MMI) in the UCITS directive is adequate: it refers to the existence of a market place where these products are dealt, their liquidity and accurate valuation. Market practices have not changed significantly over the last years to review this definition. In particular MMIs are most often exchanged on the primary market where the liquidity exists and not necessarily dealt on regulated markets or MTFs or OTFs.

- **The use of credit ratings**

Rating is a commercial activity and presents valuable opinions to investors – but cannot replace them doing their own diligence. However, rating of MMFs should not be expressed on the same scale as issuance ratings in order to avoid misinterpretations. Moreover, CESR's guidelines do refer to ratings, and so do other European regulatory texts which may seem inconsistent at a time when the regulators hope to reduce over-reliance on ratings.

8. LONG-TERM INVESTMENTS

When investors want to invest on a long term horizon they spontaneously turn to real estate, life insurance, employees benefits plans not to mention private equity for the most sophisticated ones. Some also think of securities as a long term investment. Investors and asset managers have appetite for long term investment products.

UCITS label is a recognised brand when distributing products to retail investors and marketed on the basis that they offer permanent redemption faculties, and for that reason may not appeal to long-term investors, except if these UCITS are clearly identified as such. In fact some of the products mentioned as options for long-term investors such as private equity or real estate funds are alternative investment funds ('AIFs') and it might seem more appropriate to develop retail AIFs despite the fact that AIFM Directive regulates managers and not funds.

More importantly, it would be helpful to seek convergence of UCITS, AIFMD and a potential new long-term investment product Directive in terms of organisation of the management company. The core of the difference between the directives should rest on investment rules. AMIC Council members expect that marketing and investor protection rules resulting from the recast of MiFID will also definitely apply to long-term investment products retail investors.

The AMIC would be happy to discuss further with you the points made in this letter. The Secretary of the AMIC, Nathalie Aubry-Stacey, can be reached at Nathalie.aubry-stacey@icmagroup.org should you need further information.

Yours sincerely,

Robert Parker
AMIC Chairman