1. INTRODUCTION

(…)

2. ELIGIBLE ASSETS

Box 1

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

The CSSF is of the view that there is no need to review the scope of assets and exposures currently eligible for a UCITS fund as the regulatory framework addresses the need of the market and as there are adequate safeguards to protect investors.

(2) Do you consider that all investment strategies current observed in the marketplace are in line with what investors expect of a product regulated by UCITS?

The CSSF is of the opinion that a UCITS regulated product offers currently a lot of investment opportunities for investors with a high level of safeguards.

(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.

The concept of “overall liquidity” of a UCITS fund is of utmost importance, i.e. a UCITS fund must ensure that the liquidity of its entire portfolio does not compromise the ability of the UCITS fund to comply with its redemption obligation. In this context, the CSSF is of the view that the liquidity of a financial instrument and the impact on the overall liquidity of a portfolio should be assessed in all circumstances.

Furthermore the CSSF notes that under normal market conditions and as observed in practice, the framework of rules on liquidity in place for eligible assets has proven to be solid and sufficient.
(4) What is the current market practice regarding the exposure to non-eligible assets? What is the estimated percentage of UCITS exposed to non-eligible assets and what is the average proportion of these assets in such a UCITS' portfolio? Please describe the strategies used to gain exposure to non-eligible assets and the non-eligible assets involved. If you are an asset manager, please provide also information specific to your business.

UCITS funds may gain exposure to non-eligible assets through several types of indirect investments. A UCITS may, in principle, get exposure to non-eligible assets through the investment in closed-end funds, structured products and financial derivative instruments on financial indices provided that certain conditions are met and up to certain limits.

Even if all of these possibilities of exposure to non-eligible assets are used by Luxembourg domiciled UCITS funds, the main strategies used by Luxembourg UCITS funds are total return swaps on financial indices, for instance commodity indices, and structured products on commodities.

The CSSF has not collected data in view of an estimation of the percentage of UCITS exposed to eligible assets.

(5) Do you consider there is a need to further refine rules on exposure to non-eligible assets? What would be the consequences of the following measures for all stakeholders involved:

- Preventing exposure to certain non-eligible assets (e.g. by adopting a "look through" approach for transferable securities, investments in financial indices, or closed ended funds).

- Defining specific exposure limits and risk spreading rules (e.g. diversification) at the level of the underlying assets.

As regards rules on exposure to non-eligible assets, the CSSF considers that there is no need to further refine those rules as current rules give UCITS funds limited opportunities to gain exposure to non-eligible assets.

The CSSF is of the opinion that the possibilities offered by UCITS rules on exposure to non-eligible assets must be maintained because there is a real demand in the market place for such UCITS regulated products and because there are sufficient safeguards in place (risk diversification, liquidity, risk management) in order to guarantee investor protection.

Concerning diversification rules, the principle of risk diversification should be applied at structured product level as well as at the level of its underlying assets, independently of whether the structured product contains or not an embedded derivative, in order to ensure an adequate risk diversification of such underlying assets at portfolio level of the UCITS.
(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?

There is no need to make a distinction or to further limit the scope of eligible derivatives based on their payoff. The CSSF points out that if a distinction would be made between plain vanilla and exotic derivatives, there will be a need to clearly define such notions.

The CSSF is of the view that the current framework of eligibility criteria that derivatives must meet is sufficient.

(7) Do you consider that market risk is a consistent indicator of global exposure relating to derivative instruments? Which type of strategy employs VaR as a measure for global exposure? What is the proportion of funds using VaR to measure global exposure? What would be the consequence for different stakeholders of using only leverage (commitment method) as a measure of global exposure? If you are an asset manager, please provide also information specific to your business.

Given the definition of global exposure under article 51(3) of the UCITS Directive ("The exposure is calculated taking into account the current value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions.") the CSSF considers that the concept of global exposure focuses first and foremost on the market risk dimension arising from the use of derivative instruments and that as a consequence the VaR approach (as global exposure refers to the concept of holding period and volatility of underlying assets of derivatives) is certainly the most accurate approach for measuring global exposure. In addition the VaR approach supplemented by stress testing and a regular monitoring of the leverage underlying the investment strategy allows for a comprehensive assessment of the global exposure. The Commitment Approach, the second approach currently used for the computation of global exposure, is in this sense only a very crude assessment of the global exposure / market risk of derivative exposure and more to be seen as a leverage computation method.

Please also note that the counterparty risk dimension currently included in the global exposure definition should be removed as counterparty risk is specifically addressed by article 52(1) of the UCITS Directive.

The VaR approach is first of all a risk sensitive approach for market risk quantification for all UCITS funds as it provides the decision makers with a better view (together with the stress testing program), when comparing with the Commitment Approach, on the risks relating to its investments ("cash positions” and derivatives). Next, the VaR is the only accurate global exposure / market risk quantification method for strategies for which the crude Commitment Approach does not adequately capture the related risks (for instance non-directional risks) and/or for which the Commitment Approach does not give, with regard to the specificity of the investment strategy, an adequate and risk sensitive view of the related risks (for instance volatility strategies, interest rate arbitrage strategies).
The consequence of limiting the global exposure to the Commitment approach would, first, dramatically limit the range of investment strategies possible under the UCITS Directive, even strategies with low levels of risks, and would, secondly, withdraw retail investors the possibility to invest in a highly regulated product allowing the participation in modern investment techniques.

The proportion of assets under the VaR approach currently amounts to approximately 30% of the assets.

(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?

The CSSF considers that the use of derivatives should not be limited to instruments that are traded or would be required to be traded on multilateral platforms.

UCITS rules must take into consideration the evolution in the regulatory framework and in market practices, notably the obligation for sufficiently liquid OTC derivatives to be compensated by a central counterparty and to be traded on a regulated trading platform (regulated market, multilateral trading facilities, or organised trading facilities).

Moreover, the EMIR proposal also introduces the obligation for OTC derivatives not cleared by a central counterparty, even if traded on a regulated trading venue, to mitigate adequately their OTC counterparty risk by, among others, adequate exchange of collateral thus ensuring investor protection.

3. EFFICIENT PORTFOLIO MANAGEMENT (EPM)

Box 2

(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.

Pursuant to article 51(2) of the UCITS Directive, article 11 of the Commission Directive 2007/16/EC as well as point 24 of “CESR's guidelines concerning eligible assets for investment by UCITS” (Ref. CESR/07-044b), EPM techniques include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending.

In accordance with these provisions, and set aside financial derivative instruments qualifying as EPM techniques (which are subject to the requirements laid down for financial derivative instruments in addition to the legal and regulatory provisions relating to EPM), the current Luxembourg regulation mainly distinguishes between securities lending and (reverse) repurchase agreement transactions in front of EPM techniques. The aforementioned techniques (along with the possibility to use collateral for counterparty risk mitigation purposes) are the ones that according to the
CSSF should be considered as EPM techniques.

(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.

Given the recent work performed by ESMA in the context of EPM techniques (“Guidelines on ETFs and other UCITS issues”, ref.: ESMA/2012/474, dated 25 July 2012), supplementing the existing legal and regulatory framework relating to EPM techniques, the CSSF does not see the need to further address issues or risks relating to the use of EPM techniques.

Indeed, the CSSF considers that the aforesaid ESMA guidelines that will be supplemented by guidelines on the recallability of repo and reverse repo arrangements (pending a public consultation on this specific issue) address all the major issues/risks in the context of EPM techniques (transparency, fee sharing arrangements, liquidity risk, collateral for counterparty risk mitigation, etc.).

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

With respect to the counterparties relating to securities lending and (reverse) repurchase transactions, CSSF regulation requires UCITS to enter into these transactions only if the counterparties are subject to prudential supervision rules considered by the CSSF as equivalent to those prescribed by Community law.

In addition, as regards securities lending transactions, UCITS may lend the securities included in its portfolio to a borrower either directly or through a standardised lending system organised by a recognised clearing institution or through a lending system organised by a financial institution subject to prudential supervision rules considered by the CSSF as equivalent to those prescribed by Community law and specialised in this type of transactions.

Regarding liquidity constraints, UCITS must in accordance with current regulation ensure that the volume of the EPM techniques is kept at an appropriate level or that they are entitled to request the return of the securities lent in a manner that enables them, at all times, to meet their redemption obligations.

Finally, current CSSF practice for Luxembourg UCITS is that the major part of the revenues arising from EPM transactions should be returned to the UCITS. The new ESMA guidelines go further, by requiring that all the revenues, net of direct and indirect operational costs, should be returned to the UCITS.

(4) Please describe the type of policies generally in place for the use of EPM techniques. Are any limits applied to the amount of portfolio assets that may, at any given point in time, be the object of EPM techniques? Do you see any merit in prescribing limits to the amount of fund assets that may be subject to EPM? If yes, what would be the appropriate limit and what consequences would such limits have on all the stakeholders affected by such limits? If you are an asset manager, please provide also information specific to your
business.

The policies currently in place in Luxembourg for the use of EPM techniques are based/derived from the existing legal and regulatory provisions (i.e. article 51(2) of the UCITS Directive, article 11 of the Commission Directive 2007/16/EC, point 24 of “CESR's guidelines concerning eligible assets for investment by UCITS” (Ref. CESR/07-044b), CESR guidelines 10/788) as well as local CSSF regulation.

The aforementioned framework does not limit the amount of assets of a UCITS portfolio that may be subject to EPM techniques. The CSSF sees little added value in imposing such a limit, especially as it is of the view that the current requirements provide stringent requirements in terms of both counterparty and liquidity risks as well as risk management covering all material risks (including liquidity, operational risk) relating to UCITS.

(5) What is the current market practice regarding the collateral received in EPM? More specifically:
- are EPM transactions as a rule fully collateralized? Are EPM and collateral positions marked-to-market on a daily basis? How often are margin calls made and what are the usual minimum thresholds?

For the time being, the net exposures (i.e. the exposures of a Luxembourg based UCITS less the collateral received by the UCITS) to a counterparty arising from securities lending transactions or reverse repurchase / repurchase agreement transactions shall be taken into account in the 20% limit provided for in Article 52(2) of the UCITS Directive pursuant to point 2 of Box 27 of ESMA Guidelines 10-788.

With the recent publication of ESMA guidelines on ETFs and other UCITS issues (and in particular point 38 of the corresponding document), the collateralization requirement has been further strengthened by imposing that the risk exposures to a counterparty arising from OTC financial derivative transactions and EPM techniques should be combined when calculating the counterparty risk limits of article 52 (i.e. 5%/10% limit) of the UCITS directive.

Notwithstanding the aforementioned limits, EPM transactions are generally fully collateralized.

In accordance with the current regulation in Luxembourg (and confirmed by the recent ESMA guidelines), collateral received in the context of EPM techniques should be valued on at least a daily basis, whereby collateral should be understood as comprising all assets received by UCITS in the context of EPM techniques.

As regards margin calls in the context of EPM techniques, pursuant to CSSF regulation, the agreement concluded between the UCITS and the counterparty must include provisions to the effect that the counterparty must provide additional collateral at very short term in case the value of the collateral already granted appears to be insufficient in comparison with the amount to be covered.
- does the collateral include assets that would be considered as non-eligible under the UCITS Directive? Does the collateral include assets that are not included in a UCITS fund's investment policy? If so, to what extent?

As regards EPM techniques, the current Luxembourg regulation does preclude UCITS from receiving collateral that would be considered as non-eligible under the UCITS Directive. More particularly, the CSSF regulation does provide a list of eligible collateral items (e.g. liquid assets, shares admitted to or dealt in on a regulated market of a Member State of the European Union or on a stock exchange of a Member State of the OECD, on the condition that these shares are included in a main index, etc.) that aims mainly at ensuring the liquidity and quality of the collateral received by UCITS in the context of EPM techniques.

However, the current regulation does not preclude Luxembourg UCITS from receiving collateral that is not included in their investment policy. In this context, the CSSF does not see why, for instance, a UCITS investing in the emerging markets would be prohibited from receiving collateral consisting of high quality government bonds (for instance German Government Bonds).

In our view, a requirement to impose an alignment between the accepted collateral and the investment policy of the UCITS does not make sense, as collateral is used first and foremost to mitigate counterparty risk (secondary recourse). In particular, the performance of the collateral has no impact on the performance of a UCITS. It is only in the situation of default of the counterparty where the UCITS might need to liquidate the collateral for getting compensated for the cost of default of the counterparty. Therefore, the CSSF considers that the emphasis should be put on the quality and liquidity of the collateral, the enforceability of the collateral arrangements as well as the operational processes governing collateral management (as it is actually the case in current CSSF regulation as well as the ESMA guidelines), thus allowing a UCITS to sell the collateral quickly at a price that is close to pre-sale valuation in the event of a default of the counterparty.

- to what extent do UCITS engage in collateral swap (collateral upgrade/downgrade) trades on a fix-term basis?

The CSSF has no figures on the extent of such transactions used by Luxembourg based UCITS. We may add that financial derivative instruments qualifying as EPM techniques must in all cases comply with all relevant local and European regulation relating to both EPM techniques and financial derivative instruments.

(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?

The CSSF is of the opinion that the recent ESMA work relating to EPM techniques sufficiently encompasses these issues. Hence, we don’t see the need to further define criteria in addition to the ones laid down in the ESMA guidelines.

(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 view of the CSSF, the UCITS management company should be responsible for determining haircuts that are specifically adapted to the class of assets received as collateral, (which of course must comply with the overall collateral requirements laid down in both the ESMA guidelines and local regulation) by the UCITS they manage. Therefore, the CSSF supports the ESMA guidelines, which, instead of imposing mandatory haircuts, require UCITS to establish a documented haircut policy, comprising *inter alia* a justification of the haircuts retained.

(8) Do you see a need to apply liquidity considerations when deciding the term or duration of EPM transactions? What would the consequences be for the fund if the EPM transactions were not "recallable" at any time? What would be the consequences of making all EPM transactions "recallable" at any time?

In CSSF’s view, it is not absolutely necessary to require all EPM transactions to be recallable at any time to ensure a sufficient overall liquidity of a UCITS and thus to ensure that it is able to meet its redemption obligations.

In particular with respect to repos / reverse repos where such a requirement is not provided in the standard contracts, the CSSF is not in favour of imposing a restrictive limit on the assets of UCITS subject to EPM techniques that should be recallable at any time, as this would likely force UCITS to use solely “daily” term repos which would affect the economic efficiency of these operations (i.e. lower return) without providing in turn a significant reduction of liquidity risk, keeping in particular in mind that the recallability would be available not only to the UCITS but also (due to the mirroring effects of the agreements) to the counterparty. Besides, such a requirement might have an adverse impact on the liquidity of the repo / reverse repo market.

From a regulatory perspective, please note that according to current CSSF regulation, UCITS must ensure that the volume of the EPM transactions is kept at an appropriate level or that it is entitled to request the return of the securities lent in a manner that enables it, at all times, to meet its redemption obligations and that these transactions do not jeopardise the management of the UCITS' assets in accordance with its investment policy. In addition, these transactions are covered by the risk management process to be employed by the UCITS in accordance with the UCITS Directive and Commission Directive 2010/43/EU.

The new ESMA guidelines require UCITS to have the ability to recall at any time securities lent out. Concerning repo and reverse repo arrangements, the issue of recallability has not been clarified so far as ESMA took the decision to further consult on this issue.

(9) Do think that EPM transactions should be treated according to their economic substance for the purpose of assessment of risks arising from such transactions?

The CSSF is of the view that the UCITS risk management process should take into account the economic substance of EPM transactions when assessing the risks arising from such transactions. However, from a legal and contractual perspective, we would like to emphasize that EPM transactions comprise distinct features that differentiate them from each other and from other financial transactions (e.g. loans).
(10) What is the current market practice regarding collateral provided by UCITS through EPM transactions? More specifically, is the EPM counterparty allowed to re-use the assets provided by a UCITS as collateral? If so, to what extent?

According to the current CSSF practice, the re-hypothecation of collateral by the EPM counterparty is not allowed in the UCITS world.

(11) Do you think that there is a need to define criteria regarding the collateral provided by a UCITS? If yes, what would be such criteria?

Given the rules of article 43 (4) of the Commission Directive 2010/43/EU relating to OTC derivative contracts, in accordance to which the collateral provided by a UCITS to a counterparty has to be included in the counterparty risk exposure referred to in Article 52(1) of Directive 2009/65/EC (i.e. on a net basis only if the management company is able to legally enforce netting arrangements with this counterparty on behalf of the UCITS), the CSSF would expect that the EPM techniques (in particular securities lending and repurchase transactions) are subject to the same rules (i.e. net exposure to be included for counterparty risk limitation purposes) for investor protection reasons. As the agreements generally provide for symmetric rights and obligations for both the UCITS and the counterparty, the CSSF expects that the collateral provided by UCITS takes in general the same form than the collateral received.

(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?

The CSSF is of the view that the transparency issue has been sufficiently addressed by the recently published ESMA guidelines (supplementing the existing local regulation), which define the information to be disclosed in the sales prospectus and in the financial reports of the UCITS.

4. OTC DERIVATIVES

Box 3

(1) When assessing counterparty risk, do you see merit in clarifying the treatment of OTC derivatives cleared through central counterparties? If so, what would be the appropriate approach?

The CSSF considers that upon finalization of the legislative proposals on MiFIR and EMIR, the counterparty risk rules and in particular the determination of the risk exposure for OTC derivative transactions in accordance with article 52(1) of the UCITS Directive, have to be reassessed for having an accurate and consistent treatment across European regulations, thereby taking due account of the counterparty risk mitigation provisions introduced by these proposals.
(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?

The CSSF considers that the collateral requirements in front of OTC derivatives not cleared through central counterparties should in principle be consistent between the requirements for OTC and EPM transactions.

(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?

The CSSF is of the view that UCITS should be able to contract with a single counterparty (e.g. efficiency reasons, risk considerations, etc.) provided it does comply with all the UCITS provisions (Directive 2009/65/EC, Commission Directive 2010/43/EU, CESR/ESMA guidelines) governing the conduct of business (e.g. conflicts of interest) as well as the use of derivative transactions.

The different risks relating more specifically to the use of a single counterparty are sufficiently addressed in the current rules, further supplemented by the recently published ESMA guidelines on ETFs and other UCITS issues.

In this context we do want to point out more specifically the counterparty risk, liquidity risk, risk management and transparency rules framing (non exhaustive list) the use of derivatives (including OTC derivatives and derivatives concluded with a single counterparty):

- the counterparty eligibility rules on OTC derivatives of article 50(1)(g)(ii) of the UCITS Directive;
- the valuation and liquidity rules of OTC derivatives of article 50(1)(g)(iii) of the UCITS Directive;
- the OTC derivative counterparty risk rules of article 52(1) (i.e. 5% / 10% risk exposure limit per entity) of the UCITS Directive;
- the OTC derivative counterparty risk rules laid down in article 43 of the Commission Directive 2010/43/EU (i.e. counterparty risk determination and counterparty risk mitigation by means of legally enforceable netting contracts and receipt of collateral);
- the risk management requirements laid down in articles 12, 38, 39 and 40 of the Commission Directive 2010/43/EU covering *inter alia* all the material risks to which UCITS managed by a management company are or might be exposed, including liquidity risk, legal and operational risks;
- the counterparty risk rules of boxes 26 and 27 of the CESR document CESR/10-788 covering collateral and risk exposure limitation;
- the rules on transparency (prospectus, annual report), counterparty risk determination, collateral and risk management of sections XI and XII of the recently published ESMA guidelines paper on ETFs and other UCITS issues.
(4) What is the current market practice in terms of frequency of calculation of counterparty risk and issuer concentration and valuation of UCITS assets? If you are an asset manager, please also provide information specific to your business.

The general principle is that UCITS investment restrictions (including counterparty risk and issuer risk limitations) are to be complied with on an ongoing basis. The calculation of the investment restrictions is generally done on a daily basis as the big majority of UCITS assets are valued according to a daily frequency.

(5) What would be the benefits and costs for all stakeholders involved of requiring calculation of counterparty risk and issuer concentration of the UCITS on an at least daily basis?

The principle should be that UCITS have to ensure that the investment restrictions are complied with on an ongoing basis.

(6) How could such a calculation be implemented for assets with less frequent valuations?

The principle should be that UCITS have to ensure that the investment restrictions are complied with on an ongoing basis.

5. EXTRAORDINARY LIQUIDITY MANAGEMENT TOOLS

Box 4

(1) What type of internal policies does a UCITS use in order to face liquidity constraints? If you are an asset manager, please provide also information specific to your business.

In accordance with articles 38, 39 and 40 of the Commission Directive 2010/43/EU (dated 1 July 2010), management companies/investment companies have to establish, implement and maintain an adequate risk management policy covering inter alia liquidity risk and have to employ an appropriate liquidity risk management process based on the liquidity profile of the UCITS they manage. The aforesaid policy/process also covers the situations of specific liquidity risk constraints to which UCITS might be faced with the corresponding measures for handling such situations.

Appropriate assessments in stressed situations (stress testing) are part of the implementation of the risk management policy / liquidity risk management process.

The risk management policy/liquidity risk management process is the fundamental basis of liquidity control within a UCITS and has to take into account both the asset liquidity risk and the funding liquidity risk.

(2) Do you see a need to further develop a common framework, as part of the UCITS Directive, for dealing with liquidity bottlenecks in exceptional cases?

Given the possibility already given by article 84 of the UCITS Directive to suspend redemptions in exceptional cases, the CSSF is of the opinion that the framework of the UCITS Directive could be completed with general rules concerning alternative tools to the suspension of redemptions, including for instance the possibility given to
a UCITS to activate gating/deferred redemption mechanisms for dealing with significant redemption activity, not necessarily always in relation to exceptional market situations (e.g. in relation to investor base concentration).

(3) What would be the criteria needed to define the "exceptional case" referred to in Article 84(2)? Should the decision be based on quantitative and/or qualitative criteria? Should the occurrence of "exceptional cases" be left to the manager's self-assessment and/or should this be assessed by the competent authorities? Please give an indicative list of criteria.

The occurrence of “exceptional cases” should not be entirely left to the manager’s self-assessment, but the manager (following a decision taken by the Board of Directors concerning the occurrence of an exceptional case) should inform the competent authority and duly motivate his view for the exceptional circumstances. Indeed, exceptional measures should always comply with the principles of fair treatment of investors as well as investor protection.

The CSSF is of the opinion that the criteria for assessing the occurrence of exceptional cases could be quantitative and/or qualitative.

The criteria to define the “exceptional cases” depend on the various circumstances the UCITS might be faced with and could be, for instance, market failures, exchange closures, operational issues, exceptional political, economic, military, monetary, social events as well as natural disasters or catastrophes.

(4) Regarding the temporary suspension of redemptions, should time limits be introduced that would require the fund to be liquidated once they are breached? If yes, what would such limits be? Please evaluate benefits and costs for all stakeholders involved.

In general, the suspension of Luxembourg domiciled UCITS didn’t exceed a few days, the cause(s) for the suspension having been eliminated or having disappeared promptly.

The CSSF considers that no time limits should be introduced for redemption suspensions of UCITS funds. Taking into account the experience of the last financial crisis, we may want to point out that the cost of liquidating assets at a discount rate from their fair value in a kind of “forced transactions” has always to be assessed and contrasted to the utility of generating immediate cash flow by the Board of directors, thereby always acting in the best interest of investors.

The CSSF considers that if there are persisting economic factors on which the UCITS have no impact, the Board of directors of the UCITS may consider that it is in the best interest of the fund investors to maintain the suspension for a certain time.

(5) Regarding deferred redemption, would quantitative thresholds and time limits better ensure fairness between different investors? How would such a mechanism work and what would be the appropriate limits? Please evaluate benefits and costs for all the stakeholders involved.

The possible situation of “deferred redemptions” should be stated in the fund rules /
articles of incorporation and the prospectus. The prospectus should provide for clear information on the possible use of deferred redemptions, including the criteria and modalities concerning their use / activation.

The decision for a redemption deferral (i.e. postponing a part or the entire redemption order for preventing situations where UCITS would be obliged to sell a large part of its portfolio in a short period of time and at a price that would not be fair) has to be taken by the Senior Management of the management / investment company in accordance with the overall policy (comprising the criteria) governing the use of such a mechanism.

The CSSF is of the opinion that generally speaking redemption deferrals provide for investor protection in front of significant redemption activity and that more specifically quantitative thresholds and time limits provide for fairness between the different investors.

A threshold limit of 10% of the net assets seems to be of common use in the UCITS industry.

(6) What is the current market practice when using side pockets? What options might be considered for side pockets in the UCITS Directive? What measures should be developed to ensure that all investors’ interests are protected? Please evaluate benefits and costs for all the stakeholders involved.

Concerning current market practice side pockets are extremely rare and are established by UCITS funds only in very exceptional circumstances outside the control of the UCITS. In this sense, side pockets are not to be seen as an ordinary liquidity management tool.

In very exceptional circumstances, UCITS should thus be allowed to set up within the existing structure a side pocket by means of a new sub-fund. In fact, when considering options for side pockets in the Directive, due consideration should according to our view be given to their cost efficiency. In the setup structure described above, the new UCITS sub-fund with the illiquid assets remains compliant with the accounting, reporting, evaluation and auditing requirements and respects the investor protection rules foreseen by the UCITS directive.

The possibility of setting-up side pockets should be clearly disclosed in the fund rules/articles of incorporation and prospectus. Only the Board of Directors of the investment / management company can take the decision to constitute side pockets. Side pockets cannot be open for new investors.

The Board of Directors has to inform the competent authority and motivate the decision for establishing a side pocket. The decision to constitute a side pocket must be immediately communicated to the investors of the fund.

For reasons of transparency side pockets should be subject to a regular reporting to investors and authorities.
(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?

The recently published guidelines “ESMA Guidelines on ETFs and other UCITS Issues”, ESMA/2012/474 (points 23 and 24 concerning the treatment of secondary market investors of UCITS ETFs) are in the opinion of the CSSF sufficient in terms of liquidity safeguards in ETF secondary markets.

(8) Do you see a need for common rules (including time limits) for execution of redemption orders in normal circumstances, i.e. in other than exceptional cases? If so, what would such rules be?

The CSSF is of the view that, given the existing legal/regulatory framework and market practice, there is no need for common rules as regards the settlement of redemption orders.

6. DEPOSITARY PASSPORT

Box 5

(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 CSSF has not changed its position as stated in its responses provided in November 2005 (consultation concerning the Green Paper on the enhancement of the EU framework for investment funds) and September 2009 (consultation paper on the UCITS depositary function)\(^1\), i.e. the CSSF considers that it is crucial, in order to ensure an appropriate level of investor protection and an efficient supervision of the UCITS and the depositaries, that the depositary is located in the same Member State as the UCITS.

On the basis of the considerations explained hereafter the CSSF considers that the introduction of a UCITS depositary passport would have adverse consequences mainly in relation to the protection of UCITS investors, and that the potential introduction of a depositary passport is therefore to be considered as not being appropriate. The CSSF therefore would like to express its opposition against the introduction of such depositary passport. These legal uncertainties explained below ultimately affect the investor rights depending on the location of the depositary, and the introduction of the depositary passport would hence appear to be counterproductive.

\(^1\) The CSSF did not respond to the consultation on legislative changes to the UCITS depositary function and to the UCITS managers remuneration in January 2011.
(1) The fundamental role of the depositary in relation to investor protection and the need for immediate and instant access of the UCITS home State supervisory authority to the UCITS named depositary in “normal” as well as “exceptional” situations.

The future UCITS V directive substantially expands the duties and responsibilities of a UCITS depositary compared to the current regime and invests the depositary with fundamental day-to-day duties, so to ensure an adequate level of investor protection at all times (e.g. oversight and monitoring duties, cash flow monitoring obligations and record keeping duties). Given this essential role of the depositary in terms of investor protection regarding the day-to-day activities of the UCITS, it is key for the supervisory authority of the UCITS to have an immediate and instant access to the depositary, both in terms of access to the entity in relation to the execution of its tasks, as well as in terms of access to the assets safekept and custodied by that depositary. Such immediate and instant access is essential in “normal” times but in the views of the CSSF appears to be absolutely critical in the case of stress or crisis situations.

(2) Absence of required harmonization in various areas which are a prerequisite for the potential introduction of a UCITS depositary passport

The future UCITS V directive will eventually provide a common framework in relation to the duties and responsibilities of depositaries. This harmonization, supported by the CSSF, is nevertheless limited in scope, and does not cover other essential areas, which need to be harmonized prior to the introduction of a UCITS depositary passport. As a consequence of this, the potential introduction of a depositary passport on the basis of the UCITS V common framework would be introduced in a context of legal uncertainty in relation to various legal aspects and different levels of the rights and protections for a UCITS of a given jurisdiction, depending of the location of the depositary.

The essential areas that would need to be harmonized prior to the introduction of a UCITS depositary passport are mainly the following ones:

- Custody/deposit laws

Harmonization in this area is required so to ensure a uniform regime of deposit rights of UCITS (and its investors) against the UCITS depositary. In this context, it is considered that the duty of restitution in relation to “custodial” assets to be introduced by the future UCITS V directive, covers an ultimate recourse of the UCITS against the depositary in the event of loss of assets. The introduction of a depositary passport nevertheless requires legal certainty in relation to all custody aspects and not only with respect to the ultimate recourse, and this with respect to the first level of the custody chain (i.e. the level of the depositary), as well as in relation to the further levels of that custody chain so to ensure an equal level of investor protection in all cases. Such legal certainty does not exist today due to the differences in legal systems (e.g. common law/civil law jurisdictions) and regimes with respect to depositors. As a matter of example, the custody aspects that would need to be harmonized so to
introduce the required level of legal certainty in this context are the following:
methods for acquisition and disposal, recognition of interest in the event of
insolvency, priority of rights of different investors in relation to one type of
securities in the event insufficient securities of that type are available at the
depository, asset seizure regime and procedural aspects so to prevent UCITS
assets to be potentially blocked in the event of a seizure order against the
depository (beyond mere segregation of assets obligations), investor protection
regimes in the event of involuntary dispossession and deposit guarantee schemes
and regimes (e.g. amounts covered, types of deposits protected, recourse rights,
funding mechanisms).

- Securities laws

A harmonization in this area is required so to ensure legal certainty of UCITS
rights in relation to its assets that are held in a multiple intermediary custody
chain (i.e. “intermediated securities”, i.e. situations of multiple intermediaries
between the issuer and the UCITS as the end-investor). As a matter of fact,
securities laws within the EU Member States are structurally different between
the different MS so that the UCITS rights in relation to intermediated securities
are different depending on the location of the depositary (e.g. transparent
systems with a direct legal relationship between the investor and the issuer in all
cases, direct holding systems with direct legal relationships between issuers and
investors but with investor rights to be exercised in a tiered approach with the
immediate upper tier intermediary, indirect holding systems with investor rights
only against the upper tier intermediary and not directly against the issuer, etc).
Harmonization of securities laws, which is to be seen as complementary to the
harmonization of custody/deposit mentioned above, beside others requires
uniformization of duties and liabilities of intermediaries, protection of innocent
acquirer rights in case of potential fraud, priority rights in the same
intermediated securities and allocation of securities to the rights of account
holders and an uniform approach in terms of securities forms (e.g. issuance and
holding of dematerialized securities, access to local CSDs). The need for
harmonization of the legislation on legal certainty of securities holdings and
dispositions has been recognized at European level (i.e. in the context of the

- Liquidation and insolvency laws and procedures

The future UCITS V directive will eventually allow different types of entities to
be eligible as UCITS depositary. The variety of institutions that could
potentially be designated as depositary, combined with a possible depositary
passport, would create legal uncertainties in relation to the UCITS rights in the
event of a liquidation of such depositary in the absence of uniform liquidation
procedures across the different EU Member States and across the various types
of entities eligible to act as UCITS depositary.

- Tax laws

The absence of a harmonized tax regime across the European Union, at both the
level of the depositary as an entity (in terms of direct and indirect taxes) and at
the level of the securities (e.g. withholding taxes and stamp/transaction duties),
gives raise to an unlevel playing field amongst funds of a given jurisdiction
depending on the location of the depositary appointed by such fund. Such
unlevel playing field ultimately affects the UCITS investors in terms of costs of
depository services and tax implications in relation to the income and
transactions with respect to portfolio securities.

(3) Systemic risk considerations potentially creating adverse consequences in terms
of investor protection

The UCITS depositary regime as it would result in the context of the proposed
future UCITS V directive combined with a potential depositary passport under
UCITS VI would potentially create an increased systemic risk on the basis of the
following:

- Systemic risk due to the substantial duties and obligations under the future
  UCITS V directive

As flagged in the past by the CSSF in the context of the discussions regarding
the AIFMD (and the related level II provisions), it is considered that the extent
of the depositary duties and obligations under the future UCITS V (e.g. the duty
of restitution in relation to “custodial assets”), will ultimately prevent “small”
players to be able to continue to provide UCITS depositary services and as such
concentrate the UCITS depositary mandates with a reduced number of “big”
players in a given jurisdiction and hence increase concentration, and therefore
systemic risk in relation to domestic UCITS depositary services.

- Further increased systemic risk under a depositary passport

The combination of the UCITS V regime with a depositary passport would
potentially further increase the concentration not only at a domestic level, but
also at a pan-European level, by further increasing the concentration of
depository services with a few number of “big” and potentially global providers.
In this context it should be noted that the analysis of operating models of major
global UCITS depositaries (i.e. UCITS depositaries that provide such services in
several UCITS domiciles at the same time) already shows an increased number
of creation of centers of excellences for the execution of operational tasks,
where a given center of excellence acts as the outsourced service provider of the
named UCITS depositaries located in different jurisdictions belonging to the
same group. Such concentration of resources in a reduced number of locations
would very probably be further increased in the event of the introduction of a
depository passport. In this context it is to be noted that the delegation rules
under the future UCITS V regime are to be considered as rather restrictive
(i.e. major players will, given the restrictions in terms of delegations, put in
place structures where the entity which today acts as outsourcing service
provider, be the appointed depositary going forward).

It should be noted that the introduction of the passport for UCITS management
companies in 2009 was supported by various competent authorities by the argument
that maintaining the depositary in the country of the fund would provide enough
protection for such management company passport to be given effect.

Finally, it should also be noted that from the perspective of aligning the rules applicable under the UCITS directive with those under the AIFM Directive, the AIFM directive does not foresee the creation of a depositary passport as the depositary of EU AIFs shall (also) be located in the home Member State of the AIF.

(2) If you are a fund manager or a depositary, do you encounter problems stemming from the regulatory requirement that the depositary and the fund need to be located in the same Member State? If you are a competent authority, would you encounter problems linked to the dispersion of supervisory functions and responsibilities? If yes, please give details and describe the costs (financial and non-financial) associated with these burdens as well as possible issues that a separation of fund and depositary might create in terms of regulatory oversight and supervisory cooperation.

The introduction of a depositary passport in addition to the already existing management company passport would in the views of the CSSF

- complicate the global supervision of the UCITS products and necessary actors in a UCITS set-up (e.g. the depositary and the management company) by introducing additional fragmentation of such supervision between potentially three different supervisory authorities;
- complicate the UCITS supervision by the UCITS home member State supervisory authority; and
- introduce “operational” risks in relation to the UCITS supervision inherent to a model that requires supervisory cooperation as opposed to a model with direct access of the UCITS supervisor to the UCITS depositary.

Although it is at this stage difficult to precisely assess the cost aspects of such set-up, it is to be expected that the operating costs of the UCITS supervisor under a model with a depositary passport will increase for the UCITS supervisory authority compared to the current situation.

The CSSF has so far had limited exposure to the supervisory cooperation mechanisms under the UCITS IV Directive and the related provisions under EU Regulation n° 584/2010, but the CSSF can confirm that this procedure necessarily entails delays in access to information compared to a purely domestic situation. Although the CSSF has not yet had any stress situation with respect to the management company passport, there is a risk that the inherent potential delays with respect to access to information and/or on-the-spot verifications under the procedures foreseen in the current UCITS directive might create supervisory issues in a crisis situation.

(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...)?

Not applicable, given that the CSSF is of the view that the introduction of a depositary passport is not adequate.
(4) Should the depositary be subject to a fully-fledged authorisation regime specific to
depositaries or is reliance on other EU regulatory frameworks (e.g., credit institutions or
investment firms) sufficient in case a passport for depositary functions were to be
introduced?

Not applicable, given that the CSSF is of the view that the introduction of a depositary
passport is not adequate.

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

Please see above answer to question (2).

7. MONEY MARKET FUNDS

Box 6

(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.

Money market funds (MMFs) serve retail investors, corporations and institutional
investors (pension funds, insurance companies, etc) as low-cost, efficient cash
management tool that provides a high degree of liquidity, stability of principal, a way
to manage and diversify credit risk, and a market-based yield. They are an important
source of direct short term financing for governments, corporations and financial
institutions.

MMFs are often compared (even though having differentiating features) with bank
deposits or direct investments in certificates of deposit, commercial papers, time
deposits, treasury notes and bonds (short term or with a close remaining maturity).

MMFs (and thus their investors) bear the risks and rewards of the assets held by the
fund. There is no contractual or governmental guarantee on the investments. MMFs
aim to generate a money market return based on investment selection and
opportunities.

Monetary data from the ECB show that MMF shares/units held by euro area investors
are very small relative to the deposits managed by euro area credit institutions.

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

MMFs shares/units are generally held by retail investors (households), corporations
and institutional investors (insurance corporations, pension funds, etc), the major part
of MMF investments coming from corporations / institutional investors using MMF
for cash management purposes.
What types of assets are MMFs mostly invested in? From what type of issuers? Please give indicative figures.

MMFs invest mostly in certificates of deposit, commercial papers, time deposits, treasury notes and bonds (short term or with a close remaining maturity) issued by financial institutions, corporations and governments.

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?

No detailed figures are available. However, based on our experience (and in accordance with the existing legal and regulatory framework, including CESR guidelines 10-049 on MMF) MMFs make use of EPM techniques such as repurchase agreement, securities lending and derivative transactions. For completeness purposes it is to be said that MMFs usually (and even more these days following the latest developments in Money Markets) make extensive use of overnight reverse repo transactions for ensuring an adequate level of liquidity at fund level.

MMFs accept, based on existing local regulation, high quality and highly liquid assets as collateral for counterparty risk mitigation purposes in front of EPM techniques (e.g. US Government Bonds).

Furthermore, in accordance with the current regulation in Luxembourg (and confirmed by the recently published ESMA guidelines on ETFs and other UCITS issues), collateral received in the context of EPM techniques should be valued on at least a daily basis, whereby collateral should be understood as comprising all assets received by UCITS in the context of EPM techniques.

As regards margin calls in the context of EPM techniques, pursuant to CSSF regulation, the agreement concluded between the UCITS and the counterparty must include provisions to the effect that the counterparty must provide additional collateral at very short term in case the value of the collateral already granted appears to be insufficient in comparison with the amount to be covered.

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.

While it can certainly never be excluded that MMFs, whether CNAV or VNAV, may under certain exceptional market circumstances be subject to a run risk, we do want however to highlight that the behaviour of MMFs during the financial crisis was consistent with the (risk averse) behaviour of investors across the markets at the time and was unrelated to their structural or pricing characteristics. More particularly, investors moved away from MMFs exposed to credit risks to more secure investments, including other MMFs (“Flight to quality”).
In addition, it appears important to add that the European Money Market Fund sector showed (and still shows) strong resilience during the European Sovereign debt crisis, due among other to the regulatory reforms introduced by means of the CESR guidelines.

(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 definition15? The CESR 10-049 guidelines on MMFs which were developed from the perspective of investor protection as well as systemic risk and that apply to any fund marketing/labelling itself as a money market fund (i.e. both UCITS and non-UCITS funds) represent according to our view a very robust regulatory framework that only needs fine-tuning in a specific number of areas (e.g. liquidity, disclosure) as further laid down below.

As managers of non-UCITS MMFs are, up from July 2012, subject to the AIFMD, all MMFs and their managers are already (or in the process) subject, to a high standard of regulation in the EU.

However, from a level playing field perspective we advocate consistency of rules (e.g. eligibility, risk spreading, etc.) across all MMFs products (as defined by CESR guidelines), including non-UCITS MMFs.

With regard to the definition issue of MMFs we would favour a harmonisation aiming to align the European Central Bank’s definition with the CESR framework covering thus all funds that are marketed/labelled as MMF.

(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?

The current regulatory framework set by the CESR guidelines on MMF provides for an accurate framework in terms of MMFs, making a distinction between short term money market funds (STMMF) and money market funds (MMFs). As a consequence, no new categories of MMFs need being introduced. As laid down above, consistent rules (e.g. eligibility, risk spreading, etc.) across all MMFs, whether UCITS or non-UCITS should be targeted from a level playing field perspective.

7.1. Valuation and capital

Box 7

(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.

When taking a decision to invest in a MMF, investors will have, first of all, based on
their risk tolerance/appetite, assess and then make a choice between the risk profiles (credit, liquidity, etc.) offered by the types of MMFs currently existing in Europe, i.e. STMMF and MMF. In particular, the two-tiered approach as set forth by the CESR guidelines on MMF recognizes the distinction between STMMF operating a very short weighted average maturity (WAM – 60 days) and weighted average life (WAL – 120 days) and MMFs operating with a longer weighted average maturity (6 months) and weighted average life (12 months)\(^2\), the latter targeting thus investors with a longer investment horizon when comparing with STMMF.

Given the distinctive features between STMMF and MMF and the higher quality standards for STMMF, STMMF target primarily preservation of capital and a stable NAV.

Following from the risk profiles offered by STMMF and MMF, many investors target STMMF because of the high assurance / security (i.e. capital stability) offered by the product following from the stringent requirements underlying the investments.

Given the safeguards of STMMF (by the way being the only type of MMFs that can have a constant net asset value – CNAV - pursuant to the CESR guidelines on MMFs) investors opting for STMMF expose themselves to assets for which the amortized cost valuation / accounting method provides for a reliable and accurate valuation method of the investments and hence for which a CNAV approach is accurate.

It is only in a next step that the investment choice of investors is influenced by accounting, operational, technical and tax considerations.

(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?

The CSSF is of the view that the activities of CNAV MMFs should not be reduced or even phased out as the current regulatory framework as introduced by the CESR guidelines provides for a robust framework (i.e. high quality assets, high liquidity of both assets and MMF portfolio, etc.) both in terms of investor protection and systemic risk. However, the CSSF is of the view that in number of areas the European regulation could be further fine-tuned. In this context, we do want to quote:

- the area of liquidity for MMFs (including STMMF) for enhancing their liquidity profile and enabling them for better absorbing significant redemption activity;
- the strengthening of disclosure concerning for instance the fact that MMFs do not provide for a capital guarantee;
- the removal of overreliance on credit agencies for assessing the quality of the Money Market Instruments.

The elimination of C-NAV funds could be potentially disruptive for the short term

\(^2\) Another important distinctive feature being that STMMF can only invest in securities with a residual maturity until the legal redemption date of less than or equal 397 days, while MMF can go up to a residual maturity until the legal redemption date of 2 years, provided there is a interest rate reset at least on a 397 days basis.
financing market if investors upon the removal of CNAV MMF withdraw their money from the highly regulated MMF sphere and from the Money Markets generally as they are no more given the possibility of an investment that reconciles both their risk appetite as well as their other constraints. In addition the possible transfer of assets from highly regulated MMFs to less regulated or unregulated cash management vehicles could be problematic from investor protection reasons as well as for the overall functioning of the markets.

(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?

The CSSF does not consider capital buffers as being appropriate on CNAV funds as we consider that proposals requiring MMFs to accumulate buffers (shareholder funded) or that sponsors commit capital or guarantee MMFs (sponsor funded) would fundamentally alter the business model of MMFs, especially in a situation like today where money market yields are at historically low levels.

More particularly, shareholder funded buffers would pose the question to whom it actually belongs when investors redeem shares as the cost would be borne by first generation investors to the benefit of late generation investors, whereas sponsor funded buffers would require sponsors to dedicate capital which would require an appropriate compensatory rate of return depending on how and how much of the losses/gains are shared/compensated.

In this context, it is worthwhile recalling that MMFs (including STMMF that may adopt CNAV approach) are investment products/vehicles that aim to generate a return in line with money market rates, but that do not provide for a capital guarantee. It is definitely important that investors do get this understanding by means of adequate disclosure.

(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?

First of all, it appears worth noting that amortized cost valuation/accounting (underlying the CNAV model) is currently used by both C-NAV and V-NAV funds. More particularly, there are securities investments performed by V-NAV funds for which amortized cost valuation / accounting is used as a proxy for mark-to-market valuation as it provides for an accurate and reliable valuation.

Next, it is important to highlight that amortized cost valuation/accounting provides for an accurate and reliable valuation for certain short-term instruments in normal market conditions.

For that reason, the use of amortized cost accounting is restricted to STMMF that can only invest in certain types of instruments (credit quality, maturity, etc.). In addition, amortized cost valuation/accounting is subject to a continuous monitoring process.
(including escalation process if applicable), aiming at detecting differences between
the amortized cost valuation/ accounting value and the market price of the
instruments, giving rise if applicable (as a result of an escalation process) to a switch
to mark-to-market valuation in accordance with point 19 of CESR guidelines 07-044b
on eligible assets. In other terms, if under stressed market conditions, amortized cost
valuation does no more provide for an accurate value of the corresponding
investments (as derived from a mark-to-market valuation process, given for instance
through credit spread impact), a mark-to-market valuation would have to be made.

"Stressed market conditions” (e.g. situations where exceptional and coordinated
interventions form the central banks are required) could give rise to situations where
the amortized cost valuation/accounting does not provide for an accurate estimate of
the value of the instruments held by a STMMF and hence obliges them to switch to
mark-to-market valuation.

Finally, the policies put in place by management/investment companies are derived /
based from the existing regulatory framework, providing among other for a regular
monitoring of the discrepancies between amortized cost valuation and mark-to-market
valuation and a potential switch to mark-to-market valuation under certain
circumstances.

7.2. Liquidity and redemptions

Box 8

(1) Do you think that the current regulatory framework for UCITS investing in money
market instruments is sufficient to prevent liquidity bottlenecks such as those that have
arisen during the recent financial crisis? If not, what solutions would you propose?

The CESR guidelines on MMF (CESR/10-049) do already provide for a very robust
framework in terms of liquidity by restricting the instruments that can be held by
STMMF and MMF (eligibility, minimum credit quality, maturity, liquidity profile,
WAM, WAL, etc.).

However, the MMF framework could, as already mentioned before, be further
enhanced in terms of liquidity requirements for MMFs by defining minimum levels of
liquid assets (e.g. daily and weekly) to be held by MMFs. Such measures would
further strenghten the resilience of MMFs for allowing them to meet redemption
requests in both normal and exceptional circumstances.

Notwithstanding the aforesaid potential enhancement, one can certainly never exclude
that under certain given circumstances (e.g. significant redemption from one investor
holding a big proportion of capital, market turbulences, etc.) the proportion of liquid
assets would be sufficient for meeting all redemption requests in a way that would
also be in the best interest of investors. Therefore, we would advocate that
management /investment companies were given, in addition to their possibility to
suspend redemptions in exceptional cases, the possibility to slow down redemption
pressure by means of a gating/ deferral mechanism.
(2) Do you think that imposing a liquidity fee on those investors that redeem first would be an effective solution? How should such a mechanism work? What, if any, would be the consequences, including in terms of investors' confidence?

The CSSF is of the view that measures aiming to enhance the liquidity situation of the MMFs, together with the possibility given to them to activate a gating mechanism, should be privileged.

(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?

The CSSF is of the view that the redemption restrictions mentioned do not constitute viable solutions. In fact, during the recent IOSCO discussions on MMFs, proposals like redemption in kind were considered with the conclusions drawn that the drawbacks outreach the benefits of such measures.

(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?

Even though liquidity constraints are already implicitly part of the investment restrictions that currently govern MMFs (cf. CESR guidelines), we are of the view that a minimum level of liquid assets ready for sale on a daily and weekly basis could be defined by analogy with the SEC Rule 2a-7 for further enhancing the liquidity profile of MMFs. Such a measure could further strengthen the resilience of MMFs and so further increase the confidence of investors.

(5) Do you think that the 3 options (liquidity fees, redemption restrictions and liquidity constraints) are mutually exclusive or could be adopted together?

Liquidity enhancement measure and redemption deferrals (in addition to the suspension possibility already given for UCITS funds) could be adopted together as they respond to different needs as laid down above.

(6) If you are a MMF manager, what is the weighted average maturity (WAM) and weighted average life (WAL) of the MMF you manage? What should be the appropriate limits on WAM and WAL?

N/A.

7.3. Investment criteria and rating

Box 9

(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?
The CSSF is of the view that the definition of MMI as laid down in the Commission Directive 2007/16/EC and in particular article 3(2)c) thereof (“(…) (c) they undergo regular yield adjustments in line with money market conditions at least every 397 days (…)”) deserves being reviewed by aligning it by reference to the maturity feature of the Money Market segment. Indeed a 20-year floating rate note with significant spread risk, but at least yearly refixing of the interest rate (e.g. by reference to Libor, Euribor) should not qualify as MMI.

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

It should still be possible for MMF to be rated as ratings represent still an important cost effective assistant for certain types of investors when making their investment decision.

A ban of MMF ratings would indeed be detrimental for those investors that, in contrast to institutional investors (e.g. retail investors) do not have the means and tools for running a comprehensive assessment of the quality of investment products. For those investors, ratings, while representing an industry-wide benchmark, represent a valuable tool.

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

The consequences of prohibiting investment criteria relating to ratings would mean that all investment managers would have to put in place a fully-fledged credit assessment / internal rating process that would, besides a cost point of view, not represent an ideal situation as it would lack any external judgement and thus pose the problem of subjectivity. We agree that the managers should not rely solely or mechanistically on rating agencies for assessing the creditworthiness of a fund’s instruments, but removing them completely from the regulatory provisions is not desirable either. Indeed a system where investment decisions would have to be taken on the basis of both external credit ratings and critical internal judgement by the managers, would in our view be the road to go for the determination process of the high quality of the money market instruments suitable for the fund’s investments but should not prevail.

Following from above, the CESR guidelines on MMFs should be amended on this basis for having a robust assessment system, removing the risk of potential over-reliance on external credit ratings in the selection of instruments as highlighted in the aftermath of the financial crisis.

(4) MMFs are deemed to invest in high quality assets. What would be the criteria needed for a proper internal assessment? Please give details as regards investment type, maturity, liquidity, type of issuers, yield etc.

The CESR guidelines 10-049 on MMF already provide all the criteria (e.g. eligibility, credit quality, liquidity, other risks linked to assets, maturity, maturity at individual and portfolio level, etc.) needed for having a proper internal assessment of the quality of
assets that a MMF can invest in.

8. LONG-TERM INVESTMENTS

Box 10

(1) What options do retail investors currently have when wishing to invest in long-term assets? Do retail investors have an appetite for long-term investments? Do fund managers have an appetite for developing funds that enable retail investors to make long-term investments?

The UCITS framework currently does not provide for direct access (but only limited indirect access through some investments by UCITS in debt and other instruments issued by national and supranational government and institutions). Consequently, long-term investment opportunities are mainly available through investments in (i) fund products outside the UCITS-framework and (ii) participations in non-fund products, such as pension plans, life insurance products and other retail structured products.

Retail investors do have an appetite for long-term investments.

It can reasonably be assumed that fund managers will seek other opportunities to expand on these and that they therefore also have an appetite for developing funds that aim to specifically respond to the demand of retail investors enabling them to reach their growing long-term investment goals.

(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?

The CSSF supports the idea of enhancing possibilities for retail investors and hence developing a common framework at the European level to long-term investments for retail investors. However, the CSSF believes that such framework should be dealt with in a parallel and stand-alone fund products regime, distinct from the UCITS regime.

(3) Do you agree with the above list of possible eligible assets? What other type of asset should be included? Please provide definitions and characteristics for each type of asset.

The CSSF considers that the list of eligible assets as suggested by the Commission (i.e. direct investments into unlisted companies (early or mature stage), infrastructure projects, 'real' assets (real estate, other physical assets), third-party managed funds making investments in unlisted companies and socially responsible investments including EuSEFs) is in principle acceptable, it being understood that the list is not exhaustive and open for additions in a more mature stage of this initiative.
(4) Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced? Please give details.

In the solution advocated by the CSSF, i.e. a long-term fund products regime for retail investors that is distinct from the UCITS regime, minimum liquidity constraints should be introduced. These may be similar to the current UCITS regime, such as the right for the investor to request for a redemption, but possibly adapted to the long-term character of the investments (i.e. offering less frequent opportunities to ask for such redemptions). The setting-up of a secondary market could also be envisaged as an advantageous, additional solution, provided such a market is feasible and viable in practice as this will depend on the specific fund product at hand.

(5) What proportion of a fund's portfolio do you think should be dedicated to such assets? What would be the possible impacts?

In a specific long-term retail fund structure for long-term investments that is distinct from the UCITS regime, the CSSF could imagine that a maximum of up to 80% of the fund’s assets could consist of investments in long-term assets, leaving the other 20% (or more) for more liquid assets.

(6) What kind of diversification rules might be needed to avoid excessive concentration risks and ensure adequate liquidity? Please give indicative figures with possible impacts.

Spreading investment risks avoids the excessive concentration of a fund’s investments; a minimum level of diversification of investments between assets of different types and issuers is therefore required, but depends on the specific fund type. However, the CSSF considers that more reflexions and a more thorough dialogue are required between the various actors and that it is difficult to formulate diversification rules for a possible future long-term (non-UCITS) fund products regime for retail investors at this stage.

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

In the view of the CSSF, the use of leverage or financial derivative instruments should not be excluded just as a matter of principle, i.e. these must be discussed and possibly be available in a possible future long-term fund products regime for retail investors that is distinct from the UCITS regime.

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

In the view of the CSSF, a minimum lock-up period may be a suitable technique in the context of a long-term fund products regime for retail investors, provided it is done in all transparency towards the retail investor and such period does not bind the retail investor irrevocably and unreasonably long into the product.
(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?

   In order to ensure high standards of investor protection, the CSSF would be in favour of requiring long-term investment vehicles to appoint a depositary, similar to what is already required under other investment fund product regimes such as the UCITS framework (and AIFMD).

(10) Regarding social investments only, would you support the possibility for UCITS funds to invest in units of EuSEF? If so, under what conditions and limits?

   The CSSF is of the opinion that UCITS should be able to invest in units of EuSEFs up to 10% in accordance with article 50, (2), a) of the UCITS IV Directive.

9. UCITS IV IMPROVEMENT

Box 11

(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.

9.1. Self-managed investment companies

   The CSSF is of the view that there is no need to further align the regime of self-managed investment companies with the regime of management companies.

9.2. Master – feeder structures

   Article 64(1) of the UCITS Directive requires UCITS to provide information to investors in the following two cases: where an ordinary UCITS converts into a feeder UCITS, and where a master UCITS changes. However, this article does not cover a third possible scenario, that is, where a feeder UCITS converts into an ordinary UCITS. Such conversions lead to a significant change in the investment strategy. It can be argued that similar information standards should apply across all three scenarios.

   The CSSF supports the idea to apply similar information standards in this third scenario of a conversion of a feeder UCITS into an ordinary UCITS as the investor should have the possibility to chose whether he/she wishes to continue to hold his/her investment under the new conditions.

9.3. Fund mergers

   The merger of two UCITS is subject to prior authorisation by the competent authorities of the merging UCITS home Member States. These authorities must inform the merging UCITS about their decision within 20 working days from the date of the receipt of the complete application.
Before the authorities communicate their decision, they need to consult the competent authorities of the receiving UCITS. The competent authority of the receiving UCITS must consider the potential impact of the merger on the investors of the receiving UCITS. They must assess whether the information to be provided to investors is sufficient. The authorities of the receiving UCITS can ask the fund, within 15 working days, to modify the information to be provided to investors.

One of the possible readings of these provisions is that, after the receipt of the modified version of the information to investors, the competent authorities of the receiving UCITS have 20 working days to inform the competent authorities of the merging UCITS whether they are satisfied with that modified version of the information.

Given such an interpretation practical problems can arise. It is not clear how to reconcile the general 20 working day time limit for the competent authorities of the merging UCITS for their decision on the authorisation of the merger with a 20 working day time limit for the competent authorities of the receiving UCITS for their assessment of the modified version of the information to investors.

Revision of the provisions on the timelines for the mergers of the UCITS could therefore be considered so as to increase legal certainty.

The CSSF considers that the current time limits of 15 and 20 working days are workable in practice, but that it would indeed be useful to revise and possibly clarify the provisions on the timelines for the mergers of UCITS in detail and to provide for additional deadlines for example.

The CSSF first notes in this context, for example, that if the competent authorities of the merging UCITS consider it necessary, they may make a request in writing to the merging UCITS that the information to unitholders of the merging UCITS be clarified, but that article 39(3) of the UCITS IV Directive does not impose any specific deadline on the merging UCITS to clarify the information to be provided to its unitholders.

The CSSF further notes that if the competent authorities of the receiving UCITS consider it necessary, they may within 15 working days of receipt of the complete information, request in writing, that the receiving UCITS modify the information to be provided to its unitholders, but that article 39(3) of the UCITS IV Directive does not impose any specific deadline on the receiving UCITS to modify information to be provided to its unitholders.

The CSSF finally notes that the competent authorities of the merging UCITS shall inform such merging UCITS whether or not the merger has been authorised within 20 working days of the submission of the complete merger file, but that article 39(5) of the UCITS IV Directive is not clear as regards the meaning of a “complete” merger file. It may be more appropriate to refer to the submission of a “definitive” merger file, i.e. a merger file which is complete AND also includes the clarification/ modification requested concerning the information to be provided to the unitholders of the merging and/or the receiving UCITS.
9.4. Notification procedure

Two improvements could be considered:

• Introduction of the notification of the update to the UCITS host Member State in electronic form;

  This is already applicable in Luxembourg. Written notices of updated information have to be sent to a specific e-mail address of the CSSF.

• Clarification that information on a share class is limited to share classes marketed in a host Member State.

  The CSSF has no objections to clarify this point.

It can be also considered whether to introduce a regulator-to-regulator notification for any changes to the notification file including the information on arrangements for marketing or marketing of a new share class.

  The CSSF has no objections to further consider this idea.

9.5. Alignment with the AIFM Directive

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 CSSF is in principle not opposed to any discussion to align, if appropriate, the provisions on organizational rules, delegation, risk and liquidity management rules, valuation, reporting and calculation of leverage of the AIFM Directive to the UCITS Directive. These provisions should however be adjusted to the specificities of the UCITS universe.

However, the CSSF considers that the AIFM Directive and its supplementing Commission Delegated Regulation should be regarded as a whole. As the discussion concerning the final wording of these Level 2 measures are still ongoing, the CSSF considers the timing to discuss any details on potential alignments between the UCITS and the AIFM Directive as not appropriate.

The CSSF has one more specific comment:
According to article 6 (“Conditions for taking up business”), paragraph 3, under (b) of the UCITS IV Directive, Member States may authorise management companies to provide, in addition to the management of UCITS, the following non-core services:
“(i) investment advice concerning one or more of the instruments listed in Annex I, Section C to Directive 2004/39/EC;
(ii) safekeeping and administration in relation to units of collective investment undertakings.”
According to the similar article 6 (“Conditions for taking up activities as AIFM”),
paragraph 4, under (b), of the AIFM Directive, Member States may authorise an external AIFM to provide the following non-core services:

“(i) investment advice;
(ii) safe-keeping and administration in relation to shares or units of collective investment undertakings;
(iii) reception and transmission of orders in relation to financial instruments.”

The CSSF would be in favour of amending the UCITS IV Directive to allow management companies to also provide this third category of non-core services, similar to what is provided under the AIFM Directive. In the view of the CSSF, there is no compelling reason to not allow UCITS management companies to provide this service. The removal of this distinction would allow management companies that combine a license under the UCITS Directive with a licence (as external AIFM) under the AIFM Directive to provide the same services to both UCITS and AIFs. This would simplify the operational set-up of these management companies, leading to reduced costs.