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Swedish Authorities' Response to the Consultation on Undertakings for Collective Investment in Transferable Securities (UCITS) - Product Rules, Liquidity Management, Depositary, Money Market Funds, Long-term Investments

The Swedish Ministry of Finance, Finansinspektionen (the Swedish Financial Supervisory Authority), and Sveriges Riksbank welcome the opportunity to comment on the consultation on UCITS, and more specific product rules, liquidity management, depositary, money market funds, and long-term investments.

Comments and answers to particular questions are provided with reference to the enumeration and particular question in the consultation. If a question or topic has not been commented or answered, that should not be taken to constitute our approval or dismissal.

Capitalised terms and abbreviations used in the Consultation will have the same meaning when used in this response. When used herein, 'we' should be taken to mean the common view of the Ministry of Finance, Finansinspektionen, and Sveriges Riksbank.

General

We welcome and support the Commission's work in this important matter. The regulation of UCITS is an important issue with regard to protection of consumers within the EU and the economic well-being of the EU as a whole, and carries with it complex regulatory questions. Therefore we would like to stress the need for thorough analyses of the consequences of any proposed legislation in this area. The principle of proportionality must at all times be adhered to. Also, as investment funds are global, it is important that legislative initiatives are internationally consistent.

The financial crisis has shown that the legislation concerning investment funds is not only important from a consumer protection perspective but also from a financial stability perspective. In our view,

two of the most important financial stability issues relating to these products are just partly addressed in the consultation.

First, some UCITS may currently give the impression to the investor that there is no downside risk. Second, the difference between UCITS and non-UCITS funds/related products, such as exchange traded notes (ETNs) may be unclear for some investors. These shortcomings may, for example, create "runs" by investors and cause large costs for the financial institutions due to "reputational risk". In our view, this is not fully dealt with in the consultation but needs to be considered further as it may have implications for financial stability.

Box 1 (Eligible assets and use of derivatives)

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

Currently we see no need to review the scope of assets and exposures that are deemed eligible for a UCITS fund. There are detailed rules in place in the current UCITS legislation, which were subject to recent revisions. In addition, potential problems from a stability perspective such as banks' reliance of funding from synthetic exchange traded funds (ETFs) and total return swaps should be addressed in banking regulation, i.e., CRR/CRD, and not in UCITS legislation.

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

Overall we believe that most investment strategies currently observed in the marketplace are in line with investors' expectations. However, there are a number of risks that materialize rarely that may be unexpected from an investor's perspective. One such risk is the counterparty risk in relation to the use of derivative instruments. Investors may not be aware of that a UCITS fund uses such instruments. In adverse circumstances, as counterparty risk materializes, this could create "runs" by investors. Also, it could lead to large costs for financial institutions due to "reputational risk" in the event that the counterparty defaults. While the use of such instruments by UCITS funds are important for their risk management it is important that they are handled in a way that minimize the risks, for example, by using central counterparties.

(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.

In article 84.1 of the UCITS-directive, it is stated that a UCITS shall repurchase or redeem its units *at the request* of any unit holder. From this rule on redemption in the directive it should be apparent for fund managers as well as supervisors that the liquidity of eligible assets for a UCITS should be equally high. We do not see a need to develop rules on the liquidity of eligible assets.

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

No, we don't believe that a further distinguishing or limiting of the scope of eligible derivatives is necessary. There are already safeguards in place with higher requirements on risk management systems when a UCITS uses complex or exotic derivatives.

(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?

OTC-derivatives are used mainly to reduce costs and risks in UCITS. Which derivatives that will be obliged to be traded on multilateral platforms (MTF's and OTF's) is still unclear as MiFIR is not finalized. A narrow list of these derivatives could make it more difficult for UCITS to use, for example, FX derivatives to reduce the foreign exchange risk. In addition, there are already safeguards in place for the treatment of OTC-derivatives. Therefore, we do not support introducing such an obligation at this stage.

Box 2 (Efficient Portfolio Management techniques (EPM))

(1) Please describe the type of transaction and instruments that are currently considered as EPM techniques. Please describe the type of transactions and instruments that, in your view, should be considered as EPM techniques.

According to CESR Guidelines (ref CESR/07-044) techniques and instruments related to transferable securities and money market instruments include, but are not limited to, financial collateral arrangements, repurchase agreements, guarantees received, and securities lending. EPM techniques are addressed in ESMA's Guidelines on ETF's and other UCITS issues (henceforth ESMA GL), where also reversed repurchase agreements are included. The ESMA GL should be the basis for further work and legislation on these issues. We have not identified any other transactions and instruments that should be considered as EPM techniques.

(2) Do you consider there is a specific need to further address issues or risks related to the use of EPM techniques? If yes, please describe the issues you consider merit attention and the appropriate way of addressing such issues.

Risks related to the use of EPM techniques are addressed in ESMA's GL. In ESMA's GL there are rules on the management of collateral when a UCITS enters into financial derivative transactions and uses efficient portfolio management techniques. All assets received by UCITS used to reduce counterparty risk exposure should comply with criteria laid down in paragraph 40 of ESMA's GL. It is also stated that non-cash collateral received should not be sold, reinvested, or pledged. A UCITS that receives collateral for at least 30 percent of its assets should have an appropriate stress testing policy in place to ensure that regular stress tests are carried out, according to paragraph 42. A UCITS should have a clear haircut policy in place adapted for each class of assets received as collateral (paragraph 43).

We welcome the approach in the ESMA's guidelines on EPM techniques and think that these guidelines should be the basis for further work in this area by the Commission.

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

For Swedish UCITS, securities lending is fairly frequent whereas repos are used to a lesser degree. All revenues from EPM transactions should be returned to the fund. This principle is stated in ESMA GL. A Swedish UCITS fund may not lend out financial instruments (securities lending) to an extent greater than the equivalent of 20 per cent of the fund's net asset value. Securities loans from a Swedish UCITS fund may only be made against satisfactory collateral subject to

terms and conditions customary on the market. We believe that the approach of ESMA GL, as described under (2) and above, should be the basis for further work and legislation on these issues.

Box 3 (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?

In light of EMIR, we think that the treatment of OTC derivatives cleared through CCPs must be clarified for UCITS, especially regarding the current exposure limit (set out in Article 52.1 of the UCITS IV-directive) to a single counterparty when the counterparty is a CCP. In addition, UCITS should be given incentives to clear instruments through CCPs provided that the relevant safety requirements are fulfilled. We would also like to stress the importance that the treatment of OTC derivatives for UCITS should be harmonized with how they are treated in other regulations, especially those concerning banks.

As UCITS are rarely, if ever, direct clearing members (CM) in a CCP the rules for *indirect* exposure to a CCP through a CM would benefit greatly from additional clarity. In order to deem an indirect exposure to a CCP as an exposure to the CCP itself (and not the CM) the UCITS must ensure that necessary safety features are in place. The Basel rules for capitalization of bank exposures to CCPs offer guidance on this issue (the segregation and portability requirements). It is reasonable that similar rules are applied in the UCITS context and harmonization of the rules may promote the use of more standardized legal documentation. If indirect centrally cleared trades do not fulfill such requirements the exposure must be treated as an exposure to the CM and be subject to the same restrictions and rules as an exposure to any other counterparty.

(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?

Yes, this is the approach used in the ESMA GL. We agree with the ESMA approach and see no reason for OTC and EPM transactions to be treated differently in this case. Further legislation should have consistent collateral requirements for OTC and EPM transactions.

(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.

For Swedish UCITS, daily calculation of counterparty risk and issuer concentration is expected in order to ensure that no limits are breached. Global exposure should be calculated daily.

Box 4 (Extraordinary Liquidity Management Tools)

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

In exceptional cases where temporary suspension of redemptions may be necessary, it would not be appropriate for the manager to wait for the competent authority's approval since this could lead to unnecessary delays. Therefore we believe that the manager should have this responsibility, but must, however, without delay notify the competent authority as well as the unit holders about the temporary suspension. However, if there is future evidence that the possibility to make these decisions is abused by the managers and that it leads to, for example, problems with moral hazard and arbitrary decisions, then the responsibility for these decisions should be reconsidered. A temporary suspension should only be used if it is justified in the interests of the unit holders.

(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.

The temporary suspension of redemptions should only be in place as long as it is the interest of the unit holders. The suspension should be released as soon as the specific exceptional circumstances no longer prevail.

(5) Regarding deferred redemption, would quantitative thresholds and time limits better ensure fairness between different investors? How

would such a mechanism work and what would be the appropriate limits? Please evaluate benefits and costs for all the stakeholders involved.

We believe that the concept of deferred redemption should be considered with caution. Liquidity is a basic concept for UCITS and it would be unfortunate if deferred redemption was introduced as a means for managers to circumvent the liquidity principle.

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

Side pockets are not allowed for Swedish registered UCITS. Illiquid assets in UCITS are a problem, and tailoring rules to handle this issue is a challenging task. An obvious risk is that a side pocket would consist of illiquid assets that would not be considered as eligible assets for a UCITS or at least become a very complex product. Therefore, we think that the possibility to use side pockets should not be introduced in UCITS.

Box 5 (Depositary Passport)

(1) What advantages and drawbacks would a depositary passport create, in your view, from the perspective of: the depositary (turnover, jobs, organisation, operational complexities, economies of scale ...), the fund (costs, cross border activity, enforcement of its rights ...), the competent authorities (supervisory effectiveness and complexity ...), and the investor (level of investor protection)?

A depositary passport would eliminate barriers to integration of the European fund market and lead to greater cross-border activity. It could also lead to improved competitiveness. Funds' costs for safe keeping of the fund's assets could possibly be reduced due to the improved competitiveness. On the other hand, a depositary passport could create risks for regulatory arbitrage, which may be disadvantageous to the investors. Also the distance between the depositary and the investor could create difficulties, e.g. for the investors to impose claims in relation to a depositary situated in another jurisdiction. Moreover, a situation where different national supervisory authorities exercise supervision over the depositary

institution and the fund, respectively, would create challenges and entails a need for effective mechanisms to exchange pertinent information between the authorities. Against this background, we would like to emphasise the need for thorough analyses of the consequences of a depositary passport regime before any legislation is proposed.

In this context, we would also like to emphasise that depositaries' cross-border activities follow a somewhat different logic than similar activities carried out by e.g. credit institutions and investment firms. While the latter offer their services directly to investors, depositaries offer their services to financial intermediaries (investment companies). Introducing passporting opportunities for depositaries would mean that investment companies – not end investors – would have a larger group of potential depositaries to contract with. The fact that end investors do not actively choose the depositary, and that the depositary e.g. may be subject to supervision in another Member State than the Member State of the end investor, entails that a depositary passport may give rise to specific investor protection concerns not present in other contexts.

Moreover, it is necessary to consider the need for well-functioning supervisory cooperation between the supervisory authorities in the home Member State of the depositary and the home Member State of the fund. Another issue to consider is how burdens are apportioned if a depositary fails; it would seem that the investor protection scheme of its home Member State would then have to step in. The implications of this need to be analysed in-depth.

Furthermore, the implications of a depositary passport must be analysed in regard to the taxation of the investors or the funds or both. If the depositary no longer has to have its registered office or be established in the fund's home Member State, this could mean that it will become harder for that Member State's tax authorities to assess and collect the taxes of the fund or of investors in that state. It is our experience that the introduction of the Management Company Passport (UCITS IV) had this effect. The question whether a depositary passport have any implications for the efficiency of the rules of Directive 2003/48/EC on taxation of savings income in the form of interest payments must also be analysed.

(3) In case a depositary passport were to be introduced, what areas do you think might require further harmonisation (e.g. calculation of NAV, definition of a depositary's tasks and permitted activities, conduct of business rules, supervision, harmonisation or approximation of capital requirements for depositaries…)?

We believe that a better solution would be to stipulate that the depositary shall comply with the rules of the UCITS home Member State which relate to safe-keeping of UCITS assets and that the competent authorities of the UCITS home Member State shall be responsible for supervising compliance with those rules (the situation can be compared with the Management Company Passport).

(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?

We believe that other EU regulatory frameworks ought to be sufficient in case a passport for depositary functions were to be introduced.

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

The situation can be compared with a UCITS managed by a management company, which is located in another Member State than the UCITS home Member State.

Box 6. (Money market funds)

(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?
(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?

(Answer to both 6 and 7): We believe that a common definition is desirable. During the crisis, investors' inability to distinguish between MMFs with troubled assets and liquidity problems and other MMFs compounded the high redemptions suffered by the MMF industry. A common regulation of European MMFs would mitigate this form of contagion in the future. Also, a single harmonized regulation on MMFs is necessary to promote a level playing field.

Box 7. (MMFs: Valuation and Capital)

(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?

CNAV MMFs proved particularly run-prone during the crisis. This is not surprising given that the fund investors perceived their investments as being immune to credit and market risks, thus having no downside risk. We believe that additional regulation or reduction of activities should be considered. However, any regulatory initiatives should be accompanied with adequate assessments of its impact on investors, issuers and money markets. Also, transitional arrangements may be warranted given the important role of MMFs in market functioning and funding of banks, corporates and public bodies.

Box 8 (MMFs: 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?

Yes. We do not see a need to introduce additional regulation specifically for MMF's, apart from those discussed in previous questions relating to CNAV MMF's. In general, we do not see a greater problem with liquidity for MMF's than for other UCITS.

(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?

No. It could have negative impact on the level playing field for MMF's compared to other products, for example savings accounts. It would also be problematic from the principle that all unit holders should be treated equally.

(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?

No. We believe that opening up for circumvention of the liquidity principle for UCITS would harm the UCITS product, where liquidity is a key feature. Restrictions on redemption should only be allowed in exceptional cases, as discussed in the answer to Question 3 in Box 4.

(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?

No. We believe that the current regulation, if applied correctly, appropriately addresses liquidity risks for UCITS.

Box 10 (Long Term Investments)

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?

We think that there are benefits of having a framework for long-term investments to stimulate long-term investments. However, any changes to the UCITS rules in this regard must be preceded by careful analysis. The fact that an investment is risky does not, of course, per se render it an unsuitable UCITS investment. Still, UCITS is a well-established concept and it seems worthwhile to keep UCITS as a relatively simple product. Bringing new types of products into the UCITS fold, especially when it is difficult to ascertain the characteristics of these products and what additional risks they may entail compared to extant UCITS products, might not be an advisable solution. When considering the appropriateness, in a UCITS context, of long-term investments such as those mentioned in the consultation (e.g. direct investments in unlisted companies, infrastructure projects,

real assets or EuSEF:s), it is important to keep this caveat in mind. For that reason, we believe that a stand-alone initiative is more appropriate.

Box 11 (UCITS IV improvement)

(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.

Yes, we think that the identified areas (points 1 to 4) require further consideration and that options should be developed for amending the respective provisions.

Point 1 (Self-managed investment companies)
We believe that the articles in question should be amended to empower the Commission to adopt delegated acts specifying the administrative procedures and internal control mechanism for investment companies.

Point 2 (Master-feeder structures)
We suggest that article 64(1) should be amended to cover the third possible scenario, that is, where a feeder UCITS converts into an ordinary UCITS.

Point 3 (Fund mergers)
We agree with the suggestion to revise the provisions on the timelines for fund mergers.

Point 4 (Notification procedure)
We favour the solution to introduce a regulatory-to-regulatory notification for any changes to the notification file including the information on arrangements for marketing or marketing of a new share class. This means that, in the event of a change in the information on marketing arrangements in a host Member State or marketing of a new share class, the UCITS shall notify the competent

authorities of its home Member State. After that, the competent authorities of the UCITS home Member State shall forward the information to the competent authorities of the UCITS host Member State. We also think that it should be clarified that information on a share class is limited to share classes marketed in a UCITS host Member State.

(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 harmonized so as to improve consistency between the AIFM directive and the UCITS directive? Please give details and the possible attached benefits and costs.

We do see a need to align the UCITS framework with the AIFMD, since many management companies will be authorized under both directives. Differences between the directives should only exist where a different application is intended.

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