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AFG response to the European Commissionôs consultation on Undertakings for Collective Investment in Transferable Securities (UCITS) Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments

General comments

The Association Française de la Gestion financière (AFG)[1] is grateful for the opportunity to respond to the European Commissionôs consultation on Undertakings for Collective Investment in Transferable Securities (UCITS) Product Rules, Liquidity Management, Depositary, Money

[1] The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include 425 management companies as of end January 2012. They are entrepreneurial or belong to French or foreign banking or insurance groups. AFG members manage 2,650 billion euros in the field of investment management as of end December 2011, making the Paris Fund Industry the leader in Europe for the financial management of collective investments. In the field of collective investment, our industry includes ï beside UCITS ï employee savings schemes and products such as regulated hedge funds/funds of hedge funds, private equity funds, real estate funds and socially responsible investment. AFG is of course an active member of the European Fund and Investment Management Association (EFAMA) and of the European Federation for Retirement Provision (EFRP). AFG is also an active member of the International Investment Funds Association (IIFA).

Market Funds, Long-term Investments. The following response can be read as complementing EFAMAôs answer by stressing points that are key for AFGôs members and their clients.

AFG wants to reaffirm its total accordance with the main objective of the UCITS aiming to keep products transparent and innovative for a large range of clients being retail or institutional investors.

Therefore, it is key for UCITS managers to have access to a large range of products regulated by a structure in line with the UCITS philosophy. This allows end investors to have access to a wide range of products and enable them to diversify their investments through a well supervised vehicule.

AFG would like to take the opportunity of this answer to comment on the ESMAôs report of the 25th of July. ESMA expressed definitive views on topics which are open for comments in the present consultation initiated by the European Commission and this raises an issue on the consistency and hierarchy of European regulations. We would therefore welcome clarification in this respect.

Box 1 ï Eligible Assets

<u>General comments</u>

For AFG, it is essential that asset managers are enabled to use their skills and professionalism in order to offer optimzed investment solutions to their clients. AFG thinks that this can be achieved, in the best interest of the clients, via adjusting the UCITS framework keeping the same philisophy.

(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 flexibility offered by UCITS in terms of permitted investments is highly valued by promoters and investors alike as it has indeed presented UCITS managers with tools enabling them to launch innovative products and investment strategies in order to better serve investorsô needs without compromising the high quality standards prevailing in the UCITS environment.

We believe that it is this balance between flexibility on the investment side and rigour in terms of measurement and management of the associated risks that has been central to the success of the UCITS brand.

If UCITS are to continue to be the product of choice for promoters and investors we believe it is essential that retail investors should be able to continue to benefit from product innovation and developments in investment management techniques.

From this point of view we do see the need for an updateof the scope of eligible assets and exposures for UCITS.

We would suggest to add the products listed below within the 10% ratio defined on the Article 50-2 (a) of Directive 2009/65/EC. In our view, this limit constituts an appropriate safeguard in addition to the management companyõs internal risk management policy.

- **Other funds :**

  Investments allowed in the 10% ratio (i.e. article 50-2-(a)) should be clarified. For instance, it seems that investments in AIFs are not treated in the same way by the different Member States: some consider that these funds are eligible to that ratio and some do not. Harmonization is therefore urgently required in order to ensure a level playing field among the Member States.

  Making eligible funds that are not UCITS, or not allowed in the 30% limit ratio, to that ratio (i.e. article 50-2 (a)), would also make eligible for exemple new *Venture Capital Funds* or *European Social Entrepreneurship Funds, having of course a depositary*, and also funds of funds and vehicles subject to AIFMD.

- **Loans**

  We think that the leveraged loans market has become sufficiently mature; it benefits from more than 10 years of track record through 2 full credit cycles and has an adequate liquidity to bring commercial loans into the eligible assets within the 10 per cent ratio. Key for the proper financing of the European economy, loans represent a powerful asset allocation tool, with many advantages such as:

- Capital preservation through security and covenants.
  The security and covenant package ensures that all cash flows generated by the company is and will be earmarked to prepay the debt first, at least until a normal leverage has been reached. In addition in case of the company defaults, the security offers lenders the control over the company to enhance their ultimate recovery.
- Highly diversifying asset class: loans are the most traditional route by which European companies have accessed debt markets and are often the only way to get exposure to private issuers.
- Limited volatility: 6-7 per cent annualized as measured by the Credit Suisse loan index since 1990. For instance, the volatility of European leveraged loans is lower than the volatility of European yield bonds.
- Liquid market: there is a strong liquidity on the large flow names, over EUR 1 bn in size, usually boasting public rating and a more limited liquidity in mid cap and smaller transactions, whose size range from EUR 100 m to 500 m. Even though volumes receded

significantly throughout the crisis, secondary activity remained sufficient for enabling active portfolio construction and risk management.

- Low default and recovery rate: leveraged loans default rates are well below 10 per cent since 2002 despite the crisis. In average, over 10years, leveraged loans recovery rate was 65 per cent against 35 per cent for bonds.
- Various risk / reward opportunities allowing active management through cycles (senior vs subordinated, distressed vs performing, etc)

Overall, corporate loans are sufficiently resilient and the loans market is wide enough to build diversified portfolios and invest substantial amounts and liquid enough to be actively managed.

- **<u>Commodities</u>**

  We think that the commodity asset class should also be among eligible assets to the portfolio of UCITS as it has a low historical correlation to other asset classes and could therefore increase the diversification in a portfolio.

  Indeed, exposure to commodities is already allowed but through diversified indices or sub-indices. Exposure to underlying constituents with predetermined weights and maturities may then differ from the investment managerĝs target. Also, getting exposure to commodity asset class through stocks of companies linked to the commodity market brings unwanted bias and specific risks.

  We believe that allowing cash-settled futures in major international commodities would permit diversification and decorrelation to a portfolio. Those instruments are traded on a very liquid market and are at least as liquid as the other instruments which are currently used to get exposure to the commodity asset class.

  With a view to maintain the balance between flexibility and rigorousness, we suggest that investments in commodities be restricted to products with cash settlement only.

As said, it is key for UCITS managers to have access to a large range of products regulated by a structure in line with the UCITS philosophy. This would also allow end investors to have access to a wide range of products and enable them to diversify their investments.

(2) Do you consider that all investment strategies currently observed in the market place are in line with what investors expect of products regulated by UCITS?

It is important to bear in mind that, while the UCITS framework is well adapted for retail investors, there are actually different types of UCITS investors, ranging from retail individuals investing for their own account, with or without professional advice, to large sophisticated institutional investors. These institutional investors, in turn, may be investing in UCITS for their own account or invest on behalf of their own (retail) clients.

As a result, the expectations and degree of sophistication of UCITS investors vary enormously and it is therefore difficult to identify a detailed set of common investor expectations in respect of UCITS strategies.

It also must be noted that not all UCITS are necessarily targeted for retail investors. There are indeed a number of UCITS products that are designed for more sophisticated (or even professional) investors and which are distributed with corresponding restrictions.

We believe that the variety of investment strategies currently observed has been driven by investors demand and would not exist if they had not sought such strategies with the inbuilt liquidity, transparency and other protections of the UCITS framework under the strict supervision of regulators. For this reason, investment strategies may have propensity to evolve further in the future.

This being said, we believe that the UCITS framework has to be adaptable to the development of the technicality of the industry and also to the clients needs.

(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.

Liquidity of the UCITS portfolio is a crucial element for warranting the open-ended structure of the product.

Accordingly, the UCITS framework already requires appropriate management of liquidity risks at portfolio level in order to maintain the ability of a UCITS to meet the redemption requests by investors at all times. UCITS management companies therefore already have to implement an appropriate liquidity risk management process as part of their overall risk management duties.

Nonetheless, given the focus the UCITS Directive as well as the Eligible Assets Directive (ñEADò) rightly put on liquidity, **we support the proposal to develop common standards or principles to be applied by UCITS in ensuring the liquidity of eligible assets and of portfolios as a whole** (please also refer to our answer to Box 4 on Extraordinary liquidity management rules below).

Great care should be taken, however, in formulating rules in relation to liquidity to ensure that they do not introduce the risk of creating a pro-cyclical effect by forcing funds to immediately dispose of assets which that fail to meet any prescribed liquidity tests (thereby causing those assets to fall further in value or forcing funds to sell at an inconvenient moment at a loss, which could otherwise have otherwise been limited or avoided).

(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 UCITSôportfolio? 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.

In France, retail NON-UCITS funds may invest marginaly up to 10% - in line with the implementation of the article 50-2-(a) from the Directive - in non-eligible assets which consist of financial securities and instruments. In fact we see small use of this type of instruments in the retail funds.

Alternative investment funds marketed to professional/qualified investors can hold much higher percentages of non-eligible assets. The latter might include non-liquid financial / real investments such as venture capital, private equity / debt, infrastructure projects, real estate, farm land, woodland. Such illiquid funds and hedge funds in general using leverage will naturally fall under the AIFM directive when coming into force planned for mid-2013.

French Social investment funds (Solidarity funds) have the possibility of holding up to 10% of private equity / debt in social enterprises that produce a positive social / environmental impact on the community. These funds are in particular available in employee-savings schemes sponsored by the employer.

All these funds are NON-UCITS.

As the Commission rightly notes on page 4 of the Consultation, under the current regulatory framework, UCITS may gain exposure to non-eligible assets through the following financial instruments which are themselves eligible assets:

- other collective investment schemes which are subject to supervision ñequivalent to that laid down in Community lawò and offer a level of protection ñequivalent to that provided for unit holders in a UCITSò (those criteria are further developed under the Eligible Assets Directive and related CESR guidelines concerning eligible assets for investment by UCITS);
- transferable securities, including participation notes, ADRs, GDRs, certain closed-ended funds or other instruments which meet the requirements of Article 2 of EAD and which do

not embed a financial derivative instrument or themselves constitute a financial derivative instrument;

- financial derivative instruments which give exposure to financial indices as expressly contemplated under UCITS Directive and Article 9 of the EAD (the recently adopted ESMA guidelines on UCITS ETFs and other UCITS also provide further details regarding the requirements to be met by these financial indices).

It is however difficult to provide a breakdown of the number of funds that obtain exposure in this manner or the average portion of such assets in a UCITS portfolio.

(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 the stakeholders involved:

- ***Preventing exposure to certain non-eligible assets (e.g. by adopting a ñlook-throughò 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.***

We believe that a proposal to place an absolute restriction on exposure to (certain) non-eligible assets would be very difficult to put into practice and would, in particular, have the consequence that the range of non-UCITS collective investment schemes in which investment is permitted would be narrowed considerably. Indeed, unless a target fund has been purposely structured in order to facilitate investments by UCITS, it is likely that it will have the ability to invest in some assets which do not meet the UCITS eligibility requirements which would render the target fund ineligible for investment.

Concerning the exposure obtained through financial indices, we note that in its Guidelines on UCITS ETFs and other UCITS issues. ESMA does not propose any absolute prohibition on the ability to obtain exposure to non-eligible assets. We believe this approach to be preferable to any absolute restriction.

(6) Do you see merits in distinguishing or limiting the scope of eligible derivatives based on the payoff of the derivative (e.g. plain vanilla vs. exotic derivatives)? If yes, what would be the consequences of introducing such a distinction? Do you see a need for other distinctions?

We see no merits in distinguishing eligible derivatives on the basis of their payoff profile.

We do not believe that a derivative that does not pose any risk to a UCITS from a payoff perspective should be restricted simply because it is too complex for some investors to understand. Complexity is more a function of the use of the FDI strategy rather than the instruments themselves. The experience of the last decade demonstrates that UCITS managers have sufficient risk management capabilities to deal adequately with such instruments. We therefore believe that UCITS managers should remain free to select derivative instruments (be they plain vanilla or so called œexoticô derivatives) which in their opinion best suit the interests of their investors.

Furthermore, the payoff is only one element to be taken into account when determining the standardisation of OTC derivatives for EMIR purposes[2]

What is important for retail investors is to easily understand the global risk-return profile of the fund, not of its components.
We strongly believe that the new EMIR regulation, combined with current UCITS rules, will provide for a very secure framework for the use of derivatives in UCITS. Furthermore, restricting the scope of eligible derivatives in UCITS would play against the desired level-playing field with structured notes issued by banks.

(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) as a measure of global exposure? If you are an asset manager, please provide also information specific to your business.***

We strongly believe that the VaR and commitment method are fully legitimate and complementary tools that should both be available to UCITS risk managers for measuring global fund exposure depending on the circumstances and specificities of the fund.

VaR is a well-recognised and widely used method in the UCITS industry given that market risk remains the best way to take into account the exposure of a derivative instrument (delta-adjusted). Using VaR allows the manager to take into account the correlation of the assets as well as the current market conditions. In particular for portfolios using derivatives, VaR provides investors and risk managers with a more accurate view of the global risk of a portfolio, especially when derivative exposures are offset by other derivatives (such as an FX forwards which are to be

[2] EMIR requires a comprehensive evaluation of legal and operational standardization in terms of OTC Derivatives, see Article 5(4) of Regulation 2012/648/EU. Moreover, it should be borne in mind that in addition to standardized OTC derivatives which are subject to central clearing obligations under EMIR, there are also non-standardized derivative instruments which can be optionally cleared by a CCP.

reversed by entering into a new forward agreement). To illustrate the interest of VaR, we add to this response in an annex a document showing VaR measure versus Gross Leverage. We remain at the disposal of the Commission for any further comment if necessary.

Since the VaR method was introduced, no incident or defaults have been reported on a UCITS using VaR. It should be reminded that in 2006, the French regulator (Autorité des Marchés Financiers) did implement the VaR method in order to improve the valuation for funds where the commitment was not relevant. Also, regulators (ESMA) reinforced the framework of the use of VaR in 2010 via specific stress tests and ex-post control.

It may however be useful to further harmonize the use of VaR (such as models used, history used, standardized stress tests, other parameters) so as to improve the comparability between risks taken by different funds.

For the French market a study (based on responses by large asset managers representing 64% of the AUM of French collective investment schemes) shows that 10% of the AUM uses the VaR method. Approximately 50% of those funds are using derivatives and from those 50%, 20% use the VaR method.

We understand that the obligation to mention an ñindicative level of leverageò for funds using the VaR approach would aim at creating a common indicator of leverage. However, the current leverage measure may, under certain circumstances, show irrelevant figures (ie potentially high level of leverage). As such, it could mislead investors on the type of risks that an investment carries. Therefore, we strongly believe that either the obligation to disclose a leverage level for VaR funds should be removed -as it is irrelevant- or at a minimum that the leverage measurement should be consistent with the commitment approach.

We would therefore be very concerned by any proposal to move to a regime where a leverage test (be it the commitment approach or the òsum of gross notionalsò test) becomes the only available method to calculate global exposure.

In the interest of UCITS investors, we believe that risk managers should retain the flexibility to use the method (VaR or Commitment) they deem the most appropriate for evaluating the global exposure of a specific portfolio. We will however be very interested to engage in a dialogue with regulators to discuss about possible further harmonization and improvements to the currently available methods.

(8) Do you consider that the use of derivatives should be limited to instruments that are traded or would be required to be traded on multilateral platforms in accordance with the

legislative proposal on MiFIR? What would be the consequences for different stakeholders of introducing such an obligation?

As a preliminary remark, we wish to underline that we are not aware of any particular issue in relation to investments by UCITS in OTC derivatives and that we therefore do not see the rationale for the proposed changes by the Commission.

We **fundamentally object to any limitation in the use of derivatives by UCITS**, which, we believe, would be unduly restrictive for the following reasons:

- limiting the scope of eligible derivative instruments to those traded on multilateral platforms would strongly limit the ability for UCITS to mitigate the market risk of their investment. This is due to the fact that derivatives used for hedging purposes must often be specifically modeled in order to account for specificities of a UCITS portfolio;
- trading on multilateral platforms covers only a very limited range of derivatives. Moreover, the scope of central clearing obligations under EMIR which shall determine the extent of multilateral trading of derivatives is, for the time being, far from clear. It must be expected that the market will start with some very standardized products and will only gradually expand to more sophisticated products. It is therefore to be feared that UCITS wouldnot be able to find on multilateral platforms the range of derivative instruments they need to hedge their portfolios against a number of risks or to pursue their investment strategies.

We also wish to take this opportunity to reiterate once again the need to clarify the counterparty limits as defined in Article 52 of the UCITS Directive in order to allow UCITS to make full use of the central clearing arrangements provided by EMIR.

According to that provision, UCITS have a 5% limit on exposures to a single counterparty on OTC derivatives (raised to 10% where the counterparty is a credit institution). However there is an urgent need to clarify how these limits apply in the context of central clearing to CCPs and, in particular, as to who the counterparty is for the purposes of the 5% or 10% limit. We therefore strongly wishclarity to be provided on this issue and that the 5%-10% limit be removed for any exposure to a centrally cleared trade. In the absence of such clarification, the existing counterparty limits under Article 52 are likely act as a brake on UCITS moving to central clearing, therefore preventing UCITS and their investors from benefiting from the risk reduction associated with central clearing.

We are also very concerned about the fact that, as a result of the prohibition from reusing cash obtained through repo or reverse repo transactions for collateralization of other investments (as currently envisaged in the ESMA Guidelines on ETFs and other UCITS issues), UCITS may experience serious difficulties in providing sufficient liquidity as collateral to CCPs. Should this prohibition be maintained, it would also act as brake on UCITS moving to central clearing.

Box 2 ï Efficient Portfolio Management (EPM)

General comments

First, as a matter of principle, we would seek clarifications on the legal form and legislative process for far-reaching rules bringing significant changes for the entire industry and its clients. In particular, the question arises whether these rules can be issued as ESMA guidelines or should rather take the form of a directive or a regulation. AFG welcomes that the Commission is willing to reconsider the ESMA Guidelines on UCITS ETFs and other UCITS issues and contemplates introducing respective provisions in the UCITS legislation.

Secondly, from a procedural point of view, we understand that the ESMA Guidelines could enter into force rapidely entailing important re-organisation by Management Companies and Funds. Any future work by the Commission will by definition have an inherent risk of further re-organisation in a few years. It would therefore be preferable if the application of the ESMA Guidelines could be postponed until an agreement on regulatory standards for UCITS can be found.

(1) ***Please describe the type of transactions 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.***

Transactions that are currently considered as efficient portfolio management techniques include securities lending, repurchase agreements and reverse repurchase agreements. We are of the opinion that these are appropriate transactions to be considered as EPM techniques and see no reason to either extend or reduce the list of EPM techniques currently available to UCITS managers.

(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.***

The publication of the ESMAõs Guidelines raises an important question on the consistency and hierarchy of European regulations as ESMA expresses definitive views on topics which are open for comments in the present consultation initiated by the European Commission.

However, **the risks relating to EPM are properly addressed in ESMAõs Guidelines** through transparency and disclosure requirements, risk control and liquidity management. **This being said, some rules should in our view be revisited** : §29 is unclear and not economically justified if it views fees splitting agreements as unsuitable and § 40-e on diversification, 40-i and j on use and investment of collateral and 42 on stress testing do create real operational concerns particularly with reference to the introduction of EMIR and Dodd Frank Act (DFA).

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

Counterparties involved:
UCITS managers take great care in selecting counterparties involved in EPM transactions.

Volumes, liquidity constraints:
It is very difficult to give an indication on the proportion of a UCITS assets that is typically engaged in EPM techniques as it depends to a great extent on prevailing market conditions, dividend season, quality of assets and client demands.

Revenues and revenue sharing arrangements:
We wish to underline that securities linding is a legitimate activity which benefits investors by reducing costs and contributing to the performance of the fund.

In order to provide securities lending services and to generate incremental returns, significant investments are required (including in research and technology, infrastructure, administration and risk management capabilities to constantly review counterparties and collateral parameters). Those fixed and variable costs are usually borne not only by the securities lending agent but also by the UCITS management company. In order to cover these costs, it is very important that fee-sharing agreements remain admissible not only with external agents involved in the lending activities, but also between the UCITS and its management company.

Revenue sharing agreements express the economical reality of a win-win transaction: the UCITS holders do get extra revenues through securities lending or repo and the intermediary receives an appropriate revenue for its activity on the market and in order to cover its costs to develop such an activity. Splitting agreements whereby margin is shared between fund and asset manager are totally acceptable as long as they are disclosed to the investors.

(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 any information specific to your business.

UCITS have a strict limit on the exposure resulting from derivatives (100% of the assets). Thus EPM techniques are indirectly but strictly limited and there is no need to explore any other route in that respect.

We believe that it would not be in the best interest of investors to prescribe a lower limit as to the proportion of the UCITS portfolio that may, at any given point in time, be the object of EPM techniques. Limiting the proportion of a portfolio that can be lent or otherwise engaged in

EPM techniques would limit the opportunities for UCITS to engage in securities lending transactions and would therefore lead to reduced efficiency.

Provided that risk management processes are robust and ESMAöś Guidelines on Calculation of Global Exposure and Counterparty Risks are applied, establishing a limit at the UCITS portfolio level would be detrimental to the UCITS ability to ensure best pricing and to maximize returns without further mitigating counterparty risks.

(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?***

The current market practice is that securities lending transactions are over-collateralized (indeed in several Member States, over-collateralization is a requirement under national law). Securities on loan and collateral held by the UCITS are being marked-to-market on a daily basis with any fluctuations in value being settled at the same frequency. Also valuation of collateral is calculated daily and margin calls follow when the Minimum Transfer Amount is reached. However, in certain cases a minimum level is in place below which margin calls will not be made.

- ***Does the collateral include assets that would be considered non eligible under the UCITS directive? Does the collateral include assets that are not included in a UCITS fundöś investment policy? If so, to what extent?***

Collateral must comply with the requirements set out in the ESMA Guidelines but is not required to match the UCITSô investment policy.

In this context, we wish to reaffirm our fundamental objections to the proposed principle that there should be a certain degree of correlation between the collateral received and the UCITS portfolio.

We believe that this approach is based on a wrong perception of the role of collateral in the context of EPM techniques. Indeed, it seems to assume that the collateral should be a suitable substitute to the portfolio of assets in loan which, in the case of default of the counterparty, would be directly transferred to the UCITS portfolio. In prevailing market practice, however, the collateral is provided as means of secondary recourse with respect to the entitlement to retransfer of portfolio assets. In case of default, the collateral is immediately liquidated and the proceeds used to acquire new securities matching with the UCITS investment strategy.

For these reasons, the first objective of regulatory requirements should be to ensure that the collateral received by the UCITS is both of a good credit quality and sufficiently liquid so as to warrant the possibility of smooth disposal and adequate pricing.

Accordingly, we do not believe that a correlation of the collateral with the portfolio is either necessary or desirable to protect investors. On the contrary, requiring such a correlation wouldbe detrimental to investors in a number of cases (e.g. a UCITS investing in equities would be prevented from accepting triple-A rated bonds in order to secure claims from EPM transactions).

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

We are not aware that it is a common practice for UCITS to engage in collateral swap transactions.

However, collateral upgrades might become much more relevant for UCITS in the future in order to account for enhanced liquidity needs relating to collateralization of centrally cleared OTC derivatives. Pursuant to ESMA Guidelines on ETFs and other UCITS issues, UCITS could be prohibited from reusing cash acquired through repo or reverse repo transactions for the purpose of collateralizing other obligations. This new requirement would make it very difficult for UCITS to participate in the central clearing of OTC derivatives under EMIR as it must be expected that CCPs will require cash at least to settle the variation margin.

In these circumstances, UCITS might be forced to engage in collateral upgrade transactions (e.g. with the involved broker) to facilitate provision of cash to the CCP. However, such arrangements are not the preferred option from the UCITS perspective because they involve additional fees and potentially create further counterparty risk.

(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?

Criteria on the eligibility, liquidity, diversification and re-use of received collateral have already been defined by the recently-published ESMA Guidelines on UCITS ETFs and other UCITS issues. As said, this ESMA paper raises an important question on consistency and hierarchy of the European regulations as ESMA expresses definitive views on topics which are open for comments in the present consultation initiated by the European Commission.

As suggested in ESMAâs Guidelines, a broad definition of eligible collateral is necessary to avoid liquidity and market impact. It can be efficiently managed with an appropriate haircut policy. Liquidity as defined by ESMA in its Guidelines (§40) is too restrictive since the reference to trading ñon a regulated market or MTFò is not appropriate to include funds and money market instruments in the list of collateral.

Diversification expressed by ESMA by a ratio of 20% of assets as a maximum by issuer should be revisited to allow for higher a ratio on government bonds or covered bonds for example and to take into account the diversity of counterparties.

We think that collateral should not be over regulated, since the risk lies first with the volatility of the underlying transaction, secondly with the counterparty to the transaction and only to a third degree to the quality of the collateral. In that respect stress testing collateral or adding collateral when computing the ratio referred to in article 56-2 of the Directive would not proportionate to the reality of the risk.

As far as re-use is concerned, we also consider that it should not be forbidden, since the real risk essentially stems from the leverage gained from EPM techniques and the excessive exposure it might lead to. As UCITS are strictly limited in that respect, re-use of collateral by UCITS should be authorized. With the implementation of the Dodd Frank Act and EMIR and the requirement for full collateralization of derivative transactions, funds should be authorized to use collateral received to post their own collateral in order to fulfill their obligations and avoid shortage on eligible collateral, all the more as the collateral will be traceable at any time.

This being said, we also think that cash collateral and non-cash collateral received under EPM transactions should be specifically authorized to be posted as initial margin and variation margins under EMIR for cleared and uncleared transactions.

(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 EPM? If you are an asset manager, please provide also information specific to your business.

Haircut is a very efficient way to protect investors and to adapt to the evolution of market conditions. But haircut is not a matter for regulatory measures, as it is a fine tuning instrument that needs flexibility to be efficient. Therefore, AFG objects to an imposition of mandatory haircuts on received collateral, as this approach lacks the necessary flexibility to take into account the fluctuations and evolutions in the market.

Instead, AFG supports the approach taken by ESMA following which ña UCITS should have in place a clear haircut policy adapted for each class of assets received as collateral. When devising the haircut policy, a UCITS should take into account the characteristics of the assets such as the credit standing of the price volatility, (é). This policy should be documented and should justify each decision to apply a specific haircut, or to refrain from applying any haircut to a certain class of assetsò (paragraph 43 of ESMA Guidelines on UCITS ETFs and other UCITS issues).

(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 ñrecallableò at any time? What would be the consequences of making all EPM transactions recallable at any time?

We note that this question is already addressed to a large extent by the recently published ESMA Guidelines and also that ESMA has further consulted specifically on the question of recallability of repo and reverse repo arrangements before finalizing its Guidelines in this area.

When entering into EPM arrangements, a UCITS should certainly take into account liquidity considerations in such a manner as to ensure that such arrangements does not compromise its ability to meet its redemption obligations in accordance with Article 84 of UCITS Directive.

However, we believe such an objective can be achieved without imposing a requirement that EPM transactions must be órecallable at any timeö.

We also believe that a distinction ought to be made in this respect. Indeed, whereas securities lending transactions can usually be terminated at any time, the repo market, on the contrary, is dominated by fixed-term contracts. This fixed-term nature is binding for both parties to the transaction and allows UCITS to use repo and reverse repo proceeds for the purposes of effective portfolio management.

Should there be a requirement that all repo and reverse repo arrangements must be recallable at any time, the unfortunate consequence would be that all repos other than overnight repos would de facto be forbidden for UCITS, which would have a damaging effect on the returns from such activities with no benefit from an investorös protection perspective.

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

Yes, we think that EPM transactions should be treated according to their economic substance. In fact, they are already treated that way.

This pertains in particular to securities lending and repo transactions being taken into account in the calculation of the counterparty risk limits under the UCITS Directive. In addition, assets obtained through reverse repo are submitted to the general rules on issuer concentration applicable to the UCITS portfolio because they impact the overall exposure of a fund.

(10) What is the current market practice regarding collateral provided by UCITS through EPM transactions? More specifically, is the EPM counterparty allowed to reuse the assets provided by a UCITS as collateral? If so, to what extent?

Regarding securities lending, UCITS are allowed to act only as the lending party[3] and hence are not required to provide collateral.

As regards repo and reverse repo transactions, the proceeds from such arrangements have not been regarded as collateral up to now, as there is a complete transfer of property of cash on one side and securities or monetary market instruments on the other. Each counterparty is authorized to use its property as long as it keeps its engagement to return it when due. In some situations, it is favorable to allow its counterparty to use or re-use the collateral it posted. It is for instance the case of a back to back transactions whereby the counterparty of the fund returns its position to

[3] Article 83(1) of Directive 2009/65/EC

reduce or suppress its market risk and is required to post collateral with its new counterparty. We feel that the economic substance fully justifies the use or re-use of the collateral that was posted.

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

From the perspective of UCITS investorsô protection, we do not see the need to define such criteria.

If deemed necessary for other reasons, such criteria should definitely not form part of the UCITS regime. Moreover, any measures to be potentially addressed at relevant counterparties such as banks should not restrict the ability of a UCITS to provide assets eligible as collateral out of its investment portfolio.

(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?

As far as UCITS are concerned, we wish to underline that this objective of transparency is already largely achieved through the existing disclosure and reporting obligations provided for in the UCITS Directive as well as in the recently-published ESMA Guidelines.

In particular, paragraph 25 of these Guidelines, which we fully support, provides that: ñA UCITS should inform its investors clearly in the prospectus of its intention to use the techniques referred to in Article 51(2) of the UCITS Directive and Article 11 of the Eligible Assets Directive. This should include a detailed description of the risks involved in these activities, including counterparty risk and potential conflicts of interest, and the impact they will have on the performance of the UCITS. The use of these techniques and instruments should be in line with the best interests of the UCITS.ò

Box 3 ï OTC Derivatives

(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?

AFG members are of the opinion that counterparty risk relating to OTC derivative transactions will be appropriately addressed by the EMIR regime. Under this set of rules, UCITS are deemed financial counterparties and, consequently, are subject to the entire EMIR provisions including central clearing obligation.

Having regard to the purpose of EMIR, which is precisely the elimination of risk for OTC derivatives, we are thus of the opinion that the exposure to either a CCP or an intermediating clearing member should not be taken into account when calculating counterparty limits under Article 52(1) of the UCITS Directive. Otherwise, the existing counterparty limits may inhibit UCITS transition to central clearing, thus preventing UCITS investors from taking benefit from reduction of counterparty risk effectuated by the CCP model.

Commission Recommendation 2004/383/EC (27th April 2004) Para 5.1 states the following with regards to limitations of counterparty risk exposure of OTC derivatives:
ñMember States are recommended to ensure that all the derivatives transactions which are deemed to be free of counterparty risk are performed on an exchange where the clearing house meets the following conditions: it is backed by an appropriate performance guarantee, and is characterized by daily mark ï to market valuation of the derivative positions and an at least daily marginingò. To this end, we support the view expressed recently by the Head of Commissionôs Asset Management Unit that centrally cleared swaps are not the type of OTC derivatives which UCITS rules on counterparty exposure intend to capture.

Finally, we would like to remind the European Commission that, in this consultation like in the recently closed BCBS/IOSCO consultation on margining for bilateral transaction, investment funds should not be forced to post initial margins.

AFG is of the opinion that non-prudentially regulated financial counterparties (NPFRC, e.g. pension schemes, insurance vehicles and regulated collective investment schemes as defined in the Joint Discussion Paper on Draft Regulatory Technical Standards on risk mitigation techniques for OTC derivatives not cleared by a CCP) that are not systemically important and pose little or no systemic risk should not be required to post and collect Initial Margins (IM).

In this context, we would like to draw the Commissionôs attention to the fact that the collateralization of cleared and non-cleared OTC derivatives by investment funds is completely different from that by credit institutions since investment funds have to comply with investment fund regulation and contractual restrictions. In addition, the provision of initial margin is likely to affect returns for such counterparties and as their positions will generally be directional, netting of exposures will rarely be available. By contrast, credit institutions providing services to clients have multiple exposures which are likely to net off.

(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 point of view of AFG members is that the regulatory requirements applicable to collateral should be consistent for both categories of transactions.

A consistent approach on collateral should facilitate the operational management of the collateral. However, this consistency should not be too strict and should reflect the difference in nature (purpose, usual duration, legal entity counterparty, legal agreement terms or marketôs operational practices) of transactions requiring maintenance of sufficient flexibility to allow for the most appropriate risk management practices given the particular transaction/structure/counterparty combination.

These collateral requirements should be that such collateral should be sufficiently liquid so that it can be sold quickly at a price that is close to its pre-sale valuation and must at all time meet with the following criteria:

(a) Liquidity: collateral must be sufficiently liquid so that it can be sold quickly at a robust price that is close to its pre-sale valuation;

(b) Valuation: collateral must be capable of being valued on at least a daily basis and must be marked to market daily;

(c) Issuer credit quality: where the collateral issuer is not a high quality issuer, conservative haircuts should be applied;

(d) Safe-keeping: collateral should be transferred to the custodian or its agent;

(e) Enforceable: collateral must be immediately available to the UCITS, without recourse to the counterparty, in the event of a default by that entity.

Additionally, and to support liquidity in investment funds, especially in the perspective of EMIR requirements, AFG is strongly in favour of the possibility to reuse proceeds acquired through repos and reverse repos transactions under an adequate credit risk policy.

(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?*

Counterparty risk is strongly regulated under the UCITS framework, with a maximum counterparty risk (per counterparty) limited to 10% of the fundôs NAV.

AFG strongly believes that there is no additional operational or other risks in case of UCITS contracting with a single counterparty.

On the other hand, contracting with a single counterparty can be a way to limit operational risk and in some instances best execution may lead to contracting with a single counterparty in the best interest of unit holders. It is the case, in particular, for OTC derivatives.

Additionally and despite it may be prudent to use multiple CCPs to reduce reliance on a single entity, it may not always be possible. Even if prudential management of clearing arrangements could entail the appointment of a ôback upô clearing member for end users accessing the CCP indirectly (in case of the default of the primary clearing member) this may not always be an option for any given asset class and jurisdiction. Currently for instance, there is only one CCP (LCH Swap Clear) capable of clearing Internal Revenue SErvices (IRS) for indirect clients.

For other types of investment vehicle, we are of the opinion that there might be some risks in contracting with a single counterparty as concentration ratio might not be as closely monitored as they are for UCITS funds.

Given that the counterparty risk must be reduced to a maximum of 10% by the provision of appropriate collateral, proper management of collateral assets in such UCITS is of particular importance. The measures that may be used to mitigate those risks include:

(a) posting of collateral;

(b) appropriate disclosure of the use of single counterparties to investors and what this practically means from an exposure viewpoint.

From an operational perspective, however, collateral management in case of one counterparty is certainly easier to handle than cases where several counterparties are involved, especially having regard to the new ESMA requirements on collateral diversification .

On the other hand, in certain cases it may be prudent for asset managers to maintain several counterparties of high quality from a credit worthiness, as well as market and operational capability standpoint ready for trading to support portability of transactions.

From a best execution perspective though, having high single counterparty risk concentration would need to be reflected with an appropriate best execution policy.

Nonetheless, enhancements of transparency standards would be welcome in order to further improve investor protection. If contracting with a single counterparty is part of a UCITSô investment policy, this could be disclosed in the prospectus together with general information on the applicable collateral policy and possibly the liquidation process of collateral. Further details on exposure to the counterparty and collateral received should be included in the annual report in accordance with the ESMA Guidelines on ETFs and other UCITS issues.

Operational and collateral efficiency require the utilization of a limited (or single) CCP in each asset class and duly selected counterparties for bilateral transactions. Requiring excessive diversification would increase exposure through the loss of netting benefits, the increase of risks (mostly operational) as well as impacting returns.

(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.

It is already current market practice to calculate counterparty risk and issuer concentration limits on a daily basis for most fundsôtypes.

Specifically, exposure is calculated net of the market value of collateral received from (or posted to) a legal entity counterparty and netting is applied as contractually allowed per governing legal agreements. We believe it is best practice for OTC transactions to have these calculations and valuations made on a daily basis.

The funds that have other valuation frequency have a prospectus, approved by the relevant authorities, and are duly reflecting this different frequency. For example, a fund with a weekly valuation should have its collateral valued on a weekly basis.

(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?

From AFG membersô experience, the current market practice is to to calculate counterparty risk on a daily basis as frequently as possible and as long as the prospectus foresees it. The vast majority of our members already implement a calculation process for counterparty risk and issuer concentration, which ensures daily governance.

As it is the case for daily asset/contract valuation, from a risk management perspective, the standard should be for daily counterparty risk and issuer concentration calculations. This would increase market transparency as well as risk oversight on the overall financial system. Issuer concentration should be monitored at each valuation point by the investment manager of the fund. Daily counterparty exposure calculation would provide for a significant degree of transparency and active management of counterparty risk, allowing for the increased risk mitigation/reduction actions (e.g., diversification, hedging, margining) to be taken as deemed appropriate.

Please also refer to our answer to the question 4 above in this Box

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

AFG membersô experiences are that in case of UCITS investments in transferable securities, daily valuations should not pose any problems.

For assets with less frequent valuations, the last available quotation should be considered. Alternatively, valuation models could be used in order to facilitate calculation of the relevant limits. Derivatives and collateral should be valued on a daily basis.

AFG members are of the opinion that, although a single vehicle may become illiquid, market figures do not as they are frequently updated.

Different alternative models could be used to derive valuation of portfolios with less frequent valuation, e.g. use of stale prices (any breache resulting from this model should be considered as passive and realignment with the guidelines should take place on the valuation time of the assets) or use a model that would approximate pricing and risk measures daily with reference to some kind of proxy data which updates daily (this could be used for certain holdings of externally managed funds which only price monthly - e.g. for segregated portfolios, or limited exposures in non UCITS funds) - by applying ñdriftedò prices according to mid-month moves of an appropriate benchmark index or proxy.

Box 4 ï Extraordinary Liquidity Management Tools

General comments

As a preliminary observation, we think it is important to bear in mind that UCITS are already subject to state-of-the-art requirements in terms of liquidity risk management, which have been further enhanced with the entry into force of the UCITS IV Directive. UCITS managers are required to employ an appropriate liquidity risk management process in order to ensure that the funds they manage are able to meet redemption requests from investors. This liquidity risk management process forms part of the permanent risk management function that UCITS investment management companies must establish and which must be functionally and hierarchically independent from other departments within the management company. Managers are required to measure at any time the risks to which the fund is or might be exposed, including the risk of massive and unexpected redemptions.

Should the Commission see the need for additional regulatory action in this area, due account should then be taken of the currently existing liquidity management requirements to which UCITS managers are already subject today.

Against this background, we wish to underline that we support to a large extent the recently published principles set out in the IOSCO Consultation Report on Principles of Liquidity Management for Collective Investment Schemes, which we believe, reflect the best practice already in application in the UCITS industry.

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

As already highlighted in our general remarks above, UCITS management companies already have a liquidity risk management process in place to monitor liquidity constraints and to ensure that the fund is able at all time to meet redemption requests from investors in line with the redemption policy for that fund laid down in the prospectus.

UCITS will usually put in place risk warnings, in respect of each fund, in order to monitor and to highlight where appropriate material changes in liquidity (cash positions and equivalents such as holding of liquidity funds), taking into account the nature of the relevant fund.

As example, part of this liquidity management process would be that directors of the asset management company seek for additional reporting in the event of liquidity issues: e.g. where the UCITSô investments are of a less liquid nature and/or are more difficult to price. In that case directors will liaise closely with the portfolio manager, risk manager and the administrator of the UCITS in order to assess and manage the implications of the issue.

Internal liquidity policies based on the typology of the portfolios are implemented and regularly controlled. Eligible assets for each category are selected on the basis of their liquidity. For example: WAL is the criterion applied for Money Market Funds; liquidation price and the time needed to liquidate the position for bond portfolios; for equity portfolios as well the time needed to liquidate the position.

In exceptional circumstances where ï despite the liquidity management process in place ï a UCITS would temporarily be unable to meet the redemption requests from investors, the fund manager still has the ability to temporarily suspend redemptions in the interest of its unit holders (as foreseen in Article 84 of the UCITS Directive). This is an important protection tool for investors. This possibility of temporary suspension of redemptions is, however, only envisaged as a last resort measure and used with the greatest caution and for the shortest possible period of time by UCITS managers.

(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?*

A common framework as part of a UCITS Directive for dealing with liquidity bottlenecks in exceptional cases might be useful. This would be in line with the philosophy of the brand giving clarity and establishing confidence among investors. It would show that appropriate measures could be implemented to safeguard interests of all shareholders (outgoing and remaining ones). The objective is to mitigate the risk and size of asset fire sales owing to simultaneously large redemption requests from investors.
Should the Commission seeks for such framework, it should then be developed in order to keep the UCITS managers flexibility to deal with liquidity bottlenecks using the most appropriate tools, in the best interest of investors.

(3) *What would be the criteria needed to define the ñexceptional caseò referred to in Article 84(2)? Should the decision be based on quantitative and/or qualitative criteria? Should the occurrence of ñexceptional casesò be left to the managerôs self-assessment and/or should this be assessed by the competent authorities? Please give an indicative list of criteria.*

Criteria could include elements such as abnormal slump / disappearance in trading volume or unusual frequency of large market price gaps across too many securities highlighting the absence of liquidity. Exceptional cases may arise as the result of highly varying situations. They could also include market meltdown, acts of God, outbreak of war / civil insurrection, terrorism, breakdown in physical / IT infrastructure, capital controls, currency non-convertibilityé

As it would be by definition an unexpected situation we believe it would be very difficult to define all the relevant cases.

Managers in such situations are best placed to evaluate the occurrence of exceptional cases in light of market experience. As experienced with the French authorities, in case of a temporary suspension of redemptions, a close collaboration with the AMF (Autorité des Marchés Financiers) has been put in place.

(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.***

We do not believe that strict time limits would actually be useful given that there already is a strong incentive for UCITS managers to keep the suspension period shortest as possible in order to avoid reputational damages and to provide the best possible service to clients.

It is important to bear in mind that the situation which led to a temporary suspension may be outside the UCITSĉs control (e.g. liquid assets suddenly become illiquid for a long period of time) and a requirement to liquidate a UCITS would clearly not be to the benefit of the investors in the UCITS. Indeed, in certain situations, imposing time limits might even work to the detriment of the investors as it would trigger a forced liquidation of the fund at fire sale prices.

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

The possibility for an asset manager to suspend redemptions is a sufficient instrument to deal with extraordinary cases of illiquid markets - knowing that UCITS as a rule invest in liquid assets.

Regarding deferred redemption, recourse to thresholds and time limits might ensure better fairness between different investors in some situations. The thresholds and time limits concerned should carry relevance in terms of the nature of investments (financial / real assets) and the level of risk involved.

We think it can also be an option to have a quantitative thresholds and time limits in place, as they can be useful to protect equality and fairness between investors. This option should be at the hand of management companies. In particular, a clear explanation on how investors are impacted and how their orders will be processed should be disclosed. In such cases, redemption orders should be taken into account on an equal basis for all the pending orders so as to avoid any incentive for the first to run out.

AFG considers gates to be an option. In that case, two ways should be considered to proceed with redemptions not fully served: either the orders are automatically transferred to the following redemption day or they have to be renewed by the unit holder. Both methods have advantages and drawbacks and it seems wise to leave it open for the asset manager to bear the responsibility of the choice. In any case, a clear explanation on how investors are impacted and how their orders will be processed should be disclosed.

(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 investorsô interests are protected? Please evaluate benefits and costs for all the stakeholders involved.

Side pockets have been authorized under exceptional circumstances by national regulators in the past for UCITS. That is why we think it is an option which should be changed in the UCITS framework.

Side pockets proved to be an effective way to give some liquidity to investors and to freeze only what is illiquid. It is efficient also as a protection for the remaining holders. It should not be considered as a regular tool to regulate liquidity of UCITS and as such should not be provided for in the prospectus. It would be useful to include in the regulatory framework the possibility to create side pockets and to manage them with a view to liquidate their holdings.

As well as the exceptional suspension of redemptions, the possibility of side pockets should be authorized by law and practical application should rely on an agreement with national supervisor and complete information of unit holders.

(7) Do you see a need for liquidity safeguards in ETF secondary markets? Should the ETF provider be directly involved in providing liquidity to secondary market investors? What would be the consequences for all the stakeholders involved? Do you see any other alternative?

We do believe that is essential to ensure the availability of liquidity for ETF investors and fully recognize that the right for UCITS ETFs unit-holders to redeem their shares at any time is a fundamental tenet of UCITS products.

ESMAǿs Guidelines on ETF and other UCITS issues address this issue with the sufficient level of flexibility in their § 23. They affirm the principle and leave it to the fund to organize. Therefore investors in UCITS ETFs, like in any UCITS, should be allowed to redeem directly from the fund, at NAV.

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

We do not see the need for additional rules for execution or redemtion orders in normal circumstances.

Box 5 - Depositary passport

General comments

AFG acknowledges the benefits that a depositary passport would entail and supports the introduction of a UCITS depositary passport in principle.

However, we believe that such an introduction should not occur before the role and responsibilities of UCITS depositaries have been **effectively** harmonised, implemented and enforced in practice in Member States and assessed only afterwards by the EU Commission and ESMA (level 4).

In addition, even before national transpositions can happen, the new UCITS level 1 rules aiming at reinforcing and harmonising the role and responsibilities of UCITS depositaries remain to be adopted. They will have to be followed by the drafting and adoption of level 2 and level 3 rules.

The new UCITS level 1 proposed rules are largely based on the AIFMD provisions. The level 2 AIFMD rules are also at this stage ñwork in progressò ï we are still waiting for their publication. It is therefore very difficult to anticipate the content of the UCITS level 2 measures.

The revised package will then have to be transposed and implemented by the different Member States. We therefore believe that, at this stage, the effective harmonisation of the role and responsibilities of UCITS depositaries has not occurred yet.

It is therefore too early to support the introduction of a UCITS depositary passport. Indeed, if a problem occurred in one Member State because of its lenient transposition or **enforcement** of the rules on the role and responsibilities of the depositary, it would impact the European industry as a whole. The reputational damage would be very hard to repair afterwards.

In addition, even the AIFMD does not provide for a depositary passport. It might therefore seem untimely to introduce a depositary passport for UCITS, as the UCITS Directive aims at protecting retail investors, who should benefit from a higher level of protection than professional investors, targeted by the AIFMD. In particular, it would be difficult for such retail investors to go to court in other Member States, knowing that national laws prevailing there might be different from the laws which are applied in their own Member State.

*

Detailed comments

Please find below AFG detailed comments on box 5 (page 11 of the European Commissionôs consultation paper).

(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 é), the fund (costs, cross border activity, enforcement of its rights é),

the competent authorities (supervisory effectiveness and complexity é), and the investor (level of investor protection)?

We think that, when considering the relevance of a UCITS depositary passport, obviously the first criterion to be taken into account must be retail investor protection.

From an industry perspective, there are both potential advantages and drawbacks.

On the one hand, a depositary passport would enlarge the choice of depositaries offered to funds or management companies acting on behalf of funds. Funds could therefore pick the offer best suited to their needs and would certainly benefit from a higher degree of competition among depositaries hopefully the level of fees. Investors might in turn benefit from reduced depositary costs. In addition of potential lower depositary fees and economies of scale, a depositary passport would allow a better country coverage in terms of sub-custody.

On the other hand, a depositary passport, if introduced before the role and responsibilities of UCITS depositaries have effectively been harmonised and **enforced** at national level in the same way everywhere in the EU, could be harmful to both the reputation of the whole European industry and most importantly to investors, if afterwards a wrong transposition or enforcement generates a scandal on a UCITS. In other words, **an implemented and fully assessed harmonisation of the status, role and liability regime of UCITS depositary must be an unconditional pre-requisite for a depositary passport.**

In addition, with a depositary passport, it would be very difficult for retail investors to go to court in other Member States. Indeed, national laws, including bankruptcy rules and securities law, and legal systems prevailing in the Member State where the depositary is located might be different from those of their own Member State and might be less protective. Investors, in particular retail ones, should benefit from a high level of protection and the depositary is key to such protection. Having the fund, the management company and the depositary potentially in three different countries may lead to difficult application of conflict of law rules and/or differences in interpretation in case of litigation. It would also make supervision more complex and would require a higher level of cooperation among the regulators involved.

Moreover, there is a risk that a foreign depositary might not correctly understand/apply local regulation and/or regulatory requirements and that the supervision may not be correctly implemented. There might also be potential mismatches between the market practices/accounting rules applicable to a foreign depositary and the fund auditor.

In conclusion, from an investor protection perspective, **it is not at all clear whether the advantages will outweigh the disadvantages of introducing a depositary before a pan-European assessment on the even implementation and enforcement of UCITS V is carried out.**

(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 regulatory requirement that the depositary and the fund need to be located in the same Member State reduces the range of entities that the fund or the management company on behalf of the fund can choose from. **In theory**, a fund might find a better or cheaper depositary in another Member State.

However, the introduction of a depositary passport should not occur before the role and responsibilities of UCITS depositaries are effectively harmonised. At this stage, the revised UCITS V package is still to be finalised, transposed, implemented and enforced in practice in the same way in all Member States. In other words, this prerequisite condition is not fulfilled yet; **as a consequence we believe that it is still too early to envisage the introduction of a UCITS depositary passport**.

In addition, the AIFMD does not provide for an AIF depositary passport. It might therefore seem untimely to introduce a depositary passport for UCITS, as these funds mainly aim at retail investors, who should benefit from a higher level of protection than professional investors. It would therefore make little sense to introduce a depositary passport for UCITS before a depositary passport has been tested with AIFs.

(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 depositariesé)?

The current revision of the UCITS Directive aims at reinforcing and harmonising the role and responsibilities of UCITS depositaries. However, further harmonisation might be useful, for instance regarding eligible entities. AFG believes that they should be limited to credit institutions and MIFID firms and supports the Commissionõs UCITS V proposal in this respect.

Depositaries will be faced with different national regulations, for example on the calculation of NAV or relating to the validation of the UCITSô prospectus and KIID. It will have to be ensured that they are fully competent to deal with the specificities of the Member States where the UCITS they service are domiciled.

Supervision will of course be another area that will have to be harmonised: the rules applying to depositaries should be implemented and enforced in a consistent manner throughout the EU.

But in any case **it is too soon to envisage the introduction of a UCITS depositary passport** for the reasons described above.

(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?

As explained previously, before thinking about the need for a specific authorisation regime for depositaries, the EU Commission and ESMA will have to assess enforcement in practice of the depositary provisions of the UCITS Directive once all Member States have transposed the forthcoming UCITS V Directive.

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

We think that a lot of issues remain to be addressed, as long as all provisions directly or indirectly related to depositaries have not been fully harmonised at EU level, such as national securities laws. In addition, the issue of identical enforcement of EU legislation at local level remains crucial and will have to be assessed by the Commission and ESMA (level 4) before any legislative initiative by the Commission on depositary passport.

Box 6 to 9 ï Money Market Funds

<u>General remarks</u>

AFG is fully supportive of the objectives pursued by the European Commission and other international bodies such as the Financial Stability Board (FSB) and IOSCO to identify and close any regulatory gaps as well as inefficiencies in the supervision of the financial sector in general, with a view to mitigating systemic risks and reducing the possibilities of regulatory arbitrage. French money market funds industry **agrees** with the last report published by IOSCO on the 9th of October. In that context, AFG is curently working to a ñCode of practiceò for money market funds (MMFs). This Code will provide money market fundsô managers and clients with criteria applying to the management of a VNAV French money market funds.

AFG believes that MMFs went through significant reforms that strengthened their resilience, such as the CESR/ESMA Guidelines on a common definition of European MMFs. Hence, at this stage, the reform of MMFs should focus on the fund's internal liquidity risk, and in particular require MMFs to comply with certain liquidity requirements (e.g. a minimum amount of a fund's portfolio should mature within one day and within five business days) and to take into account investor concentration and segments, industry sectors and instruments, and market liquidity positions.

In addition, AFG would welcome precisions on the valuation of the fund and would support the limitation of the application of the linear methodology to maturities below 3 months, as it is the case for all other types of funds.

AFG members consider MMFs, like any other categories of UCITS, are subject to potential downside valuation. UCITS are in line with clientôs expectations. Clients are now familiar with the CESR/ESMA Guidelines for MMFs. We therefore believe that it is not necessary to set up a separate framework for MMFs.

Box 6 - Money Market Funds

(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.

MMFs are instruments that provide investors with daily liquidity and asset diversification. Investors get a diversified short-duration exposure which they otherwise could not get due to minimum investment amounts of securities.

MMFs allow corporate treasurers and other institutional investors to manage deposit credit risk through diversification, thereby avoiding the risk associated with the concentration of deposits in a few select banks and the absence of unlimited deposit guarantee schemes. MMFs can also be used as an outsourcing tool as regards the analysis of credit and counterparty risks, as they are managed by professional and specialist asset management teams.

The alternatives to MMFs are fiduciary deposits, repurchase agreements, and direct holdings of short-term debt instruments. For retail investors, the only feasible alternative are structured products or bank deposits, both of which exhibit highly concentrated counterparty risk.

As buy-side entities, MMFs contribute to the demand for securities issued by companies, offering them the possibility to diversify their financing from bank loans. The same applies to governments and financial institutions. In this way, MMFs constitute a keyfunding for the real economy. The fund industry plays a key role in the management of long-term savings and pension schemes for the benefit of millions of European citizens. Regarding MMFs, they have also a strategic role as they contribute to the efficiency of money markets and to the short-term financing of the economy (i.e. banks, corporates and sovereigns). They provide an intermediation service between lenders and borrowers in the short-term debt markets.

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

MMFs are broadly used by retail and institutional investors as an efficient way to achieve diversified cash management. At the end of 2011, MMF shares/units were held by Euro area investors as follows: households (EUR 169 billion), non-financial corporations (EUR 146 billion), insurance corporations and pension funds (EUR 87 billion), and other sectors (EUR 169 billion).

The French MMF industry represents ú 347,6 billion as of end of December 2011, that is about one third of overall French funds. In Europe, the French industry represents a third of MMFs. French MMFs are owned for more than 75% by institutional investors and non-financial companies. Retail investors account for about 9%.

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

MMFs invest in all types of short term instruments: commercial papers, treasury bills, floating rate notes, short term bonds, repos, fiduciary deposits. Types of issuers are banks, financials, corporate issuers, sovereigns, agencies, supranational.

The ECB data shows that MMFs held 2.7% of all debt securities issued by Euro area nonfinancial sectors at end 2011, and 5.4% of all debt securities issued by Euro area credit institutions.

In France, asset managers are key holders of local issues on certificates of deposit and commercial papers. With around 156 billion of French money market instruments held by money market funds, and for the sake of risk diversification, these funds hold in their portfolios some 131 billion euros of additional money market instruments issued on foreign markets.

Average MMFs allocation would be: money market instruments about 65%, short term bonds 20%, and reverse repo/deposit account for 15%. The average by type of issuers would be: financial institutions 70% of the portfolio, corporate 10%, and government/supra national agencies 20%.

(4) To what extent do MMFs engage in transactions such as repo and securities lending? What proportion of these transactions is open-ended and can be recalled at any time, and what proportion is fixed-term? What assets do MMFs accept as collateral in these transactions? Is the collateral marked-to-market daily and how often are margin calls made? Do MMFs engage in collateral swap (collateral upgrade/downgrade) trades on a fixed-term basis?

Repos are used by MMFs to invest cash over very short periods of time. Such repos involve a short-dated maturity and are fully collateralized. In addition to the fact that repos are short-dated, they very often allow both parties to terminate the transaction early (within 24 or 48 hours), which is a positive feature for MMFs. In France, bilateral repo is commonly used. On the other hand, securities lending is unusual for MMFs.

The securities taken as collateral are also usually of high quality and liquid. That means that cash collateral agreements (which can also be called ñmargining arrangementsò) can be implemented so as to take into account variations in the market value of the collateral, if any. It is important to point out that collateral attached to the repo transaction implies that, all other things being equal, repos are less risky than other collateral-free financial instruments such as direct buying of debt securities.

The key is the adequacy of the investment risk management process to ensure sufficient liquidity in the fund. Ideally, collateral should be marked to market daily and should trigger daily margin calls when necessary, as is often done for other types of operations (FX swaps, OIS swapsé), but this may increase the operation cost and reduce its attractiveness, thus weighing on global repo volume. However, the threshold level triggering calls may help reducing this administrative cost.

(5) Do you agree that MMFs, individually or collectively, may represent a source of systemic risk ('runs' by investors, contagion, etcé) due to their central role in the short term funding market? Please explain.

MMFs did not cause the financial crisis, but were caught up in it

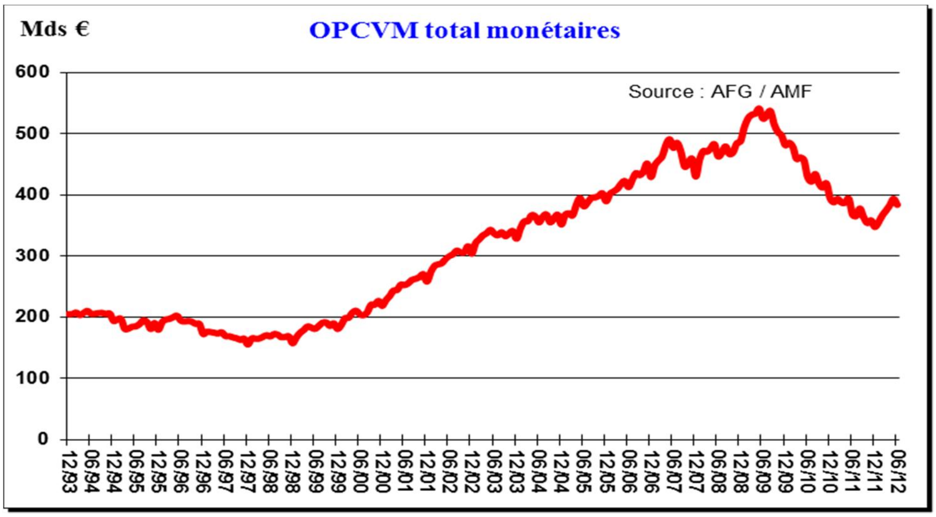
MMFs did not cause the financial crisis. Rather, and as is well documented, an extended period of easy credit caused the financial system as a whole to become over-leveraged, culminating in a series of headline events in September 2008, and a crisis of confidence in the financial system in general, and the banking system in particular.

In 2007, the financial crisis caused strains among MMFs in Europe after the outbreak of the subprime crisis. Investorsô concerns reflected the fact that a small number of ñcash-enhancedò funds (that were not wlissified as MMFs)had purchased asset-backed securities to boost their returns. The difficulties experienced by these non MMFs funds created confusion for investors about the definition, classification and risk characteristics of MMFs.

In 2008, Euro area domiciled MMFs experienced net outflows only in the third quarter when the market for short-term credit ceased to function following the Lehman bankruptcy. It was not the case for the French market of VNAV, where assets were growing as investors were looking for safe investments benefiting to very short term funds, some of which invested in governement T-bills.

This trend continued during the first half of 2009 because of the negative performance of the equity markets. Assets under management went thus back to the previous end of the year level on the second half of the year due to lower interest rates return.

In 2010-2011, investors reduced significantly their holdings of MMFs, mainly because of the competition from banks, particularly in Continental Europe, which actively encouraged their clients to reallocate their portfolios out of MMFs to deposits in order to strengthen their balance sheets. The steepening of the yield curve, with money market yields moving to unprecedented lows, also had an impact on the attractiveness of MMFs as an investment vehicle. There is no evidence, however, that investors redeemed pre-emptively from their funds to be on the side of caution. What is certain is that MMFs were able to cope with the withdrawals without being forced to sell securities at fire-sale prices.



The role of MMFs in the short term funding market

We agree that MMFs are important providers of short-term funding to financial institutions, businesses and governments. However, the importance of this role and of the risks associated with the link of MMFs to the short-term markets should not be overestimated as MMFs have not reached a systemic size in Europe.

Monetary data from the European Central Bank (ECB) show that MMFsô balance sheets represent 4% of the balance sheets of Monetary Financial Institutions (MFIs) in the euro area, with credit institutions (banks) accounting for the remaining 96%. This statistic confirms that bank deposits are the principle vehicle used by retail investors in Europe to manage their cash and MMFs play a very modest role in credit intermediation in Europe. This is largely due to the fact that European financial system is bank-dominated.

MMFs are entities that are not exposed to a level of risks similar to banks

The liquidity transformation performed by MMFs is of an order of magnitude significantly less than that performed by banks, and is subject to tight controls.

Under ñnormalò market conditions a MMF has daily liquidity as do the short-term debt instruments it invests into. As such, no liquidity transformation takes place and no liquidity mismatch occurs. It is worth noting that this is also true for a MMF with daily liquidity even where its duration exceeds one day because the underlying securities have daily liquidity as well. Only if the securities the fund is invested into no longer have daily liquidity, for example due to an abnormal market situation, and the fund maintains its daily liquidity to its investors (especially to those redeeming shares), is there a liquidity mismatch. Such a case can be addressed by liquidity risk management (as already established under UCITS IV) and where the situation does not improve, by a (temporary) suspension of redemption (also possible under UCITS).

The asset/liability maturity mismatch of MMFs is very limited and the credit quality of their portfolio is high. MMFs do not make loans but instead invest only in very short-term, high quality, marketable debt instruments.

MMFs are highly-regulated institutions

The vast majority of MMFs are UCITS. This means that their managers must, amongst other things, employ a risk management process that enables them to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.[4] For a MMF, this includes a prudent approach to the management of currency, credit, interest rate, liquidity risk and a proactive stress-testing regime. In addition, managers of MMFs must have appropriate expertise and experience in managing these types of funds.

It should also be noted that the implementation of the new CESR/ESMA Guidelines, which took effect in July 2011, represents a **major and decisive** step towards greater transparency and increased clarity. The Guidelines propose two MMF subcategories: ñshort-term MMFsò and ñMMFsò. They also provide a robust framework to limit the main risks to which MMFs are exposed, i.e. interest rate risk, credit/credit spread risk and liquidity risk.

In practice, the requirements of the CESR/ESMA Guidelines and the UCITS Directive oblige MMF managers to keep high-quality and liquid portfolios to avoid running into liquidity difficulties.

The CESR/ESMA Guidelines also require managers of MMFs to draw investorsô attention to the difference between MMFs and bank deposits. Enhancing investor awareness about the exact nature of MMFs will strengthen MMFsô resilience in crises.

(6) Do you see a need for more detailed and harmonised regulation on MMFs at the EU level? If yes, should it be part of the UCITS Directive, of the AIFM Directive, of both Directives or a separate and self-standing instrument? Do you believe that EU rules on MMF should apply to all funds that are marketed as MMF or fall within the European Central Bank's definition?

AFG considers that it would be best to stay away from a new self-standing piece of legislation to avoid the propagation of a large number of separate directives covering different segments of the investment fund industry.

[4] See Article 51 of the UCITS Directive.

ESMA (previously CESR) accomplished a very good job in defining rules for MMFs and short-term-MMFs. Even if most MMFs are UCITS in Europe, some are not and must nevertheless comply with ESMAôs requirements to be labelled as MMFs. The present architecture of the regulation seems appropriate. It is confusing to use the label MMF for funds that are not compliant with ESMAôs rules and it is the case for MMF established under the regulation of third countries. Therefore, in our view, it is not relevent to introduce provisions concerning MMFs in the UCITS Directive.

The EU rules on MMFs should apply to all funds that are marketed as MMFs. No fund should be allowed to use the ñMMFò label if it does not comply with all the EU rules on MMFs.

(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?

AFG is in favour of maintaining a two-tier approach based on ñshort-term MMFsò and ñMMFsò as defined by the CESR/ESMA Guidelines in 2010. The main advantage of a two-tier system is to give the choice which is very appreciated by investors .

Box 7 - Valuation and Capital

(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.

From a commercial point of view, there is a major difference between CNAV and VNAV funds in the way they are perceived. CNAV are understood to be deposit like instruments with a stability of the value that refers to the accounting of a deposit. VNAV MMFs are understood to be investment schemes and therefore to have as such possibility of market impact, as risk is inherent to all funds including MMFs. This is the way MMFs are marketed in France for example, where CNAV have not been authorised.

(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 reform of MMFs should focus on the fund's internal liquidity risk, and in particular require MMFs to comply with certain liquidity requirements and to know their clients by takeing into account client investor concentration and client segments, industry sectors and instruments, and market liquidity positions.

Clients of MMFs funds are looking for daily liquidity. Therefore, in our view, it would be more in line with the philosophy of a money market fund to limit the application of the amortization method to maturities below 3 months. This option already in place for French asset management industry gives the advantage to both sides -clients and asset managers - of being in line with the market.

In case amortization would be limited to maturities below 3 months, there should be a transitory period in order to avoid any negative impact in the market. For instance, in France, portfolios experienced such a reform in 2002/2003 where the market principle was clarified. Positions with more than 3 months maturity could no longer be subject to amortization. In order to smooth any market impact following this decision, asset managers benefited from a 1 year and a half transition period to adjust their portfolios.

AFG Code of practice for money market funds will aim to define all those criteria aiming to a more liquid and transparent money market product.

(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?

For MMFs, like for any other investment vehicle, risk is supported by holders/subscribers. It should also be taken into account that there is no leverage in MMFs. Therefore, there is no need for capital requirements.

We do not retain in any case this option as appropriate for VNAV funds.

(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?

AFG is strongly in favor of the mark-to-market methodology. However, as some money market instruments might be difficult to price, because the market trades OTC or when market prices are not available at the very short end of the yield curve, it is important to allow MMFs to use a marked-to-model method like for other type of funds.

In case of a ñstressed marked conditionsò (large bid/ask spread), the common practice for VNAV is to adopt a more conservative valuation using bid instead of mid price. This allows all redemptions but also is favourable for new subscriptions in the fund.

As previously said, AFG will set up a ñCode of practiceò for money market funds applicable to the French industry. As it is also required by IOSCO, AFG will aim to define the specific context for issues (i.e. lack of valuation, liquidity,é) for which it will be possible to the use a marked to model methodology.

Box 8 - Liquidity and redemptions

(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?

Given that French MMFs are UCITS, their managers must, amongst other thing, employ a risk management process that enables them to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.

There has not been any major shock on the liquidity of MMFs, especially VNAV MMFs, even in the recent tense periods. Therefore, we consider that the current regulation is adequate to avoid liquidity problems on VNAV.

In addition, considering that the UCITS framework is available for money market funds like other funds, improvement on the UCITS global framework as proposed in the Box 4 Liquidity, would also benefit to the UCITS MMFs.

(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?

Liquidity fees do not apply to VNAV MMFs as they are valued on market prices. They also have the option to move to bid pricing in stressed markets in order to protect non-redeeming investors.

Generally, we are not in favor of redemption ñrestrictionsò (in a strict sense) for MMFs. Redemption restrictions are a very useful and appropriate tool for intrinsic illiquid strategies where the fund has already distant redemption windows (hedge funds for instance). MMFs are intrinsic liquid strategies and apart a complete dry out of liquidity (where in any case a fund cannot substitute itself to the market), there is always potential to pay for redemptions (and of course those who need liquidity pay the price of liquidity as the NAV mirrors the market pricing).

We firmly believe that VNAVs through their mark-to-market pricing already place the price of the needed liquidity by redeemers on those redeemers.

(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?

Considering that the UCITS framework is available for money market funds like other funds, improvement on the UCITS global framework as proposed in the Box 4 Liquidity, would also benefit to the UCITS MMFs.

There is no need for measures specific to MMFs.

(4) Do you consider that adding liquidity constraints (overnight and weekly maturing securities) would be useful? How should such a mechanism work and what would be the proposed proportion of the assets that would have to comply with these constraints? What would be the consequences, including in terms of investors' confidence?

We agree that MMFs should hold a certain percentage of their assets in cash or securities accessible very quickly, to be able to meet redemptions without incurring losses that could affect the remaining shareholders. The introduction of mandatory portfolio liquidity requirements, i.e. minimum holdings of assets held in assets that would be accessible within one day and within one week are necessary. Those are the type of criteria that the French industry of MMFs will write down in its ñCode of practiceò.

We set up in France a minimum overnight ratio of 10% and a weekly minimum ratio of 15% (i.e. 5% from 2 to 7 days). These ratios include only very liquid and immediate settlement product like: reverse repo, deposit, money market instruments. Such criteria should be adapted in the case of dedicated funds in accordance with the expectations of the clients.

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

AFG position is that liquidity fees are not applicable for VNAV, redemption restrictions are already covered by the UCITS Directive whereas liquidity constraints should be imposed to both CNAV and VNAV funds.

(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?

AFG believes that CESR/ESMA Guidelines provide a robust framework to limit the main risks to which MMFs are exposed, i.e. interest rate risk, credit/credit spread risk and liquidity risk. Specifically, the reduction in the WAM to no more than 60 days for short-term MMFs and 180 days for MMFs, limits the overall sensitivity of the fundsô NAV to changing interest rates. The reduction of the WAL to less than 120 days for short-term MMFs and less than 397 days for MMFs, limits credit and credit spread risk.

Box 9 - Investment criteria and rating

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

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

We would like to reiterate AFGôs general position that supports regulatorsô efforts to reduce over-reliance on rating agencies, relating to both requirements for ratings of instruments in the fund and ratings of the fund itself.

Rating is a commercial activity and nothing should prevent credit rating agencies from offering their services if they are approved of by investors or/and issuers. However, rating of MMFs should not be expressed on the same scale as issuance ratings in order to avoid misinterpretations.

Some clients, mainly international firms, have included ratings as a criterion to select investments and apply it to MMFs. They should be taught that rating does not prevent them from developing an proper appreciation of risk.

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

We fully support the recent European Commissionôs proposals[5] that aim at reducing the risks of over-reliance of fund managers on credit ratings and introduce a requirement for the managers not to solely or systematically rely on external credit ratings for assessing the creditworthiness of a fundôs assets.

External credit ratings may be used as one factor among others in this process but should not prevail.

In this context, we strongly believe that the mandatory use of credit rating agencies to determine whether or not a MMF may invest in a money market instrument should be reconsidered as the significance of the ratings of credit rating agencies in CESRôs Guidelines on MMFs is thus overstated.

What matters is management companies to employ a risk-management process which enables them to monitor and assess the credit quality of the money market instruments they invest in, within a framework that should not be limited *a priori* by the rating of credit rating agencies. In carrying out its due diligence, the management company should be able to overwrite the credit rating of an instrument if it can conclude that the instrument is of high quality, taking into account a range of factors such as the liquidity profile and the nature of the asset class represented by the instrument.

Against this background, we are in favour that ESMA deletes paragraph 4 in Box 2 and paragraph 1 in Box 3 of the CESR´s Guidelines which stipulates that a money market instrument is not of a high quality if it has not been awarded one of the two highest available short-term credit ratings by each recognized credit rating agency that has rated the instrument.

This decision would also allow another major problem raised by the Guidelines and the ESMA Q&A to be addressed, in relation to the requirement that the MMF management company must check the short-term credit ratings awarded by each recognized rating agency that has rated an

[5] See proposal for a Directive of the European Parliament and of the council amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to UCITS and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of the excessive reliance on credit ratings and proposal for a regulation amending Regulation (EC) No 1060/2009 on credit rating agencies.

instrument to determine if the instrument is of high quality. As there are already 28 credit rating agencies registered with ESMA ï a number that is likely to increase in the future - we strongly believe that this is unworkable for compliance and economic reasons.

Finally, we would also draw attention to an additional problem raised by ratings which concerns the lack of flexibility of the rating agencies in the case of an issuerôs downgrade and its pro-cyclical herding behavior, particularly on the downside.

We would like to remind that ratings are often used in the reportings of the portfolio to do a synthetic presentation. This is a way for clients to compare one MMF to another. But it is not the only element of comparison. In our opinion, rating is only a piece of information to be provided to the client on the allocation type of the portfolio.

(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.

Many factors can be used internally to assess the quality of an issuer or a specific paper:

- Fundamentals: regulatory and economic environment, management and corporate strategy, balance sheet dynamics, earnings previsionsé .
- Technicals: supply/demand, Central Bank eligibility, Commercial Paper program size, back up lines, public issue/private placement, FRN/asset swapsé
- Relative value: sector peers, similar maturities, instrument type comparisoné

AFG members have always been concerned by the fact that it is necessary to describe the investment process to clients. Adding transparency makes clients more comfortable with the investment strategy and as a consequence managers experience less runs in case of stressed conditions. The asset management company has to make sure all departments involved (front office, compliance, risk, salesé) do it that way like for other UCITS funds.

Box 10 ï Long Term Investments

General comments

AFG welcomes the Commission proposal to create an appropriated framework for Long-Term Investments.

Indeed AFG is already actively working on the possibility to develop such an appropriate framework for adapting new financing needs with clientôs expectations. One of the lessons of the crisis is that both investors and issuers are looking for less volatile investment schemes.

One of the results of the crisis is that investors are increasingly looking for what they perceive as safe and liquid investments, a tendency that is reinforced by regulators who have pushed for an increased ñtransparencyò on risks (see for example the recent risk/reward metrics in the UCITS KIID) and have discouraged less liquid products. They have also strongly reinforced capital adequacy rules of banks, insurance companies and potentially pension schemes.

These moves have their logic but their side-effects are very detrimental to the proper financing of the European economy, especially in an era of deleveraging, as they discourage long term savings, especially in shares (the risk metric for stocks UCITS in the KIID is almost always 7!)

This is why it would be really important that long-term savings/investments could in the future find an appropriate space in the European funds regulation including ï with appropriate transparency- in the UCITS framework with a retail passport. It would permit the European asset/fund management industry to play, for the benefit of its clients, an even stronger role in the financing of growth and employment in Europe.

(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?

We do believe that there is an appetite, from retail investors to invest in long-term assets as a way for them to diversify their portfolio and, in particular in the current turbulent market conditions, to gain exposure to new asset classes such as infrastructure, real-estate and commodities that are less correlated to financial markets.

As the Commission rightly notes in the Consultation Paper, investing in less liquid assets also implies a number of constraints in the sense that such products usually require a certain level of minimum initial and on-going subscriptions, sufficiently long lock in periods due to the investment types, low liquidity and challenges with valuation.

An element to be taken into consideration is that the appetite of retail investors to invest in long-term assets is largely dependent on the sufficient attractiveness of the applicable product design. As an illustration of this, the experience of our members shows that retail investors are usually not interested in investments that provide no exit possibilities for several years unless they obtain significant advantages in return (such as associated tax benefits, state allowances or the inclusion in some form of pension savings schemes, for instance).

From a fund managersô perspective, there certainly is a wish to develop funds that enable retail investors to seek long-term outcomes in pursuit of their individual goals. Fund managers do have an appetite to invest in long-term assets in the interest of retail investors, as part of a well-diversified and risk-reward adjusted investment portfolio.

(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?

As already mentioned in our general remarks above, we would welcome the creation of a common EU framework for investment funds investing in less liquid long-term assets, which would include an EU passport.

Generally speaking, we advocate against an inflation of new directives or regulation covering investment funds and would have a strong preference for having as many products as possible covered by the already existing directives (i.e. UCITS and AIFMD).

AFG considers that the Long Term Investments framework should not be caught in the AIFMD directive, which is designed for institutional investors and does not provide a retail passport, but also because it is not conceived as a product regulation either.

We would suggest the Long Term investment framework to be incorporated in the UCITS framework retail clients are now familiar with. But, in order to preserve the image of the brand, the introduction of a new clearly distinct long term UCI (UCILT) chapter into the UCITS Directive would be necessary. The new chapter would take into account the specificities of long-term investments funds by replacing when necessary those UCITS rules that do not fit with long-term types of assets (eligible assets, borrowing powers, valuation and redemption requirements) and by otherwise deferring as much as possible to the UCITS rules on e.g. governance, organization, depositary duties and obligations, etc. This approach would ensure that long-term investments funds benefit from many of the well-recognized UCITS rules and would provide an efficient way to achieve cross-border distribution to the retail market. This would also allow Member States to transpose the new regime into already existing national law, without being forced to start from scratch.

It is true that it can be argued that there would be a risk to create confusion among retail investors and weaken the UCITS brand which is recognized as a quality label by regulators and investors worldwide. A very distinct set of rules within UCITS applying to Long-Term UCITS (UCILT) would placate most of these fears but a new directive very near the UCITS directive could also be studied.

There are different arguments to take into account when considering whether this new framework should be developed as a new category of funds within the existing UCITS framework or if it would be more appropriate to develop a new quasi stand-alone framework, specifically dedicated to retail investment funds investing in long-term assets, copy-pasting much of the UCITS directive and incorporating specific rules on eligible assets, valuation, etc... This is indeed a complex issue which would probably require further analysis, given that each option has a number of advantages and drawbacks.

We believe in any case that those funds should explicitly be carved out from the AIFMD: they would not be AIF and marketing to retail investors would not happen under Article 43 of the AIFMD but under the new regime specifically developed for them.

(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.*

Generally speaking, we agree with the list of possible eligible assets suggested by the Commission although it would probably require some clarifications/further refinements (e.g. the inclusion of ñunlisted companiesò as an eligible investment potentially results in almost any types of holdings through a company possible).

In this context, we also believe that it would be important to ensure sufficient flexibility in the determination of the eligible assets in order to react swiftly to potential new financing needs of the real economy as for example adding loans in a larger proportion. We would therefore recommend following the UCITS approach, whereby only broad categories of eligible assets are defined in the level 1 Directive, subsequent details being provided through technical standards to be developed by ESMA.

Furthermore, investments in less liquid assets such as financial instruments or bank deposits should be possible in order to allow for proper liquidity management

(4) *Should a secondary market for the assets be ensured? Should minimum liquidity constraints be introduced?*

We understand the reference to a ñsecondary market for the assetsò to be related to the need to provide investors in longer-term investment funds with redemption opportunities.

Given the fact that a retail investor personal situation and/or financial position may change over time due to unforeseen circumstances requiring the disposal of certain financial in short order, it may be appropriate to build in some form of extraordinary specific early redemption facility for such investors. Indeed, the principle of a secondary market should not be compulsory for all eligible assets.

In order to increase the attractiveness of such products to retail investors, we would also recommend permitting at least semi-open funds structures enabling investors to redeem their units at regular intervals.

Liquidity is the major point to be investigated as some current practice would have to be adapted to a long term view. A daily or even monthly evaluation of a long-term investment is as confusing both for the investor and the manager. Other long-term assets, such as the general assets of an insurance company, are evaluated once a year without preventing its liquidity.

The long-term value of the portfolio should be therefore stabilized, without jeopardizing the principle of liquidity, by moving away from the erratic variations of the markets.

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

We believe it is impossible to give a single answer to that question.

In practice, the proportion of a portfolio allocated to longer-term or less liquid investments would depend upon the fundôs investment objectives and the liquidity that it offers to its retail investors. The closer the objective and the more liquid the terms offered to shareholders, the lower the allocation to long-term or less liquid investments.

We believe the proportion of long-term assets in the portfolio should be aligned with the product structure in line with the principle enshrined by Article 16(2) AIFMD. Accordingly, entirely closed-ended funds investment in illiquid assets could account for up to 100% of the portfolio. Semi-open ended funds, on the other hand, would require a certain proportion of more liquid assets in order to maintain their capability of redeeming fund units at certain intervals or to deal with extraordinary early redemptions as referred to in our answer to question 4 above.

(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.

As a general rule, diversification is an essential feature of fund investments and is of particular relevance in the case of open-ended funds.

In relation to closed-ended funds, it could be envisaged to allow products focusing on single investments such as a specific infrastructure or energy projects with high financing needs. In that case, however, additional safeguards should apply at the distribution level in order to ensure appropriate investor protection. Such safeguards could comprise a general requirement for investment advice with strict suitability standards or particular conditions for qualification of investors.

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

The use of financial derivatives instruments in longer-term investment funds should not be banned considering that these instruments may be very useful to mitigate certain investment risks, such as currency risks, for instance, in the best interest of investors. In addition, the new frame work could also fit for long term structured funds which are based on the use of derivatives.

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

In order to ensure the most efficient functioning of longer-term or less liquid investments in the best interest of all the shareholders, it may be sensible to allow for a prescribed minimum investment period prior to allowing redemptions and to allow redemptions to be limited on an on-going basis.

As already mentioned in our answer to question 4 above, it would be required to define certain parameters around allowable circumstances which may allow earlier redemption by an investor, without unduly negatively impacting the other investors and also allowing the fund manager to efficiently carry out the investment mandate to the best of its ability.

(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?

Yes, as already mentioned in our answer to question 2, we believe that an EU framework for longer-term investment funds should be framed alongside the investor protection principles of the UCITS directive, while taking into account the specificities of investments in real or other illiquid assets, and should facilitate EU-wide marketing (via an EU passport) and management of this new fund type.

The UCITS framework contains, among other, provisions relating to risk management, organizational rules and internal audit that are fit for purpose. Also inherent are the fact that UCITS must maintain on-going risk management procedures and continued evolutions of requirements in relation to stress tests, back-testing systems, reporting to competent authorities and disclosure of information to investors through the KIID, prospectus and periodic reports.

(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?

In order to facilitate fund-of-funds structures providing enhanced diversification to retail investors, we would see benefits in allowing funds established under the new framework to hold units of target funds investing in unlisted companies or other longer-term or less liquid assets, including those EuSEF and EVCF which have chosen to benefit from the protection of a depositary, a very necessary feature of retail funds.

Box 11 ï UCITS IV improvements

(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.

- **Self-managed investment companies**

The UCITS Directive does not extend to self-managed investment companies the organisational and conflict of interest rules (through level 2 measures) applying to asset management companies through a reference to article 12 (there is no reference to article 31).

In France, these level 2 measures already apply to investment companies. Please see below article 411-1 of the RGMAF:

« *3° Lorsque la SICAV ne délègue pas globalement la gestion de son portefeuille telle que mentionnée à lôarticle L. 214-7 du code monétaire et financier, elle doit remplir lôensemble des conditions applicables aux sociétés de gestion et exécuter les obligations applicables à ces sociétés*. »

We believe that such an amendment of the UCITS Directive would be relevant, provided that it includes some derogations relating to initial capital and applies the proportionality principle.

- **Master ï feeder structures**

The UCITS Directive provides for a specific information regime in cases whereby a UCITS becomes a feeder fund or changes master funds, i.e. investors should be notified 30 days before the event and should not be charged any redemption fee. We support the Commissionôs proposal to extend this procedure to cases whereby a feeder UCITS becomes a ñstand aloneò UCITS.

We would like to propose applying a ñlook throughò approach for UCITS that invest in a feeder whose master is itself a UCITS. Indeed, by definition, a feeder invests more than 10% of its portfolio in its master. However, we believe that UCITS should be allowed to invest in a feeder of a master provided that the master complies with the UCITS Directive.
In other words, such feeders should be considered as assets eligible to the portfolios of UCITS.

- **Fund mergers**

We believe that the inconsistency in the UCITS Directive regarding the delays relating to the authorisation of cross border mergers should be solved.

The UCITS Directive provides that, in case of a cross border merger, the competent authority of the merging fund has a 20 working day delay to authorize the merger. Within this delay, the competent authority of the merging fund has to send the merger file to the competent authority of the receiving fund. The latter authority may ask for additional information for the attention of the investors in the receiving fund. Such request should be made within 15 working day of receiving the file initially provided by the competent authority of the merging fund. The competent authority of the receiving fund would then have a 20 working day delay to approve the additional information. Such a delay makes it impossible to comply with the global 20 working day delay allowed for the authorization of the merger.

In our opinion, it is not necessary to allow a 15 working day delay for the competent authority of the receiving fund to react on the additional information received for the attention of investors in the receiving fund, as the interests of the investors in the receiving fund are not impacted as much as those of the investors in the merging fund.

We therefore suggest allowing a 6 working day delay for the competent authority of the receiving fund to request information for the attention of investors in the receiving fund, starting from reception of the initial merger file. Additionally, we propose allowing a further 6 working day delay for the competent authority of the receiving fund to give its opinion. In case it does not give any negative opinion within this 6 day delay, its opinion shall be assumed positive. Any negative opinion shall be communicated to the competent authority of the merging fund and to the merging fund itself.

On the topic of cross border mergers, we would like to share an additional comment with the Commission. Indeed, we believe that the tax regime applying to cross border mergers should be revised in order to ensure the efficient implementation of the UCITS Directive. For instance, it may be worth referring to the common system of taxation applicable to cross border reorganization of companies in the EU.

- **Notification procedure**

The UCITS Directive provides that notifications should be made electronically from regulator to regulator. However, it also provides that information on any subsequent change relating to the distribution of the UCITS has to be made by the UCITS in writing directly to the host regulator before the relevant change is implemented.

We support the Commissionôs proposal that such information to the regulator should be made electronically through a European harmonised process.

We also support the Commissionôs proposal that information on a share class is limited to share classes marketed in a host Member State.

The Commission also considers that information on a subsequent change to the initial notification file (including marketing rules and statutory rules) should be provided by the home regulator to the host regulator.

As a general principle, we believe that the regulator to regulator notification procedure should apply over the whole life of the UCITS and not only to the initial registration of the fund.

On the topic of notifications, AFG would like to share an additional comment with the Commission. The UCITS IV Directive aimed at streamlining the notification process; however, the implementation of such ñproduct passportò is still not fully harmonised among the different Member States, which may add some specific requirements on the distribution of UCITS on their national territory. For example, marketing documents are currently not standardised at EU level and require host regulator approval. More generally, harmonising marketing rules would reduce legal uncertainty and in turn improve the efficient implementation of UCITS IV.

(2) Regarding point 5, do you consider that further alignment is needed in order to improve consistency of rules in the European asset management sector? If yes, which areas in the UCITS framework should be further harmonised so as to improve consistency between the AIFM Directive and the UCITS Directive? Please give details and the possible attached benefits and costs.

First and foremost, we would like to raise the Commissonôs attention on the fact that, at the time of drafting this response, the level 2 measures of the AIFMD are not available yet. We would therefore highlight that our comments are made subject to the content of the AIFMD level 2 measures. We believe that a full and proper cost benefit analysis should be made before the AIFMD rules are extended to UCITS.

- **Organisational rules**

We believe that aligning the UCITS Directive on the AIFMD in respect of organisational rules would make sense, considering that some management companies may manage both UCITS and AIFs.

- **Delegation**

The debate on delegations in the AIMFD level 2 rules is still ongoing at the time of writing. We therefore are not in a position to make any comment on this topic.

- **Risk and liquidity management rules**

In our opinion, the specific nature of AIFs justifies specific risk and liquidity management rules. However, these rules are neither necessary nor proportionate for UCITS as UCITS assets are mainly traded on regulated and liquid markets.

- **Valuation**

We are of the opinion that the specific nature of the assets in the AIFsô portfolios justifies specific valuation rules (e.g. external valuer). However, these rules are not relevant for UCITS for the reasons mentioned above: valuation of UCITS assets, negotiated on regulated and liquid markets, do not imply the same issues as the valuation of AIF assets.

- **Reporting**

As far as we know the current reporting applicable to UCITS has proven appropriate. UCITS are not systemically relevant and should not be subject to the same reporting rules as AIFs.

- **Calculation of leverage**

We believe that the burden of calculating the leverage in accordance with the AIFMD rules would not be proportional to the amount of leverage used by UCITS ï which is limited to 2. Therefore we think that an alignment of the UCITS rules on the AIMFD rules in that respect would not be relevant.

(3) Additional comments on UCITS IV improvements

AFG would like to share additional suggestions on UCITS IV improvements, most of which have already been submitted to the Commission in the form of a ñwish listò.

- **The obligation to contribute to the guarantee fund should only apply to management companies that are allowed to hold securities**

Article 12.2 letter b of the directive requires management companies to participate to an investor compensation scheme. However, such an obligation does not seem to make sense for companies that are prohibited by their national law to hold the assets of their clients, especially as the account holders (ñteneurs de compteò) of these assets are already under the obligation to participate to such a scheme. As a consequence, the UCITS directive imposes a **duplicated participation** that relates to the same assets. The obligation to participate to an investor compensation scheme should therefore only apply to management companies that do hold their clientsô assets. Furthermore, European legislation already exists on the loss of assets by depositaries and on insurance and capital requirements applying to asset management companies. Therefore, regulators should ensure that UCITS V does not provide for inconsistent or duplicated requirements.

- **Funds of funds need to be defined at European level**

Some definitions are still missing in the UCITS IV directive, which lead to its provisions being interpreted in different ways by the national authorities of the Member States. For instance, the concept of ñfund of fundsò is not precisely defined at European level and needs to be clarified in order to ensure a higher level of harmonisation throughout the EU. The absence of a definition at European level has led to concrete issues, such as inconsistencies impacting the KIID.

Indeed, the KIID introduced by the UCITS IV directive sets specific obligations (in particular relating to the disclosure of charges) for funds that invest a ñsignificantò portion of their assets in underlying UCITS. This might therefore lead to an inconsistent disclosure in the different Member States of the investment policy of the fund or of the charges, as they might have a different understanding of what a ñsignificant portionò is. As a consequence, investors are not in a position to compare the KIIDs of funds of funds domiciled in different Member States.

- **The wording of the UCITS Directive should be improved**

  - **The wording of article 50 should be aligned with that of MiFID and clarified**

The definition of a number of concepts should be updated in line with MIFID. For example, MIFID uses the concepts of ñfinancial instrumentsò and ñregulated marketsò while the UCITS directive (article 50.1.b) still refers to ñtransferable securitiesò, ñorganised marketsò and ñother regulated marketsò. It would therefore be useful to ensure a smooth articulation between the two pieces of legislation, as such inconsistency creates difficulties of interpretation which for example impact the investment rules and the reporting of securities in the UCITS annual report.

Additionally, the notion of eligible foreign markets used in article 50.1. c) should be clarified. Only third country markets that are explicitly approved by regulators may be eligible. This provision should be reworded the other way round in order to authorise all markets except those that are prohibited.

  - **Translation issues should be solved**

The French version should be amended as per the English text i.e. only **naked** short selling should be banned. Indeed, such incorrect translation creates legal uncertainty and does not allow a full harmonisation of the implementation of the rules in the EU.

  - **The wording of Articles 52 and 53 should be clarified**

The wording of these articles (on the risk spreading ratio) is confusing because it uses alternately the words « issuing body » or « body » and it is difficult to ascertain whether they refer to « groups ». This is particularly confusing for the implementation of article 53 on funds whose investment policy is to replicate the composition of a certain stock or debt securities index.

  - **Clarification of Article 51.2**

AFG requests to add units or shares of collective investment undertakings to the list of instruments referred to in Article 51.2. Indeed, Article 51.2: ñMember States may authorise UCITS to employ techniques and instruments relating to transferable securities and money market instruments under the conditions and within the limits which they lay down provided that such techniques and instruments are used for the purpose of efficient portfolio managementò.

  - **Clarification of Article 50.1.e.iii (30% ratio)**

Article 50.1.e.iii has been interpreted in different ways by the Member States due to lack of precision on the object of the ñasset segregationò. We therefore propose to re-word this provision as follows: ñasset segregation **in the depositaryôs books**ò in order to ensure a more harmonised implementation of this provision throughout the EU.

- **UCITS management companies should be authorised to perform the activity of reception and transmission of orders**

The scope of activities allowed for UCITS management companies should include the possibility of ñreception and transmission of orders in relation to one or more financial instrumentsò. As AIFMs may be allowed to provide for such reception and transmission of orders (article 6 paragraph 4 of the AIFMD), we donôt see why UCITS Management Companies could not be allowed to provide for the same service ï otherwise, it would not ensure a level playing field between the two types of management companies.

- **Introduction of provisions to accommodate FATCA and Dodd Frank Act**

    - **FATCA**

According to the Internal Revenue Services (IRS) notice n° 2011-34 relating to FATCA, a fund could be deemed to meet the FATCA requirements if it meets the three requirements, amongst which the fund prohibits the subscription for or acquisition of any interests in the fund by certain persons (e.g recalcitrant US persons). However funds applying this prohibition may be considered as non harmonised CIU. Therefore, we wish the Directive to include a provision allowing the refusal to sell shares or units of UCITS to US persons for FATCA purposes.

    - **Dodd Frank Act**

The Dodd Frank Act provides for an exemption for foreign private advisers based in particular on the number of US persons that invest in the funds they manage. As a consequence, in case UCITS managers wish to benefit from that exemption, they may have to force some redemptions upon US persons.

However, the UCITS Directive does not explicitly offer the possibility to select investors before they subscribe or exclude them once they have subscribed into the fund. Indeed, it only provides that UCITS are offered to the public (article 3) and that shares or units are redeemed or repurchased upon the request of investors (article 84).

These provisions are not interpreted in the same way throughout the EU and they are not implemented in a harmonised way throughout the EU. It seems that some Member States allow for excluding certain investors once they have subscribed into a UCITS.

We would therefore greatly appreciate an explicit clarification in the UCITS Directive confirming that the forced redemptions mentioned above are consistent with the Directive.

If you need any further information, please donôt hesitate to contact myself, at +33.1.44.94.94.29 (p.bollon@afg.asso.fr) or Eric Pagniez at +33.1.44.94.94.06 (e.pagniez@afg.asso.fr).

Sincerely yours,

Pierre BOLLON

ANNEX to Box 1 Question 7 - VaR measure and Gross leverage

The goal of this note is to analyse the relationship between Value-at-Risk as defined by the UCITS IV directive and Gross leverage. More leverage doesnât always mean more risk, and the use of derivatives, for the purpose of hedging, can significantly reduce risk exposure. We illustrate this statement by using, as global measure of risk, *Historical VaR with a 99% confidence level and a time horizon of one month.*

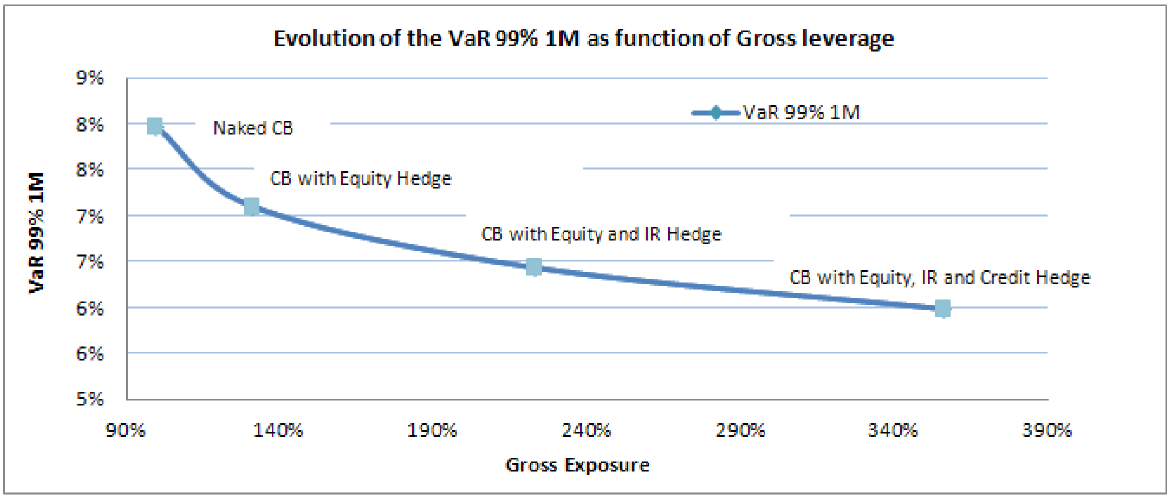
Our approach:

The first step is to consider a convertible bond which has significant sensitivities to three risk factors:

- Equity risk (delta greater than 30%)
- Interest rate risk (duration greater than 3)
- Issuer spread risk

We compute VaR (99% confidence level, 1 month horizon) on this single convertible bond.
Secondly, we hedge in a stepwise way the above mentioned risk factors (equity risk, then equity and interest rate risk, and so on). At each step, we compute VaR measure (as defined above) and Gross leverage.

The table and graph below show the relation between VaR and Gross leverage when derivatives are used as hedging instruments:



Portfolios	***Gross leverage***	***VaR 99% 1M***
Convertible Bond (CB)	*100.0%*	*8.0%*
Convertible Bond with Equity Hedge	*131.4%*	*7.1%*
Convertible Bond with Equity and Interest rate Hedge	*223.1%*	*6.4%*
Convertible Bond with Equity, Interest rate and Credit Hedge	*356.5%*	*6.0%*

Thus we can see that more leverage doesnât always mean more risk, and the use of derivatives, for the purpose of hedging, can significantly reduce risk exposure.