FINANCE
DENMARK

The Danish Investment Association's Response to ESMA Call for Evidence on the review of the Eligible Assets Directive

August 7, 2024

The Danish Investment Association's Response to ESMA Call for Evidence on the review of the Eligible Assets Directive

The Danish Investment Association extends its gratitude to ESMA for the invitation to engage in the consultation regarding the UCITS Eligible Assets Directive 2007/16/EC dated 19 March 2007.

It is of paramount importance to The Danish Investment Association that UCITS, as an esteemed and reliable marque, upholds its repute.

Hence, the significance of this consultation is duly acknowledged by The Danish Investment Association. In this context, The Danish Investment Association eagerly anticipates furthering the critical discourse on eligible assets, with the objective of optimizing outcomes for retail investors and broadening the spectrum of investment strategies.

Q1: In your view, what is the most pressing issue to address in the UCITS EAD with a view to improving investor protection, clarity and supervisory convergence across the EU?

Maintaining the credibility and recognition of the UCITS label must be central to this review. The global reputation of the UCITS as an effective conduit for retail investors is built on being a secure, well-diversified, liquid, and transparent collective investment vehicle. This means clear, harmonised rules which retain a degree of flexibility to leverage in a safe manner the benefits of limited exposure to assets uncorrelated to financial markets. This is essential to ensure that investors have the necessary and convenient access to a diverse portfolio selection, aligning with societal ambitions to facilitate the green transition optimally, and enabling investment managers to employ the most effective investment strategies, serving the best interests of the investors.

An even playing field across EU member states is required. National divergencies across Member States must be minimised, as this not only risks undermining the credibility of the UCITS brand but also increases time and cost for managers when seeking legal certainty in obscure and diverging interpretations. In particular, clear guidance from EU regulators on the eligibility of indirect exposures, via, for example, delta-one-securities, ETPs, or other CIS. Regulators should also provide guidance on disclosure requirements in marketing material and prospectus, risk management principles, and valuation principles pertaining to indirect exposures.

The review of the asset eligibility framework must be comprehensive, focusing not solely on the provisions of the EAD but of the UCITS asset eligibility framework and its interlinkages with other legislative measures which emerged since 2007, as well as addressing market advances, including the wide range of financial instruments which have emerged.

The impact on the UCITS Directive itself should be limited in order to maintain regulatory stability, which is a key supporting factor behind the development of the European financial market. Regulatory stability requires that the primary actions of convergence and clarity should focus on risk management and disclosures, and not restrictions or additional look-through obligations. The latter will lead to regulatory instability as they will act as a de facto restriction / ban on indirect exposures.

Q2: Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITS EAD rules with respect to financial indices? If so, please describe any recurring or significant issues that you have experienced and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence. Where relevant, please specify what indices this relates to and what were the specific characteristics of those indices

that raised doubts or concerns. Where possible, please provide data to substantiate the materiality of the issue.

Additional clarity could be provided by ESMA on certain of these terms, notably regarding the term 'market' as referenced in Article 9(1)(b) *("they represent an adequate benchmark for the market to which they refer")* as it remains unclear the possibility of incorporating a complex strategy as a "market". It may be more appropriate to refer to a collective of assets.

The Benchmarks Regulation (Regulation (EU) 2016/1011) was enacted almost a decade after the EAD, and its requirements overlap with those set out in Article 9(1) of the EAD. Where the benchmark administrator is authorized or registered in accordance with the Benchmark Regulation, the requirements of Article 9 of the EAD should be limited to requiring the index to be sufficiently diversified – as governance and transparency issues relating to financial indices are regulated in the Benchmarks Regulation. Furthermore, in light of the governance and conflict of interest requirements for benchmark administrators under Article 4 of the Benchmark Regulation, it should be clarified that, when investing in a derivative instrument of a financial index, there is no restriction on the counterparty being from the same financial group.

We also note divergent approaches across Member States regarding whether a look-through approach is necessary with respect to the underlying assets the UCITS gains exposure to via financial indices.

Q3: Have you experienced and recurring or significant issues with the interpretation or consistent application of the UCITS EAD rules with respect to money market instruments? If so, please describe the issues you have experienced and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence. Where relevant, please describe the specific characteristics of the money market instruments that raised doubts or concerns.

At this juncture The Danish Investment Association do not have any remarks to offer.

Q4: Have you experienced any recurring or significant issues with the interpretation or consistent application of UCITD EAD provisions using the notions of "liquidity" or "liquid financial assets"? If so, please describe the issues you have experienced and how you would propose to amend the UCITS EAD to better specify these notions with a view to improving investor protection, clarity and supervisory convergence. Where relevant, please explain any differences to be made between the liquidity of different asset classes.

There exists uncertainty as to whether these terms refer to there being adequate liquidity in the overall fund or whether the assessment is with respect to each individual asset. Should the term '*liquidity*' be interpreted as pertaining to the liquidity of each individual asset, it would necessitate stringent obligations for UCITS managers and substantially limit variable the scope of variable investment strategies.

Further, liquidity, in the context of Article 2(1)(b) of the EAD, refers to the potential an individual financial instrument may have to compromise the ability of the UCITS to redeem at the request of the unit holder.

The permissible extent of illiquid investments in the portfolio is also a question in light of policy goals of, for example, In the role that funds, and particularly the UCITS brand, are poised to assume in contributing to propelling the sustainability agenda for retail investors and the transition towards a low-emission society.

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?

As drafted, the presumption in Article 2(1) of the EAD stipulates that it applies only where there is no information available to the UCITS that would lead to a different determination. Managers may not rely on this presumption as a universal rule, as admission to trading on a regulated market does not universally make an instrument inherently liquid, however this presumption does hold true for a multitude of scenarios and reflects the pragmatic, risk-based approach managers take to such situations.

Since 2007, this presumption has been supplemented/superseded by additional rules, strengthening the core role of the manager as being to manage investment risks. In particular, recent amendments to the UCITS Directive recognize and equip the manager with liquidity management tools to better allow the management of liquidity risk. Removing the presumption could have the effect of requiring a routine analysis in situations where doing this adds no value.

The 2020 ESMA CSA on UCITS liquidity risk management identified, in paragraphs 9 – 11, a few cases in which NCAs identified significant liquidity risks which could jeopardise the ability of the UCITS under review to meet redemption requests or fulfil other obligations. For a very limited number of UCITS, liquidity profiles pointed to potential asset/liability mismatch risks, which were only sometimes mitigated using liquidity management tools. In most cases, the exercise found that the level of compliance with the applicable rules on liquidity risk management was satisfactory with entities meeting their regulatory obligations.

We consider that the topic of liquidity or negotiability of assets should be dealt with as a separate topic to the question of suitability of assets for inclusion in a UCITS portfolio; i.e., no additional specific requirements should be imposed specifically on transferable securities admitted to trading in terms of their liquidity and negotiability, aside from the pre-existing requirement for the manager to analyse the liquidity of each specific asset even if admitted to trading on a regulated market, as part of its liquidity management policy. At most, we consider that supplementing this presumption with more specific guidance setting out the parameters of what may be considered sufficient liquidity and negotiability would be a useful addition.

Q6: Please explain your understanding of the notion of ancillary liquid assets and any recurring or significant issues that you might have experienced in this context. Please clarify if these are held as bank deposits at sight and what else is used as ancillary liquid assets. Where relevant, please distinguish between ancillary liquid assets denominated in (1) the base currency of the fund and (2) foreign currencies.

The UCITS Directive currently does not stipulate a definitive limit for ancillary liquid assets. Additionally, the limits established at the national level for the possession of such assets lack clarity, resulting in varying interpretations of these constraints within different European Union jurisdictions.

This has given rise to issues in practice, in particular in the context of the shortening of the settlement cycles by countries such as the US, Canada and Mexico in May of this year, in cases where a fund's dealing cycle and the standard settlement cycle for securities in a domestic market diverge. This is especially pronounced for funds with a multi-jurisdictional mandate across jurisdictions which operate different settlement cycles.

We advocate for clarification on the limit to ancillary liquid assets at an EU-wide level, which would permit the limit to be temporarily exceeded in cases of operational exigencies, such as significant changes in investment allocation, or substantial subscription/redemptions.

Q7: Beyond holding currency for liquidity purposes, do you think UCITS should be permitted to acquire or hold foreign currency also for investment purposes, taking into account the high volatility and devaluation/depreciation of some currencies? Where relevant, please distinguish between direct and indirect investments.

We do believe this should be possible, however only where the associated risks are adequately disclosed and effectively managed, and that the exposure itself is disclosed in the prospectus. However, as foreign currency trading is not listed as an investment service in Annex I to MiFID II, it appears that a change to this legislation would be needed in order to permit this.

Currently, it is possible for a UCITS to gain exposure to foreign currency, through foreign government bonds or other international assets.

Q8: Have you observed any recurring or significant issues with the interpretation or consistent application of the 10% limit set out in the UCITS Directive for investments in transferable securities and money market instruments other than those referred to in Article 50(1) of the UCITS Directive? If so, please explain the issues and how you would propose to address them in the UCITS EAD with a view to improving investor protection, clarity and supervisory convergence.

Interpretation issues arise with the ambiguity of the terms themselves as well as the divergent interpretations across Member States.

The question of what is a transferable security or money market instrument "other" than those eligible under Article 50(1) of UCITS has been interpreted differently by national regulators – regarding which instruments are eligible, whether direct/indirect exposure is possible, and whether it is permissible to obtain geographical or sectoral exposure which departs from what is declared in the UCITS articles of incorporation or fund rules.

The wording of Article 2(1) of the EAD also creates uncertainty as to the 10% limit, due to outdated references to the old provisions of now repealed UCITS Directive, and the volume of cross-references and interrelations between sub-points. For example, it is unclear whether assets which fail to meet the criteria of Article 2(1)(c)(i) and (d)(i) but which satisfy (c)(ii) and (d)(ii) should be incorporated within the 10% limit.

As outlined further below with respect to **Question 14**, we also suggest, in order to reflect regulatory developments which have taken place since the enactment of the EAD, clarifying that an open-ended CIS that does not comply with the requirements of Article 50(1)(e) of the UCITS Directive can be included within the 10% limit under Article 50(2)(a).

It is imperative for the maturation of the investment universe that these terms are clearly defined in a harmonized manner across the European Union, while simultaneously ensuring not to dilute the UCITS brand and credibility.

The Danish Investment Association advocates for this evolution to be facilitated by ESMA drafting clear guidelines on risk management and other relevant considerations for the investments in the 10% bucket.

Further to the aforementioned points, it would be judicious for ESMA to conduct a thorough assessment of the current 10% threshold in relation to the ongoing developments within financial instruments. Given the complexities of the contemporary financial market, a recalibration of this threshold—potentially to 15%—might be

warranted. Such an adjustment would enable UCITS managers to exercise greater strategic discretion, thereby facilitating the deployment of investment strategies that are more finely attuned to the subtleties of the current financial landscape and to the benefit of investors.

Q9: Are the 'transferable security' criteria set out in the UCITS EAD adequate and clear enough? If not, please describe any recurring or significant issues that you have observed and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

These are broadly considered appropriate.

It may be prudent to consider aligning the definition of '*transferable security*' with that set out in Article 4(1)(44) of MiFID II, subsequently incorporating additional requirements as necessary.

It could be advantageous to shift the focus of the eligibility criteria from the type of instrument to the type of underlying exposure being invested in, particularly given the continuous development of new instrument types. It would also be constructive if the guidance could include an explanation or purpose for the criteria, to facilitate a more straightforward assessment and potential extension to other instruments.

Q10: How are the valuation and risk management-related criteria set out in the UCITS EAD interpreted and applied in practice, in particular the need for (1) risks to be "adequately captured" by the risk management process and (2) having "reliable" valuation/prices. Please describe any recurring or significant issues that you have observed with the interpretation or consistent application of these criteria and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

These criteria should generally focus on the required expertise and experience of staff in relation to the relevant asset class and the implementation of adequate procedures for managing the relevant risk. In other words, we interpret these criteria to imply that the manager is obliged to ensure that all material risks associated with the investment are encapsulated within the risk and investment compliance processes. Similar to our answer to **Question 5** above, the role of the manager is that of risk management. This practice must be a constant element when adding new assets to the portfolio, including via indirect exposure to underlying assets.

However, we note that the interpretation of the phrase '*risk to be adequately captured*', which is also used in CESR 10-788, remains ambiguous, and additional guidance on this matter would be beneficial. It remains uncertain as to what factors need to be taken into account when investing in indirect exposure, such as delta-1 securities, including but not limited to concentration limits, global exposures, VaR, etc.

Q11: Are the UCITS EAD provisions on investments in <u>financial instruments backed by, or linked to the performance of assets other than those listed in Article 50(1)</u> of the UCITS Directive adequate and clear enough? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence.

Differences exist between Member States on the question of whether there is an obligation for the manager to look through to the underlying assets where a UCITS invests in a financial instrument backed by or linked to the performance of assets which are not directly investable. These divergent interpretations imply a greater or lesser possibility of obtaining indirect exposure to underlying assets which are not directly investable by the UCITS.

There is a need to harmonise the approach across Member States, setting out common criteria on whether a look-through is required when investing through derivatives, indices, delta-one securities, ETPs or other funds.

Different review as to how to harmonise these provisions have been noted so far – this has been elaborated in **Question 13**.

We believe the regulation on this matter should strike a balance between safeguarding the core characteristics of UCITS as a conventional product that is appropriate for retail investors broadly, while also catering for the more sophisticated investors seeking exposure to more complex products and contemporary investment trends. And simultaneously, for the benefit of investors, the UCITS regulation should provide for efficient portfolio management and consistency across member states and across UCITS providers.

We would suggest also establishing explicit disclosure rules to assist investors in better understanding the operation, merits and risks of these techniques.

The Danish Investment Association's Response to ESMA Call for Evidence on the review of the Eligible Assets Directive

August 7, 2024

Q12: Is the concept of « embedded » derivatives set out in the UCITS EAD adequate and clear enough? Please describe any recurring or significant issues that you have observed with the interpretation or consistent application of this concept and how you would propose to amend UCITS EAD to improve investor protection, clarity and supervisory convergence.

At this juncture The Danish Investment Association do not have any remarks to offer.

Q13: Linked to Q11 and Q12, ESMA is aware of diverging interpretations on the treatment of delta-one instruments under the EAD, taking into account that they might provide UCITS with exposures to asset classes that are not eligible for direct investment (see also Section 3.2). How would you propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence? Please provide details on the assessment of the eligibility of different types of delta-one instruments, identify the issues per product and provide data to support the reasoning.

We advocate for a harmonised interpretation of the treatment of delta-one instruments across Member States. In particular, the situations in which the manager is obliged to conduct a look-through to assess the underlying assets must be clearly defined, in order to ensure investor protection and legal certainty for all parties. Examples of national divergences include the approach taken have been outlined in the response to **Question 11**.

This would ideally be done via ESMA guidance on eligibility criteria for these types of instruments, specifying whether the guidance relates to direct or also indirect investments, such as wrapped assets.

Q14: Have you observed any recurring or significant issues with the interpretation or consistent application of the rules on UCITS investments in other UCITS and alternative investment funds (AIFs)?

In this context, have you observed any issues in terms of the clarity, interaction and logical consistency between (1) the rules on investments in UCITS and other open-ended funds set out in the UCITS Directive and (2) the provisions on UCITS investments in closed-ended funds set out in the UCITS EAD? Please describe any recurring or significant issues that you have observed in this respect and how you would propose to amend the relevant rules to improve investor protection, clarity and supervisory convergence.

Where relevant, please distinguish between different types of AIFs (e.g. closed-ended, open-ended), investment strategies (real estate, hedge fund, private equity, venture capital etc.) and location (e.g. EU, non-EU, specific countries).

In this context, please also share views on whether there is a need to update the legal wording used in the UCITS EAD and UCITS Directive given the fact that e.g. they refer to 'open-ended' and 'closed-ended funds', whereas it might seem preferable to use the notion of 'AIFs' by now given the subsequent introduction of the AIFMD in 2011.

There is a lack of clarity in these criteria, resulting in different approaches in Member States.

- The principle of risk-spreading would benefit from further detail.
- The eligibility limits to which investments in funds are subject can be circumvented using delta-one securities.
- More guidance would be welcome on the topic of risk management and investment compliance when investing in other funds. Currently, it is unclear whether a UCITS can obtain indirect exposure via investing in other funds to assets which do not comply with the UCITS policy and risk restrictions. For example, it is unclear to what extent a UCITS fund, operating under a commitment approach, can invest in a fund which follows a VaR approach and employs leverage, strategies, and instruments not permitted under the UCITS' investment policy.

We agree that the distinction in the EAD between 'open-ended' and 'closed-ended funds' is outdated and should be updated to take into account the AIFMD and also the ELTIF. The current reference to '*closed-ended funds*' means that only closed-ended funds can be included within the 10% limit in Article 50(2)(a) while other funds are excluded based only on their open-ended nature. Since the enactment of the EAD in 2007, comprehensive regulation at the manager level was enacted for open-ended AIFs, and at the product level for ELTIFs. The distinction becomes less logical where we note that the EAD permits a UCITS to invest in venture capital vehicles from non-EU jurisdictions (subject to certain requirements), although these may be less liquid than open-ended funds. We therefore believe it would be preferable to replace the notion of closed end funds in Article 2(2) of the EAD with a reference to AIF, whether open or close ended, as well as funds similar to AIFs from non-EU jurisdictions, subject to comparable rules on manager supervision, availability of valuation, etc.

Q15: More specifically, have you observed any recurring or significant issues with the interpretation or consistent application of the rules on <u>UCITS investments in (1) EU ETFs and (2) non-EU ETFs</u>?

At this juncture The Danish Investment Association do not have any remarks to offer.

Q16: How would you propose to amend the UCITS EAD to improve investor protection, clarity and supervisory convergence with respect to the <u>Efficient Portfolio Management</u> (EPM)-related issues identified in the following ESMA reports:

(1) Peer Review on the ESMA Guidelines on ETFs and other UCITS issues;
(2) Follow-up Peer Review on the ETF Guidelines; and
(3) CSA on costs and fees.

In this context, ESMA is interested in also gathering evidence and views on how to best address the uneven market practices with respect to securities lending fees described in the aforementioned ESMA reports with a view to better protect investors from being overcharged.

We believe that disclosure to investors, permitting them to make an informed decision, is the best approach. Provisions regarding disclosures, risk management, contractual terms and others are already reflected in the ESMA Guidelines for competent authorities and UCITS management companies and as such are currently being applied. The use of efficient portfolio management (EPM) techniques benefits both end-investors (as a source of additional revenues improving the performance of their investments) and markets as a whole (by providing additional liquidity in the markets).

The issues identified with the cited ESMA reports quoted above relate to variations in EPM costs charged to UCITS, notably where EPM techniques were carried out by the management company or a related party, referring to a Better Finance research paper. The costs expended for engaging in EPM techniques must be viewed in the context of the quality of protection afforded to investors against risks inherent in EPM techniques. The level of cost will be commensurate with, for example, the experience of securities lending agent, the level of indemnity provided for counterparty default, the percentage of the portfolio on loan; examples of factors impacting variations in costs are as follows:

i. The degree of collateralisation – 100% cover will necessarily entail more cost.
ii. The experience of the securities lending agent (internal or external), and whether they provide indemnification for counterparty default.
iii. Additional counterparty risk assessment – i.e., a second due diligence on borrowers proposed by the securities lending agent.
iv. Overside by the management company, including as to the quality of collateral.
v. The percentage of the portfolio out on loan, which differs from UCITS to UCITS.

Given that costs are deducted only from the additional income generated through the use of EPM techniques themselves and not from the fund's assets, it would be to the detriment of investors to attempt to maximise such additional returns at the expense of investor protection. As the basis for the fee-split are the gross revenues, there is no risk that any hidden revenues will be deducted. Further, investors can easily compare UCITS which apply such a fee-split.

We have been concerned with proposals in the past (for example, during Parliamentary negotiations in the recent AIFMD/UCITS review) to limit direct and indirect operational costs related to EPM to a certain percentage of the revenue generated. Limiting the costs which can be deducted for engaging in EPM would result either in also limiting the range of affordable protections available to the fund manager in terms of risk management techniques outlined above or would simply lead managers to discontinue their use of EPM techniques altogether. This in turn would reduce competition in the market for EPM providers, leading to investors possibly being offered terms that are less suitable for them due to lack of competition. In addition to cutting investors off from a significant source of additional performance, this would also negatively impact the functioning of financial markets in removing a source of liquidity as securities lending activities decline. We suggest that any concerns that EPM techniques are not being employed for the best interests of investors can be allayed by transparency as to the features, revenue and costs of the EPM technique employed, as is already the case per ESMA guidelines.

Q17: Would you see merit in linking or replacing the notion of EPM techniques set out in the UCITS Directive and UCITS EAD with the notion of securities financing transaction (SFT) set out in the SFTR? Beyond the notions of EPM and SFT, are there any other notions or issues raising concerns in terms of transversal consistency between the UCITS and SFTR frameworks?

At this juncture The Danish Investment Association do not have any remarks to offer.

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? [...]

Readability of the EAD would be greatly enhanced by updating references within the EAD from outdated legislation – in particular, replacing references to the repealed Directive 85/611/EC with the existing UCITS Directive.

This would also be a good opportunity to align the definition of concepts such as '*regulated market*' or '*financial instruments*' with those provided for in MiFID II, recognising the possibility to invest in emission allowances consisting of recognised units for the purposes of compliance with the requirements of Directive 2003/87/EC (Emissions Trading Scheme).

As outlined above, the Benchmarks Regulation entered into application after the enactment of the EAD. The EAD established several requirements for the use of financial indices by a UCITS, however certain of these have been surpassed by the establishment of specific regulations of direct application in the Benchmarks Regulations. Where the administrator of the index is authorised or registered in accordance with the Benchmarks Regulation, there should therefore no longer be a need for duplicative requirements concerning governance and transparency, such as those in Article 9(b) and (c) of the EAD.

Q19: Are there any national rules, guidance, definitions or concepts in national regulatory frameworks that go beyond ('gold-plating'), diverge or are more detailed than what is set out in the UCITS EAD? If so, please elaborate whether these are causing any recurring or significant practical issues or challenges.

We are concerned with the disparities in interpretation and application of the directive among Member States, attributable to the absence of harmonization. There are numerous examples of differing interpretations of the directive at the national level across various European Union member countries The Danish financial sector, for instance, perceives an over-implementation of certain requirements, notably:

- **Other funds**: In Denmark, national law stipulates that a UCITS may only allocate investments to other funds that strictly adhere to the risk-spreading principles of UCITS. This interpretation seems to impose a more stringent requirement than that of the EU (as per Article 143(2) of the Danish UCITS law).
- **Derivatives**: In Denmark an executive order stipulates the use of derivatives in UCITS, which imposes specific local requirements in addition to EU requirements. This has resulted in a lack of alignment across funds and reduced transparency for investors.

These instances underscore the imperative for ESMA to foster harmonization, thereby ensuring a consistent regulatory environment across the European Union. Such an environment is essential for UCITS managers to extend their services seamlessly across the Union, unimpeded by disparate national regulations.

20: Please fill in the table below on the merits of allowing direct or indirect UCITS exposures to the asset classes listed therein, taking into account the additional instructions provided in the footnotes. Please assess and provide evidence on the

merits of such exposures in light of their risks and benefits taking into account the characteristics of the underlying markets (e.g. availability of reliable valuation information, liquidity, safekeeping). To substantiate your position, please fill the table with any available data and evidence (e.g. on liquidity or valuation of the relevant asset classes and underlying markets). ESMA acknowledges that the availability of data on direct/indirect exposures to some of the asset classes listed in this table is limited and would welcome receiving any available data (whether on individual market participants and products or marketwide) and even rough estimates that help to understand the practical relevance of the relevant asset class for UCITS and the possible impact of any future policy measures.

At this juncture The Danish Investment Association do not have any remarks to offer.

Q21: Please elaborate and provide evidence on how indirect exposures to the aforementioned asset classes (e.g. through delta-one instruments, ETNs, derivatives) increase or decrease costs and/or risks borne by UCITS and their investors compared to direct investments.

Further detail is provided in the answer to **Question 13**.

Indirect exposure can be achieved through a number of mechanisms:

1. Through open or closed AIFs: The benefit of obtaining exposure in this way is that exposure will be via a well-managed and regulated fund, allowing diversification and de-correlation of the portfolio and with limited leverage.
2. Through derivatives: This permits exposure to assets not directly investable (e.g. gold or oil futures) with market depth and volume, again allowing diversification and de-correlation of the portfolio, provided that they are netted, and diversification limits are respected.
3. Through indices: The benefit is that these are regulated financial instruments, permitting indirect investments into specific markets and various other financial instruments, as long as the diversification limits are respected.
4. Through exchange-traded products (ETPs): This again provides diversification without leverage and lower replication costs.

The main advantages overall of investing through these mechanisms are operational ease, regulatory security and reducing overall risks (through diversification) borne by UCITS investors. UCITS asset managers may not have the necessary expertise to operationally enabling direct investments and or doing so would require many resources, for example setting up custody for assets such as carbon allowances (via a union registry account) or accessing the liquidity venues for these assets. UCITS asset managers must regardless perform detailed due diligence on the indirect access vehicles they invest in and confirm the adequacy of the product setup (for example, with respect to custody). ETCs in particular are a regulated well-established transparent security form typically held within a regulated Central Securities Depository and traded on regulated exchanges throughout the day, offering increased liquidity over the physical market.

A drawback is that investing through these instruments can reduce transparency and increase costs due to their complex nature and associated fees. Improved diversification and additional sources of return can potentially justify these effects. The process of ‘wrapping’ an ineligible asset may not serve in some cases to improve the characteristics of the investment but is merely used as a means of making the underlying investment eligible for the UCITS.

Q22: Under the EAD, should a look-through approach be required to determine the eligibility of assets? Please explain your position taking into account the aforementioned risks and benefits of UCITS gaining exposures to asset classes that are not directly investible as well as the increased/decreased costs associated with such indirect investments. A look-through approach would aim to ensure that the list of eligible asset classes set out in the UCITS Level 1 Directive would be deemed exhaustive and reduce risk of circumvention by gaining indirect exposures to ineligible asset classes via instruments such as delta-one instruments, exchange-traded products or derivatives. Where possible, please provide views, data or estimates on the possible impact of such a possible policy measure.

Some nuances have emerged so far on this question. Overall, a consensus exists that harmonisation and greater clarity is required as to when a look-through approach is required.

- One approach would follow the practice in Germany, which permits a broad range of underlying assets for delta-one instruments which is in practice restricted by the manager's fiduciary and risk management obligations, which in reality requires a look-through to the underlying. Another suggestion would follow the approach of the Spanish regulator, whereby a look-through approach is not required in the case of a delta-one instrument which meets the conditions of (i) daily trading, and where (ii) the market price is determined on the basis of third-party transactions.
- With respect to UCITS funds, one suggestion is that, considering that the application of the UCITS passport means that UCITS domiciled in one Member State may market their units in the other Member States without the latter being able to subject these undertakings or their units to any other rules (except those which, in those States, do not depend on the matters covered by this Directive), managers should not be obliged to carry out any additional due diligence on the suitability of these vehicles beyond that required for diversification or investment policy issues.
- Another approach would agree that a look-through approach should be required. Although the investment manager should have the ability to identify the most cost-effective and transparent method of gaining exposure to an asset (i.e. whether direct or indirect), the same eligibility criteria should still apply in relation to the underlying investment exposure. This ensures that the investor benefits from the same level of protection regardless of whether exposure is taken directly or indirectly. We recommend that 'look-through' is further defined, such that it refers to the pre-investment analysis (and recurring re-assessment), and does not refer to a continuous monitoring requirement which imposes cumbersome operational techniques and the acquisition of data on all the underlying components.

A general remark is that an overly restrictive approach may negatively impact the UCITS in terms of diversification and its risk-adjusted return profile. This is important to consider, in order to maintain the reputation of the UCITS brand both in European and abroad while enabling it to remain a safe, attractive and competitive product.

Q23: What are the risks and benefits of UCITS investments in securities issued by securitisation vehicles? Please share evidence and experiences on current market practices and views on a possible need for legislative clarifications or amendments.

We note some drawbacks in the existing framework for investing in securitisations:

- The risk retention rule and certain rules requiring heightened due diligence disincentivise managers from investing in securitisations. Investing in a securitisation requires both up front and ongoing due diligence to enable

managers to obtain appropriate information about the asset. This is a complex and costly process, in addition to further regulatory burdens of managers in recent times (such as monitoring ESG risks, operational resilience) and in the context of a downward trend in management fees.

- Valuation procedures are also a disincentive, requiring managers, in the absence of a representative market price, to cross-check valuations by obtaining quotes from independent third parties. This service imposes a cost on institutions which, although not the main cause, contributes to the lack of appetite for such investments.
- Furthermore, a distinction should be drawn between different types of securitisations – those without tranches, those with tranches (ABS/MBS) and instruments subject to the EU Securitisation Regulation. This distinction is necessary as the process of tranching implies inherent risk and complexity. Securitisations should refer to the assets subject to the EU securitization regulation.

Q24: What are the risks and benefits of permitting UCITS to build up short positions through the use of (embedded) derivatives, delta-one instruments or other instruments/tools? Please share evidence and experiences on current market practice and views on a possible need for legislative clarifications or amendments.

Financial short positions can be a natural element in an investment strategy for both investment and risk management purposes.

Benefits include, for example, the ability for a UCITS with a simple bonds strategy to manage its credit risk through short positions in a CDS-index or manage its interest rate risk by taking short positions in bond futures. More complex strategies targeting certain risk premia, such as hedge fund or allocation strategies, could use short positions to lock in the risk premia they aim for. The current distinction between a fund using the commitment approach and the limit of 100%, and a fund using the VaR approach, is in our experience quite effective in ensuring the distinction between simple and complex funds and the extent of the use of short positions.

In terms of risks, using physical short positions, which can be used by selling assets 'borrowed' via reverse repos or securities borrowing, is difficult for UCITS, as it collides with the very limited allowance to re-use collateral.

By way of suggestion, we propose that the underlying exposure must be subject to a review so that the funds can only take an indirect short position if the investment policy of the fund allows it, as this would ensure correct and sufficient disclosure/information to the investors.

Q25: Apart from the topics covered in the above sections, have you observed any other issues with respect to the interpretation or consistent application of the UCITS EAD? If so, please describe the issues and how you would propose to revise the UCITS EAD or UCITS Directive with a view to improve investor protection, clarity and supervisory convergence.

As the topic of asset eligibility is linked to the risk management methods, namely the commitment approach and VaR approach, further guidance on this would be beneficial. Different interpretation arises in practice as to the use of derivatives and their purpose and which 'complex' sub-strategies are appropriate for a fund using the commitment approach.

It would also be beneficial to modify Article 50(2)(a) of the UCITS Directive to allow investments financial assets which do not meet any of the requirements for each of the types of assets provided for in Article 50(1), as well as for indirect investments in assets which are not per se suitable for UCITS. This provision could be interpreted

as a general derogation from the provisions of Article 50(1), rather than being applicable only to transferable securities or money market instruments. This modification would allow, as outlined above, CIS which do not meet the requirement under Article 50(1)(e), such as certain open-ended non-UCITS ETFs admitted to trading, should be eligible for inclusion in the 10% limit in Article 50(2)(a). We envisage this could be achieved by way of amendment to ESMA's Opinion on Article 50(2)(a).

Another suggestion relates to Article 54 of UCITS, which permits a derogation from the diversification rules, allowing a UCITS to invest up to 100% of their assets in public debt of a single issuer if the securities are from at least 6 different issues. Where this requirement of holding securities from at least 6 different issues is not met, the fund would need to be classified as an AIF. The purpose behind this requirement to have at least 6 issues was stated, in a Recital to the UCITS Directive, as being not to disturb the functioning of the capital market and the financing of Member States as opposed to being motivated by investor protection. We note that this requirement to have at least 6 issues does not mitigate credit risk, which is the main risk which would be faced by a UCITS when investing up to 100% of its assets in a single issuer. This also means, for passive funds which a recommended minimum holding period whose portfolio is often based on a zero coupon bond, more ISIN benchmarks would be included in the portfolio, increasing the difficulty and expense of management as well as duration risk, to the detriment of the product's performance. Furthermore, this requirement was extended to government securities received by UCITS as collateral in ESMA's Final Report on the Revision of the provisions on diversification of collateral in ESMA's guidelines on ETFs and other UCITS, solely for the reason of aligning with the provisions of Article 54(1) of the UCITS Directive despite recognising the operational challenges of implementation.

It should be clarified that "tokenized" traditional financial instruments, such as fixed income instruments, are also eligible assets for UCITS funds, either in the UCITS Directive itself or within ESMA's Q&A document. Comparably, Article 4(1)(15) of MiFID now provides that a '*financial instrument' means those instruments specified in Section C of Annex I, including such instruments issued by means of distributed ledger technology,*" following the insertion by Article 18 of the DLT Pilot Regime Regulation (EU) 2022/858.