

Updating the UCITS Eligible Assets Directive

A Simmons Client Note

Updating the UCITS Eligible Assets Directive

ESMA's [Final Report](#), which was published on 26 June 2025, sets out technical advice to help the European Commission assess what, if any, changes should be made to the UCITS Eligible Assets Directive (EAD).

The EAD helps define the assets in which a UCITS can invest – where the Commission eventually lands in terms of revising the EAD will, then, have a significant impact on those managing UCITS.

This Client Note provides a detailed summary of the key topics which ESMA addressed for those who have yet to read the report, and includes our assessment of the advice that ESMA has given the Commission. For those looking just for our analysis, please skip to each 'What does Simmons think?' box.

It's worth noting, though, that the Commission is not bound to follow ESMA's recommendations and, with the Council of the EU and the European Parliament due to review any proposal that the Commission adopts, much can change between now and the final legislation being agreed.

What does Simmons think?

- The recommended changes will not lead to the UCITS regime being fundamentally modernised and enhanced.
- Overall, ESMA's recommendations are sensible but not far-reaching – in many ways, the revisions represent a tweak around the edges of the EAD rather than a significant updating of it – although some of the proposed changes would be unwelcome. Our reaction to the key proposals is:
 - It is a positive sign that ESMA recommends using a regulation to achieve harmonisation since, this way, the rules will be directly applicable. That said, much depends on the changes actually made - introducing harmonised tightening of eligibility of assets for UCITS, for example, would not be a welcome move.
 - The proposed expansion, which would allow UCITS to gain indirect exposure to alternative assets via a 'look-through' requirement within the 10% trash bucket, seeks to balance calls to broaden eligible asset classes with preserving the UCITS brand reputation. Opinions will likely vary: some may view ESMA's proposals as too cautious, limiting UCITS' ability to deliver higher returns, while others may see them as sufficiently conservative to safeguard the UCITS brand.
 - Elements of the proposed 'look-through' requirements represent a backward step. The requirements would restrict UCITS from gaining exposure to alternative assets (i.e., limiting the use of delta one securities, ETNs, ETCs, AIFs, etc) except within the 10% trash bucket. Notably, UCITS currently investing up to 30% in non-UCITS funds to access private assets would face a reduced limit of 10% (including all trash bucket assets). These proposals are likely to face strong pushback, as they would hinder some UCITS from maintaining their current investment strategies, but managers will need to closely assess the overall effect of each element of the proposals to determine the impact.
 - ESMA has suggested the creation of a further, less liquid fund type falling between UCITS and ELTIFs. Of itself, this is not necessarily a bad proposal, but this should not be a result of a tightening of the EAD regime. We also expect that this new fund type would not be ready by

the time the changes to the EAD would be made. Whilst ESMA has proposed a transition period for the proposed changes, we expect this would have to be several years to create such an alternative vehicle. Even if it were ready in time, the new fund type would also not have the international reputation that has been built by UCITS over decades, so any UCITS converting to this new fund type may be impacted negatively.

- We also consider it a missed opportunity that the EAD will not make investment in non-EU ETFs easier, where these can provide better outcomes for investors through better pricing of the non-EU ETFs.
- We expect there will be strong opposition on some recommendations (in particular the look-through requirement) from both National Competent Authorities who will want the updated eligibility regime to be no more restrictive than under current interpretations / requirements and the funds industry. We hope the Commission will listen to calls, as it did in relation to ESMA's recommendations under the ELTIF 2.0 revisions, in order to avoid damage to the UCITS brand and industry.

The Final Report runs to 224 pages and contains:

- ESMA's **recommendation** that the Commission should adopt a directly applicable regulation – this would help ensure that the way the UCITS rules are applied is harmonised across the EU
- ESMA's **policy assessments** (at Sections 4 to 17) in respect of the topics on which the Commission requested technical advice and
- ESMA's **proposals** (at Annex VI of the Final Report) – these set out suggested changes to the [UCITS Directive](#) and to the [EAD](#).

This Client Note gives a brief background to the Final Report and then follows the Report's format to look at the areas which ESMA considered in drafting its advice to the Commission.

In each case, we look at the current position under the UCITS Directive framework and the key issues raised in response to ESMA's Call for Evidence.

We also offer our views as to the impact we think ESMA's advice, if followed, might have for UCITS ManCos.

What issues does the Final Report cover?

This Client Note deals with the following topics (click on the link below to go direct to that section).

[Liquidity under the UCITS framework](#)

[Exposure to alternative assets](#)

[Financial derivative instruments](#)

[Investment in AIFs](#)

[Investment in foreign currencies](#)

[Securitisations](#)

[Short positions](#)

[The definition of transferable securities](#)

[Money Market Instruments \(MMIs\)](#)

[Financial indices](#)

[Ancillary liquid assets](#)

[Efficient Portfolio Management \(EPM\)](#)

[Alignment with MIFID II, DLT and MiCA](#)

Why has the Final Report been published – and what happens next?

- Since March 2007, when the [EAD](#) was published, the significant increase in the number and type of financial instruments now traded on financial markets has created uncertainty as to whether certain categories of assets are eligible UCITS investments.
- Questions of interpretation have also arisen – for example, regarding the eligibility of direct or indirect exposures to asset classes such as structured/leveraged loans, catastrophe bonds, commodities, etc.
- In June 2023, the Commission [mandated](#) ESMA to review the divergence in how Member States have implemented the EAD and to recommend amendments to bring the EAD into line with market developments. Our summary of the Commission’s mandate can be found [here](#).
- ESMA published a [Call for Evidence](#) in May 2024 (see our summary [here](#)), seeking views on the pros and cons of UCITS gaining exposure to various asset classes as well as on some key notions and definitions used in the EAD and their consistency with other pieces of EU legislation.
- The Final Report just published sets out ESMA’s policy proposals taking into account feedback received to the Call for Evidence (as well as to an earlier ESMA survey and data collection exercise).
- The Commission will consider ESMA’s advice and, if it decides changes to the EAD are needed, will adopt a legislative proposal to introduce these.
- The Council of the EU and the European Parliament will then review the proposal and reach a political agreement of a final text.
- That text will subsequently be published in the Official Journal.
- At this stage, it is too early to be sure of any firm timings.

What does the Final Report say?

The Final Report begins by noting that its review has identified divergence in the application of UCITS eligibility requirements across the EU.

One particular source of divergence identified was in relation to the eligibility of delta-one instruments, whilst ESMA also noted that the authorisation processes varied in their approach to scrutinising the eligibility of assets.

ESMA has, therefore, recommended that a Regulation (which is directly applicable in all Member States) should be used, in order to ensure that the application of UCITS rules is harmonised across the EU.

(i) Liquidity under the UCITS framework

The current position

Liquidity is a central feature of the UCITS framework – a UCITS must be able to sell financial instruments in an appropriately short time frame without compromising the fund’s ability to redeem investors at their request. This requires UCITS ManCos to monitor on an on-going basis that the UCITS can redeem investors on request and in accordance with the fund’s redemption profile.

ESMA’s work has identified a number of areas where it believes that targeted improvements and clarifications can be achieved.

ESMA notes, for example, that there are divergent interpretations as to whether analysis of liquidity is required at the level of the individual assets and / or the aggregate portfolio. ‘Many’ respondents to the Call for Evidence were of the view that liquidity must be assessed at the aggregate fund portfolio level and that UCITS investments in assets with limited liquidity are allowable provided there is a sufficient level of liquidity within the overall portfolio composition so investors are able to redeem on request.

ESMA sees room for improvement in respect of the presumption of liquidity and negotiability in the EAD for listed instruments.

Most respondents to the Call for Evidence supported keeping the current presumption of liquidity provisions, which, they argued is a well-functioning and reliable tool, particularly helpful when it comes to recently issued securities for which there is a lack of relevant historical data.

On this point, the Final Report states that ESMA is “of the view that the liquidity and negotiability of assets cannot be presumed” – instead, these should always be assessed ex ante and on an ongoing basis. This is underpinned by evidence, from ESMA’s 2020 Common Supervisory Action (CSA) on UCITS liquidity risk management that some UCITS ManCos were over-reliant on the presumption in the EAD when investing in listed securities that might not have displayed sufficient liquidity. (Our summary of the results of the CSA can be found [here](#).)

What does ESMA recommend?

- **Liquidity criteria**

ESMA suggests additional clarification as to the criteria which a UCITS ManCo should take into account when assessing the liquidity of assets.

Principles-based criteria are already included in CESR’s 2007 [Guidelines concerning eligible assets for investment by UCITS](#) and ESMA wishes to see these incorporated into the legal text of the EAD in order to provide greater clarity, legal certainty and convergence.

These cover a number of characteristics, including market-depth, prices and costs, as well as more targeted factors (rating, volatility, sector of the issuer, etc.).

These asset-level liquidity assessment criteria, though, do not consider the liquidity assessment at the portfolio level, even though this is equally important.

Accordingly, ESMA believes that a range of criteria should be taken into consideration to analyse liquidity at both the asset and the portfolio level.

The asset liquidity assessment should

- be performed on the basis of a minimum common set of criteria, relevant to the asset being assessed
- consider reasonably expected or predictable changes to the liquidity profile as well as current liquidity and
- cover both normal and stressed market conditions.

The fact that a given financial instrument does not fulfil one or more of the criteria should not automatically lead to it being deemed ‘less liquid’ or ‘illiquid’ since other factors intrinsic to the security might give rise to a different categorisation.

- **Liquidity assessments at asset and portfolio level**

ESMA is not persuaded by the idea that the liquidity assessment should be performed solely at portfolio level.

Rather, the asset level liquidity assessment (the aim of which is to assess whether an asset satisfies the necessary conditions to be deemed investible for UCITS) should be distinguished from the broader liquidity risk management at portfolio level (which is to ensure the UCITS ManCo’s overall system enables investors to redeem on request).

Consequently, ESMA recommends that the legal text should be amended to clarify this distinction.

- **Presumption of liquidity and negotiability**

ESMA proposes that it should be made clearer in the EAD that the listing of an instrument is an important criterion when assessing / forecasting the liquidity and negotiability of an asset – but it is not the only one and should not lead UCITS ManCos automatically to presume the current and future liquidity and negotiability of their investments.

What does Simmons think?

If implemented, ESMA's recommendations would represent a change in the regulatory philosophy governing UCITS liquidity as they would move the framework from a more prescriptive, rule-based approach – where listing acted as an indicator for liquidity – to a more principles-based, risk-aware approach.

UCITS ManCos would be required to actively demonstrate and continuously monitor the liquidity of their holdings, regardless of listing status.

This implies an increase in the operational burden and the sophistication required for UCITS liquidity risk management and would necessitate the development and implementation of robust internal processes, advanced data analytics capabilities, and potentially new technological tools to perform continuous liquidity assessments across the entire portfolio, extending beyond just unlisted or complex assets.

This change could also encourage UCITS ManCos to adopt and effectively utilise more sophisticated Liquidity Management Tools (LMTs) to cope with the enhanced scrutiny on asset liquidity.

It will be interesting to see what stance the Commission takes in light of ESMA's recommendations.

(ii) The definition of transferable securities

The current position

Transferable securities are defined in Article 2(1)(n) of the UCITS Directive as

- shares in companies and other securities equivalent to shares in companies
- bonds and other forms of securities debt
- any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange.

This definition is built on by Article 2 of the EAD, which (among other things) requires that

- the security is capable of being 'reliably' valued (the 'valuation' criterion)
- the security's acquisition is consistent with the UCITS's investment objectives and / or investment (the 'consistency' criterion) and
- that the risks of the security must be 'adequately captured' by the UCITS's risk management process (the 'adequately capturing risks' criterion).

What does ESMA recommend?

ESMA's view is that

- the current definition should be clarified and simplified in order to improve supervisory convergence
- while better alignment between the concept of 'transferable securities' used in the UCITS and that in MIFID II is desirable, the criteria used in the EAD exist for the specific purpose of ensuring clarity in respect of eligible UCITS investments and bringing the two regimes closer will require careful calibration
- the **valuation criterion** needs to be further clarified. Valuation should occur on a periodic basis, taking into account the subscription and redemption frequency set out in the fund documentation. National Competent Authorities (NCAs), though, noted occasions when market participants valued securities based on the market price of listed transferable securities, but with illiquid exchange prices. ESMA's advice is that EAD valuation-

related criteria should specify that any valuation assessment is supported by adequate market liquidity and sources of information

- the **consistency criterion** should also be clarified, in this case by linking the necessary assessment with the Level 2 due diligence obligations and
- the **adequately capturing risks criterion** is too broad and open to different interpretation as to how to apply it in practice. As a result, ESMA recommends that, to be eligible for UCITS investment, the risks of an asset class must be fully understood, managed and incorporated in the UCITS risk management procedures.

What does Simmons think?

If implemented the ESMA's recommendations would have the following consequences for UCITS ManCos

- **Supervisory Convergence**

The goal of "improving supervisory convergence" implies that UCITS ManCos operating cross-border could face more uniform expectations and scrutiny from NCAs, potentially reducing some previous ambiguities but also requiring adherence to a more consistent, and likely stricter, standard.

- **Alignment with MiFID II (and other EU legislation)**

While "careful calibration" is needed, the push for better alignment with MiFID II and other relevant EU legislation suggests UCITS ManCos might need to review their internal policies and procedures to ensure consistency across different regulatory frameworks. This could lead to streamlining some processes but also require adjustments where divergences exist.

- **Refined Valuation Processes**

The clarification on valuation criteria means UCITS ManCos could have to ensure their valuation assessments are consistently supported by adequate market liquidity and reliable information sources. This might necessitate reviewing and potentially enhancing their valuation policies and data feeds.

- **Enhanced Risk Management Frameworks**

UCITS ManCos would be required to ensure the risks of all asset classes are "fully understood, managed, and incorporated" into their risk management, moving away from broad interpretations. This implies a more granular and sophisticated approach to risk assessment.

Again, it will be interesting to see if the Commission agrees with these recommendations.

(iii) Exposure to alternative assets

The current position

The UCITS Directive contains an exhaustive list of traditional asset classes - in particular transferable securities and money market instruments (MMIs) - in which a UCITS can invest.

Investments in financial derivatives were not originally permitted but, in 2002, UCITS III introduced these as possible investments. Even so, derivatives on ineligible asset classes (such as alternatives) are not permitted.

The EAD introduced the concept of "transferable securities backed by, or linked to, the performance of" assets which are ineligible for direct investment under the list in the UCITS Directive, though this has led to divergent interpretations between Member States and among market participants.

- Market evolution and the development of new financial instruments

Changes in market practices since the EAD's introduction in 2007 have led to the development of a variety of sophisticated or structured financial instruments. Many of these are listed and actively traded on regulated

markets (so meet the requirements of an eligible asset) while others represent entirely new asset classes, such as crypto-assets.

Evidence which ESMA has gathered shows that there is divergence as to whether, when and what type of indirect exposures to various alternative assets are allowed.

Finally, the introduction of the AIFMD framework in 2013 has raised the question whether UCITS are the right vehicle for making large-scale investments in alternative assets, since this would risk blurring the lines between UCITS and AIFs.

- Look-through to the underlying asset

ESMA's Call for Evidence raised the question whether a look-through approach should be applied to the level of the underlying asset to ensure that a UCITS cannot gain exposure to ineligible assets wrapped in a securities form.

Respondents were divided – most rejected the idea of a look-through approach while others supported it. Some supported a middle way, with a look-through approach to prevent significant indirect UCITS exposures to alternative assets, while leaving some room for limited exposures with a view to improving risk diversification and fund performance.

- EuVEECAs, EuSEFs, ELTIFs and retail AIFs

ESMA believes that the product-specific EU regulations made under the AIFMD framework (i.e., for EuVEECAs, EuSEFs and ELTIFs) might be better vehicles than a UCITS for investment in alternative assets.

At the same time, many market participants like the UCITS retail marketing passport while the rules on marketing of AIFs to retail investors are left to individual Member States rather than being harmonised across the EU.

For ESMA, this raises the question whether the national rules on the marketing of AIFs to retail investors should be harmonised – or, indeed, whether a new EU AIF product should be created, which would be dedicated to investments in asset classes deemed ineligible under the proposed revised UCITS framework. Such a product could meet potential investor demand for a “semi-liquid” product situated between UCITS and ELTIF.

- The 10% 'trash limit'

Application of the look-through is likely to concern well below 10% of total UCITS net assets on an aggregate basis. UCITS which have minor indirect exposures to alternatives would largely remain unaffected since ESMA's proposal would include an exemption from the look-through within the 10% 'trash bucket'.

The trash bucket is a 10% limit in the UCITS Directive the purpose of which was to allow limited investment in certain types of (particularly, unlisted) securities and certain debt instruments that might not meet all the criteria set out in the UCITS Directive.

In 2021, in light of differing interpretations as to how the 10% limit should apply, ESMA published an opinion to clarify that it does not cover investments in collective investment undertakings (CIUs).

Investments made within the 10% limit are not subject to the look-through approach, though other EAD conditions regarding the eligibility of the asset class continue to apply.

- Expanding the list of eligible assets in the UCITS Directive

A number of respondents to the Call for Evidence argued for the list of eligible assets for UCITS to be expanded so it would explicitly allow for investments in certain alternative asset classes, in particular, commodities, crypto-assets and catastrophe bonds.

However, ESMA notes that a Level 2 measure, such as the EAD, cannot amend a Level 1 text in this way – it can clarify certain key concepts and definitions used in the UCITS Directive but cannot override or amend its provisions. Moreover, including commodities in the list of eligible assets would directly go against the UCITS Directive, which forbids UCITS from investing in precious metals or certificates representing them.

What does ESMA recommend?

- The 'look through' approach

ESMA has come down on the side of those respondents who argued for a middle way.

Not applying any form of look-through would risk allowing UCITS to gain significant exposures to alternative assets, which would blur distinctions between UCITS and AIFs.

On the other hand, indirect exposure to alternative assets raises challenges in terms of risk management and valuation as well as transparency towards retail investors.

Given the existence of different supervisory practices and policy preferences among the NCAs on the issue, the Final Report invites the Commission to clarify the applicability of the look-through approach.

As a result, ESMA's draft proposals include application of a look-through approach in the EAD – if accepted, this would mean that asset classes should not be backed by, or linked to the performance of, other assets which may differ from those referred to in Article 50(1) of the UCITS Directive.

The look-through approach would be performed to the level of the final underlying of the investment – it would not affect investments in traditional shares or bonds but is intended, instead, to limit the use of instruments that provide for exposures to alternative assets.

- Transitional clause

To avoid issues as a result of a look-through approach being brought in, ESMA recommends that there should be an appropriate transitional period following the amendment to the EAD so UCITS which have indirect exposures to alternative assets of beyond 10% would have sufficient time either to reduce their exposures to alternative assets or to liquidate and set up an AIF.

ESMA, though, believes that allowing grandfathering rules would risk dividing the UCITS brand between UCITS authorised before the revised EAD applied and those authorised afterwards.

If the Commission decided in favour of amending the list of eligible assets in the Level 1 UCITS Directive, to harmonise the rules on distribution of AIFs to retail investors or to create a dedicated AIF product, ESMA proposes that a sufficiently long transitional period should be granted as to allow market participants to adapt their business practices.

- Retail AIFs

ESMA invites the Commission to consider harmonising rules on marketing AIFs to retail investors and / or developing the new “semi-liquid” product suggested above as a means of alleviating concerns about the adverse impacts of a UCITS look-through approach.

- The 10% ‘trash bucket’

The Final Report notes that it might be advantageous to leave room for UCITS to be permitted limited indirect exposure to alternative assets, in order to improve risk diversification and generate returns from uncorrelated assets.

ESMA recommends that the 10% limit should be broadened to cover all eligible asset classes listed in the UCITS Directive, including financial derivative instruments and open-ended AIFs. Any investment made under this 10% limit would be exempt from the look-through approach.

- Expanding the list of eligible assets in the UCITS Directive

Since, as noted above, the EAD cannot amend a constituent element of the UCITS Directive such as the list of eligible assets and ESMA's mandate is to propose clarification to the EAD, the Final Report does not recommend any large-scale Level 1 changes to expand or restrict the list of directly eligible asset classes.

(Note that ESMA does suggest some changes to certain Level 1 provisions but these are limited to ensuring consistency with proposals affecting the EAD.)

What does Simmons think?

Look-Through Approach

- ESMA's key recommendation is to apply a look-through approach to determine the eligibility of UCITS investments. This would ensure that UCITS cannot gain indirect exposure to ineligible assets (e.g., alternative assets) through instruments like delta-one products, ETNs, or ETCs. A 10% limit is proposed for indirect exposures to alternative assets, exempting such investments from the look-through approach.
- This recommendation aims to allow limited diversification while maintaining investor protection. ESMA arrived at this recommendation even though, as it acknowledged, the data collected as part of the Call for
- Evidence showed the application of the look-through approach would concern only a relatively small portion of the total UCITS net assets on an aggregate basis, well below 10%. ESMA has, therefore, asked the EU Commission to clarify the applicability of this approach. If this look-through approach was to be applied it would be a major departure from the current UCITS regime.

10% Limit

- ESMA suggests clarifying the eligibility criteria for assets under the UCITS Directive but refrained from expanding the list of eligible assets (e.g., commodities, crypto-assets, catastrophe bonds) due to regulatory and conceptual challenges, citing that it was outside the scope of its review. A more helpful recommendation is the broadening of the wording in the relevant UCITS provisions so that the 10% limit should be extended to all eligible assets listed in the UCITS Directive including FDI and units in classes of open-ended AIFs . Effectively this recommendation would allow UCITS to gain indirect exposure to otherwise ineligible assets (e.g., commodities, real estate, crypto-assets, structured/leveraged loans, catastrophe bonds) within this 10% aggregate limit, subject to certain regulatory safeguards (e.g., on liquidity and valuation). This would provide an avenue, albeit it limited, for UCITS to gain exposure to alternative investments.

AIFMD Framework More Appropriate for Investments in Alternative Assets

- While acknowledging that some direct investments in alternative assets was beneficial for improving risk diversification and generating of risk returns, ESMA was ultimately of the opinion that alternative assets are deemed more suitable for the AIFMD framework, which is better equipped to handle their risks.
- Consequently ESMA believes that investments in alternative assets should be made in AIFs and that the Commission should consider
 - harmonising the rules around marketing AIFs to retain investors and
 - creating a product with marketing rules for a new retail AIF.
- While there is clear merit in doing this in the context of limiting UCITS from investing in alternative assets, it may cause confusion as AIFMD is primarily an alternative investment manager level measure with limited product rules. In addition, ELTIFs have recently gone through a major revamp to make that AIF product more appealing to be use by both managers and retail investor alike.

Transition Period

- It is, perhaps, regrettable that ESMA has elected not to examine revising the list of eligible assets based on their features and characteristics and has instead focussed on how the EU Commission could revise AIFMD by creating new a new retail AIF product.
- This also affected ESMA's thinking in relation to its approach to the transition to the new regime where it recommended that the transition period could be tied to any new product and marketing rules for AIFs.

(iv) Money Market Instruments (MMIs)

The current position

MMIs are transferable instruments, including treasury bills, certificates of deposits and commercial papers, which comply with medium to short-term maturity limits and are considered of a high credit quality.

The UCITS Directive defines MMIs with regard to their characteristics, i.e., that they

- are normally dealt in on the money market

- are liquid and
- have a value which can be accurately determined at any time.

However, definitions of MMIs can also be found in the EAD, the Money Market Funds Regulation and MIFID II – and these definitions differ partly because each legal act has a different purpose.

Additionally, while the UCITS Directive provides a list of eligible MMIs, the EAD clarifies the criteria which are to be used when assessing whether an MMI is eligible for UCITS.

Since the EAD is generally understood to require a financial instrument to be reclassified as a MMI where it meets one of the criteria that the EAD lays down, some types of securities (such as high yield bonds), which may not have the characteristics of an MMI, may need to be classified as such.

Another issue raised in feedback to the Call for Evidence is that Member States have different interpretations as to the classification of specific asset classes, such as loans, as MMIs.

What does ESMA recommend?

ESMA agrees that clarity is needed whether some instruments can be reclassified as MMIs during their lifespan and that such reclassification should be carefully assessed, taking into account the features an MMI is expected to have.

As such, the relevant provision in the EAD should “not be viewed as an obligation to automatically classify an instrument with a maturity of no more than 397 days” as an MMI – instead, other elements such as the liquidity of the instrument and its risk profile (including the credit quality of the issuer and of the instrument as well as the interest rate risks) need to be taken into consideration.

To this end, the Final Report proposes a recalibration of the criteria set out in the EAD (in particular, the risk management criterion and liquidity assessments). These criteria would also guide whether the specific instruments qualify as MMIs for the purpose of the UCITS eligibility assessment.

What does Simmons think?

If implemented, ESMA’s recommendations would have the following consequences for UCITS ManCos

- **Liquidity and Credit Risk**

UCITS ManCos would not simply be able to rely on an MMI’s classification as such but would have to perform a continuous, robust assessment of its actual liquidity and credit risk. This would require more sophisticated internal processes and data analysis capabilities to monitor MMIs effectively.

- **Portfolio Construction and Due Diligence**

The proposed new approach would likely lead to more stringent due diligence processes for MMIs. UCITS ManCos would need to demonstrate that they fully understand the risks of the specific MMI, including its underlying exposures, if applicable, and that these risks are properly managed and integrated into the UCITS’s overall risk management framework. This might make certain types of MMIs, or those from less transparent issuers, less attractive for UCITS investment due to the increased burden of demonstrating ongoing eligibility.

(v) Financial derivative instruments

The current position

UCITS have been able to use financial derivative instruments for investment and hedging purposes since 2002. But while such investments allow UCITS to access a wide range of strategies and alternative assets, they expose UCITS to the risks inherent in them. So, the UCITS framework contains specific rules on the management of risks arising from derivatives transactions and, in particular, OTC derivatives.

In order to give greater clarity on the issue of financial derivative instrument eligibility, the EAD covers

- financial derivative instruments which are to be considered as liquid financial instruments
- eligibility criteria for derivatives on financial indices
- the subcategory of transferable securities and MMIs which embed a derivative instrument.

Under the current framework, a UCITS can gain exposure to derivatives through either

- a direct investment in financial derivative instruments or
- transferable securities embedding a derivative.

and the EAD requires the rules on derivatives to apply regardless of which option is used. In both cases, this implies a look-through approach in addition to the safeguards set out for the investment in such asset class.

However, interpretational questions have been raised about the distinction between (a) transferable securities backed by or linked to the performance of other assets and (b) those embedding derivatives, with some taking the view that a look-through approach is only required in the latter case and not in the former.

An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price or other variable, so long as (in the case of a non-financial variable) the variable is not specific to a party to the contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

- Delta-one instruments

Similar issues arise in the context of delta-one instruments, where ambiguities exist whether these fall into the category of transferable securities which

- embed a derivative or
- are backed by, or linked to, the performance of other assets.

Delta-one instruments are generally taken to be financial instruments with a delta at one with the asset or the basket of asset to which their performance is linked (i.e., where a move of 1% in the value of the underlying assets results in a 1% move in the value of the financial instrument, without optionality or leverage effects).

The general view is that investments in delta-one instruments are beneficial for UCITS in terms of diversification, reduced costs and lower risks associated to the underlying and most respondents argued for the regulatory treatment of delta-one instruments to be clarified.

However, there is divergence between NCAs - and in the market - as to how delta-one instruments are treated and how, or whether, a look-through approach is applied.

The Final Report underlines that:

- investments in financial derivative instruments with underlyings that are not directly eligible within the 10% limit (i.e., without the application of a look-through approach) remain subject to all relevant limits and conditions provided for investments in derivatives, and
- UCITS ManCos must fully understand the risks related to the investment in derivatives “including the underlying risks, the impacts on the portfolio of the UCITS, the compatibility of the financial derivative instrument with the characteristics of the UCITS, as well as the accurate assessment of the value of the derivative”.

What does ESMA recommend?

The Final Report accepts that introducing a look-through approach would provide legal certainty and increase supervisory convergence – even so, investments in derivatives are subject to specific limits and conditions.

As a result, ESMA recommends the clarification of some aspects around the perimeter of financial instruments embedding a derivative – it puts forward the CESR guidelines concerning eligible assets for investment by UCITS

(which contain a non-exhaustive list of financial instruments embedding a derivative) as a possible basis for the classification of some financial instruments as embedding a derivative.

ESMA's advice also sets out criteria which a UCITS can consider in its assessment of whether a transferable security or money market instrument should be regarded as embedding a derivative or if the derivative component shall be deemed to be a separate financial instrument.

ESMA's criteria focus on whether the derivative component can contractually or economically be considered an independent financial instrument from the host transferable security or MMI.

- Delta-one

ESMA considers that the application of a look-through approach should be clarified in the EAD as a way of to improving supervisory convergence.

It also recommends that exposures to ineligible assets would be allowed only within the 10% limit set out in the UCITS Directive, regardless of the inclusion of delta-one instruments in the category of financial instruments that embed a derivative.

What does Simmons think?

The biggest focus here is around instruments embedding a derivative. It is not clear from the legislative proposal that what can be considered to embed a derivative is made any clearer. ESMA acknowledges and supports the non-exhaustive list of structured financial instruments (SFIs) that can be considered as embedding a derivative, namely

- credit linked notes
- SFIs whose performance is linked to the performance of a bond index
- SFIs whose performance is linked to the performance of a basket of shares with or without active management
- SFIs with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management
- convertible bonds and
- exchangeable bonds.

But for certain of the key jurisdictions (including Lux and Ireland), delta-one instruments have been treated as not embedding a derivative – and, therefore, with no look-through imposed.

Applying a look-through even to delta-one instruments and capping such holdings at 10% where the underlying would be ineligible would be a considerable shift and unwelcome to many fund managers, particularly those looking to take a strategic exposure to bespoke indices, baskets or commodities.

The use of transferable securities backed by or linked to the performance of other assets has been a helpful feature of the existing regime, enabling sophisticated managers to create uncorrelated returns within portfolios via a tradeable limited recourse instrument.

Aligning the treatment of derivatives with transferable securities in any event ignores the limited liability benefits of the latter as well as the liquidity profile, particularly where such instruments are traded on venue. It is disappointing not to have seen a more sophisticated analysis from ESMA of the benefits and risks of delta-one in the report.

On the treatment of direct investment in OTC derivatives, there is little change in the proposals. An OTC derivative can still only be entered into on an eligible underlying – and commodity derivatives are still prohibited. Derivatives can still be used for synthetic shorting (although physical shorting continues to be prohibited).

The counterparty criteria for OTC continues to be determined at member state level (which can be quite tricky for managers with UCITS in various jurisdictions and member states have been inconsistent in terms of stating what categories of counterparty are locally approved). Likewise, developments under EMIR in terms of daily mark-to-

market valuations have not been considered where they might do away with the “reliable and verifiable valuation” requirements specifically under UCITS.

On the listed derivatives side, MTFs have been added to the existing regulated markets category, which is helpful, although from a counterparty exposure perspective EMIR 3 will focus more on the status of the clearing house than the nature of the execution venue.

(vi) Financial indices

The current position

UCITS can use a broad spectrum of financial indices, for a number of different purposes, such as

- to pursue investment strategies, gaining exposures to the basket of assets composing the index
- to track or replicate the performance of the basket of assets within the index
- to measure the UCITS’s performance (including in order to calculate performance fees).

Use of such indices may include exposures to assets that are not themselves eligible for direct investment.

Since 2016, the UCITS framework has co-existed with the Benchmark Regulation (BMR), which contains rules on the governance of, input data of and contributors to a given benchmark.

The BMR has recently been reviewed with a view to recalibrating, in part, the regulatory burden on administrators of smaller EU benchmarks and some respondents to the Call for Evidence were hopeful that this simplification of the BMR might reduce the inconsistencies between it and the EAD. Others argued for various requirements in ESMA’s Guidelines on ETFs and other UCITS issues to be removed or amended as these are now dealt with by the BMR.

Feedback also highlighted instances where Member States diverge, for example, by having different rules on the eligibility of assets comprising the financial index and additional requirements for indices that exceed the 5/10/40 diversification requirements for UCITS.

What does ESMA recommend?

ESMA accepts that greater legal clarity could be provided on financial indices, while noting that the relevant rules in the UCITS Directive have not been made entirely redundant by the BMR as they set out important criteria that an index should fulfil in order to be eligible for UCITS investments.

ESMA considers that the application of a look-through approach should include financial indices, to address issues around the eligibility of financial indices comprising assets that are not eligible for direct investment.

UCITS should be able to invest in financial derivative instruments which provide exposure to financial indices comprising assets, such as commodities, that are not eligible for direct investment within the 10% limit, while ensuring that the indices are sufficiently diversified. The proposed look-through approach should provide legal clarity and ensure convergence going forward.

Should the Commission decide to allow exposure to commodities or other ineligible assets through derivatives on financial indices, ESMA would recommend it

- incorporates the safeguards in the ESMA guidelines on ETF and other UCITS issues within the text of the UCITS Directive as investment limits and
- makes it a requirement that the characteristics of the single constituents of the financial indices are assessed.

The Final Report emphasises that the 10% limit in the UCITS Directive is an aggregate figure - all possible forms of exposures (including exposures to commodities or other ineligible assets through derivatives on financial indices) must be combined and not go above the threshold.

To increase harmonisation of interpretation across Member States, ESMA recommends (among other things) that, where an index refers to regulated markets or MTFs where certain transferable securities or MMIs are highly dominant and the concentration limit is raised to 35%, this derogation must be included in the fund rules or instruments of incorporation and be approved by the UCITS's home NCA.

In respect of points raised by stakeholders on ESMA's guidelines on ETFs and other UCITS issues, ESMA feels that these would be best dealt with as part of a future review of its UCITS guidelines more generally.

What does Simmons think?

The majority of ESMA's recommendations on financial indices would appear to represent a balanced approach to addressing the challenges posed by indices that may include ineligible assets, while maintaining the integrity of the UCITS framework.

The proposed application of a look-through approach to financial indices would be a logical step to ensure that UCITS funds do not gain indirect exposure to ineligible assets without proper safeguards if this proposal is introduced for other asset classes. However, the look-through proposal would also potentially reduce the ability of UCITS to gain exposure to alternative assets through the use of financial indices.

Therefore, whilst the recommendation to allow limited exposure to ineligible assets (e.g., commodities, crypto-assets etc.) through derivatives on financial indices within the 10% aggregate limit appears a pragmatic solution and may serve to address issues that managers currently face when dealing with eligibility requirements and divergent guidance across the Member States, this could mean managers of some UCITS would not be able to pursue their investment strategy as they do under the current UCITS restrictions. In addition, the success of this proposal will depend on the effective incorporation of safeguards, such as those outlined in ESMA's guidelines on ETFs and other UCITS issues, into the UCITS Directive.

The emphasis on harmonisation, particularly the requirement for NCAs to approve derogations (e.g., raising the concentration limit to 35% for certain indices), is a welcome development. This will help reduce divergence in the interpretation and application of rules across Member States.

That said, the recommendations could have gone further by addressing the growing importance of ESG considerations in financial indices. Incorporating ESG factors into the eligibility assessment of indices would align with broader regulatory trends and investor expectations. Given the overall regulatory uncertainty and likely future amendments to the Sustainable Finance Disclosure Regulation / Taxonomy Regulation and possible future guidelines on ESG, it is unsurprising that ESMA has opted to not give greater detail on this issue. Should the Commission decide to harmonise eligibility requirements for financial indices within one piece of legislation, this would be welcome; however, it would be anticipated that ESG-related financial indices would have to account for additional requirements.

(vii) Investment in AIFs

The current position

Before a UCITS can invest in an open-ended CIU, this must meet a number of conditions set out in the UCITS Directive.

A closed-ended fund is an asset class not explicitly referred to as eligible for UCITS in the UCITS Directive, although the EAD includes conditions which must be met for the closed-ended fund to qualify as a transferable security and so become eligible.

What did respondents request?

Respondents to the Call for Evidence argued that

- the UCITS Directive and EAD terminology should be updated in light of the subsequent introduction of AIFMD and the EuVECA, EuSEF and ELTIF Regulations.

- UCITS should be permitted to invest in AIFs – and, in particular, in ELTIFs
- the distinction which the UCITS legislative framework draws between closed-ended and open-ended funds is unclear and needs to be reconsidered
- investing in a non-EU ETF can be a challenge for a UCITS as often the ETF may not meet the UCITS Directive's conditions (in particular, those on equivalence of supervision and level of regulatory protection). Some respondents argued that some of the UCITS Directive conditions should be more flexible, at least allowing UCITS to invest more freely in non-EU ETFs within the 10% limit provided for in the UCITS Directive (which, ESMA's [Opinion on Article 50\(2\)\(a\)](#) clarifies, is limited to transferable securities and MMIs). Others felt that a non-EU ETF should always be considered as meeting the UCITS eligibility requirements.

ESMA notes that, to date, AIFMD does not provide for a harmonised framework for non-EU AIFMs marketing AIFs in the EU or for the product regulation of EU AIFs while the investment strategies and risk profiles of AIFs (including EuVECAs, EuSEFs and ELTIFs) can differ significantly from UCITS.

AIFs may be permitted e.g. to invest in illiquid or less liquid assets, use leverage on a substantial basis or engage in transactions (such as short selling) where UCITS cannot.

What does ESMA recommend?

ESMA accepts that the UCITS Directive and EAD terminology should be updated in light of subsequent legislation.

ESMA also recommends that UCITS investments in AIFs should not lead to circumvention of the UCITS Directive's investment restrictions and investor protection standards - this includes the application of a look-through approach, although some flexibility to invest in AIFs would be allowed as look-through would not apply within the 10% limit.

ESMA's proposals follow the approach taken in the UCITS Directive and the EAD and distinguish between open-ended AIFs and closed-ended AIFs.

By Article 50(1)(e) of the UCITS Directive, an open-ended AIF is eligible for investment by a UCITS where

- it meets the conditions included in the definition of UCITS
- it is authorised under laws which provide that they are subject to a supervision considered equivalent by Member States
- the level of protection for unitholders in the AIF is equivalent to that provided for unit-holders in a UCITS
- the business of the open-ended AIF is reported half-yearly and annually
- no more than 10% of the assets of the open-ended AIF in aggregate can be invested in units of other UCITS or open-ended AIFs.

ESMA's recommendation is that, for an authorised EU AIF which is managed by an authorised AIFM under the AIFMD, it can be presumed to meet the supervision condition (see the second bullet point above) unless the UCITS knows of a reason why it does not.

- [Open-ended AIFs](#)

ESMA also considers that it should be clarified that units or shares of open-ended funds should not be taken to be transferable securities – instead the Article 50(1)(e) eligibility criteria should always apply.

- [Closed ended AIFs](#)

The Final Report supports continuing to allow UCITS investments in closed-ended AIFs where these financial instruments prove to have the same characteristics as transferable securities, so fulfil the EAD eligibility criteria for transferable securities – such as when the units or shares of an AIF are listed on a regulated market and are liquid financial instruments.

To ensure that investors remain adequately protected, ESMA also proposes that (i) closed-ended AIFs should be subject to an equivalent level of supervision and (ii) there should be a limit of 10% as to how much of the target UCITS's or AIF's portfolio can be invested in units of other UCITS or AIFs.

In applying the look-through approach, ESMA recommends that UCITS should not be able to invest in AIFs (whether open- or closed-ended) which provide exposure to ineligible asset classes.

Finally, units or shares of AIFs which fall within the 10% limit are financial instruments that fulfil the criteria set out in the EAD (subject to certain exceptions).

ESMA's recommendations seek to clarify the eligibility requirements in respect of units or shares of AIFs which do not meet all the provisions set out in the UCITS Directive.

Nevertheless, a UCITS may invest in such AIFs within the 10% limit, subject to certain requirements which ESMA specifies in its legislative proposals for the EAD (though it accepts that these criteria could alternatively be included in the UCITS Level 1 Directive).

What does Simmons think?

Unsurprisingly, ESMA has broadly recommended retaining the status quo in relation to investment in AIFs. However, the recommended look-through requirements would also be applied to AIFs, which would be a very unwelcome development as this would effectively reduce the maximum exposure to alternative assets through AIFs from 30% to the 10% 'trash bucket' limit.

Some respondents advocated for UCITS to be permitted to invest further in AIFs, but this did not seem likely. There is only a slight relaxation of the restrictions recommended, whereby open-ended AIFs that are not otherwise eligible could be included in a UCITS's 10% 'trash bucket' that is currently reserved for transferable securities and MMIs that do not meet their respective eligibility criteria.

Permitting UCITS to invest in non-EU ETFs, or at least introducing guidance making it easier to do so, would have broadened the range of assets that UCITS could hold and simplify the investment process for managers. However, it is probably not surprising that ESMA did not do so, perhaps with a view to protecting EU ETFs (themselves usually UCITS) from the competition offered by non-EU ETFs (which tend to be US-domiciled).

The updating of the rules regarding investment in AIFs is welcome but retaining eligibility of certain closed-ended AIFs as a transferable security means that these rules would not be clarified as much otherwise possible.

(viii) Ancillary liquid assets

The current position

Under the UCITS Directive, a UCITS can hold "ancillary liquid assets", but the Directive does not define this as a term nor does it provide explicit limits as to the amount that can be held (which has led to divergence among Member States).

The UCITS Directive recitals note some of the limited circumstances which might justify the holding of such assets (for example, to cover current or exceptional payments).

Since the UCITS III amendments, UCITS have also been able to invest in bank deposits, with a limit of 20% of deposits able to be made with the same body.

What does ESMA recommend?

Since risk diversification is a core principle of the UCITS Directive and holding ancillary liquid assets can expose UCITS to similar counterparty risks as are associated with investments in bank deposits, ESMA's recommendation is to clarify in the Level 1 UCITS Directive that the 20% counterparty limit for deposits made with the same body also applies to ancillary liquid assets.

On the other hand, ESMA does not suggest prescribing a maximum amount of ancillary liquid assets that a UCITS may hold, given that these may be needed to cover for exceptional payments and unfavourable market conditions.

Neither does ESMA believe there is the need for an exhaustive definition of ancillary liquid assets. It concludes that asset classes other than deposits could also qualify as ancillary liquid assets, so long as meet a number of tests, namely that

- they cover a liquidity need
- they are of an amount coherent with that need
- they are readily available
- they are held for no longer than is strictly necessary to cover the liquidity need and
- the UCITS can demonstrate to its NCA the connection between the holding of ancillary liquid assets and the circumstances that justify this.

What does Simmons think?

Significant changes to rules on the holding of ancillary assets were neither necessary nor expected.

The recommended clarification that holdings in ancillary liquid assets are subject to the 20% counterparty limit may cause issues where a UCITS does need to hold higher levels of these and needs to identify other counterparties to comply with this requirement.

However, we agree that a maximum limit in holdings of ancillary assets should not be introduced as this flexibility might be needed in exceptional circumstances such as stressed market conditions.

(ix) Investment in foreign currencies

The current position

In the context of investments, the list of eligible assets in Article 50 of the UCITS Directive contains no explicit reference to foreign currencies. (At the same time, ESMA notes, the UCITS Directive doesn't contain any explicit risk diversification requirements, either.)

The only explicit reference to foreign currency in the Directive is to allow UCITS to acquire this through back-to-back loans and to invest in derivatives whose underlying are foreign rates or currencies.

As such, foreign currencies can be relevant in the context of Efficient Portfolio Management (EPM) techniques that serve the purpose of hedging against currency risks related to investments - the UCITS Directive does not clarify whether other forms of exposure to foreign currencies are allowed.

The foreign exchange (or 'forex') market is a decentralised OTC global financial market, recognised as one of the most liquid markets.

Investment in currencies, though, can expose investors to risks arising from a number of factors, such as complexities of transactions, counterparty risks and leverage.

There was overwhelming support from respondents to the Call for Evidence for allowing UCITS to gain exposure to foreign currency for both liquidity and investment purposes, with the proviso that the associated risks must be properly disclosed and managed.

What does ESMA recommend?

ESMA considers that UCITS are already permitted to hold foreign currency as ancillary liquid assets.

Article 50(1)(f) of the UCITS Directive allows for deposits with credit institutions and Article 52 provides for risk diversification requirements in relation to deposits. In light of this, ESMA's view is that UCITS investment in foreign currencies are allowed.

As such, ESMA considers that

- the EAD does not need to be amended with respect to foreign currencies and
- exposure to foreign currencies is allowed (provided that it falls within the category of deposits, is the underlying of a financial derivatives instrument or qualifies as an ancillary liquid asset or for the purposes of EPM).

What does Simmons think?

We agree with ESMA's interpretation that UCITS may already hold foreign currency for both EPM and investment purposes.

We also agree that UCITS should continue to be able to hold foreign currency, including for investment purposes.

(x) Efficient Portfolio Management (EPM)

The current position

The regulatory framework with relevance to EPMS is broad and includes

- the UCITS Directive
- the EAD
- ESMA's Guidelines on ETFs and other UCITS issues
- CESR's Guidelines concerning eligible assets for investment by UCITS and
- ESMA Q&As.

A UCITS can use EPM techniques related to transferable securities and MMIs. The EAD specifies that these must be entered into in order to

- reduce risks
- reduce costs or
- generate additional capital or income for the UCITS with a level of risk consistent with the fund's risk profile and risk diversification rules.

(The Final Report emphasises that EPMS do not fall under the definitions of 'transferable securities' or MMIs and under no circumstances can use of them lead a UCITS to diverge from the investment objectives laid down in the fund's rules, instruments of incorporation or prospectus.)

- EPM techniques and costs

Feedback to the Call for Evidence highlighted that many respondents felt that the EPM-related rules are too strict, particularly in relation to costs, selection and management of collateral as well as the alignment with the SFTR.

Most respondents believed that fee splitting arrangements would help to preserve the competitiveness and the quality of the EPM services provided to UCITS while enabling UCITS ManCos, while ensuring adequate disclosure to investors of the generated and retained fees for initiating, preparing, and executing EPMS.

- Collateral arrangements

Respondents to the Call for Evidence were split between, on the one hand, those who called for clarification as to whether a UCITS can engage in collateral arrangements that do not provide for the title transfer and, on the other hand, those seeking fewer restrictions on the use of cash and other collateral to improve liquidity, allowing UCITS to access centralised clearing services of CCPs.

ESMA notes that potential inconsistencies between its guidelines and the later changes brought about by UCITS V have led to divergent application of the guidelines when it comes to collateral arrangements that do not provide for title transfer.

- [Securities financing transactions \(SFTs\)](#)

The vast majority of respondents did not support the idea of aligning the UCITS and SFT Regulation (SFTR) frameworks – the SFTR covers a narrow spectrum of EPMs (in particular, excluding derivatives and any possible EPM techniques that the financial market may develop in the future) while the list of SFTs it contains are not tailored to what is permitted under the UCITS framework.

What does ESMA recommend?

- [EPM techniques and costs](#)

ESMA accepts there are benefits in allowing UCITS to engage in EPM techniques with a view to generate additional income or reduce risks for investors, but feels it is important to ensure that the benefits of these transactions flow to the investors rather than being retained by the UCITS ManCo.

ESMA's [Guidelines on ETFs and other UCITS issues](#) underline that all revenues arising from EPM techniques (net of operational costs) should be returned to the UCITS, while ESMA Q&As have clarified that the Guidelines do not prohibit the deduction from revenues of costs incurred in the use of such techniques, so long as adequate disclosure is made in the UCITS's annual report.

However, addressing cost related matters would need to be done through amendment to the Level 1 UCITS Directive and is outside the scope of the (Level 2) EAD.

As a result, the Final Report recommends that the Commission consider providing further clarity on EPM-related costs and fees, including in respect of fee split models. ESMA flags the policy proposals contained in its 2023 [Opinion on undue costs of UCITS and AIFs](#), which it believes may help tackle the risk of UCITS investors being charged with undue EPM costs.

- [Collateral arrangements](#)

ESMA recommends considering whether the UCITS Directive could be amended to clarify the perimeter of 'eligible' collateral arrangements and to allow for the deployment of 'other collateral arrangements', provided certain risk mitigation conditions are met. (Any amendments of the ESMA guidelines on ETFs and other UCITS issues should be assessed as part of a future review of those guidelines, taking into account the outcome of the current EAD Review.)

- [SFTs](#)

ESMA accepts that linking the EPM and SFT frameworks might raise interpretational issues and does not see merit in developing an exhaustive list of EPMs as this could result in current or future EPM techniques that the market may develop being restricted.

Since the SFTR recognises the use of SFTs and total return swaps by managers of CIUs as EPM techniques, ESMA believes that the SFTR's definitions of these transactions and instruments are also relevant in the context of the UCITS Directive, to the extent that they are compatible with the UCITS eligibility requirement of EPMs.

What does Simmons think?

There has been confusion for some time on precisely what is caught by the term EPM techniques in the context of UCITS – does it, for example, include derivatives or is it more limited to securities financing techniques? In relation to derivatives, what is "EPM" is likewise unclear and without regulatory guidance. It would have been helpful for some of this to have been clarified.

On the costs aspect of EPM techniques, ESMA is not proposing any changes, but recommends the Commission addresses the matter in a systematic review of the Directive. Simmons makes no comment on this aspect.

On collateral, though, we would agree that permitting security collateral arrangements in the context of EPM techniques makes sense. It is very odd for a UCITS to be required to transfer scheme assets absolutely when giving collateral, but not to be able to grant a pledge under which it retains an ownership right in the collateral (equity of redemption). This precludes the UCITS from entering into a number of standard services and

arrangements. Given title transfer collateral is accepted, a softening of the requirements around depository delegation to a secured party receiving securities collateral would have been welcomed but is not envisaged.

On using certain of the definitional aspects of SFTR in the context of UCITS, it is not clear that this will add certainty. The definitions in SFTR, and inclusion of TRS in that context (which may or may not be an EPM technique), is likely to add further confusion.

(xi) Securitisations

The current position

UCITS are permitted to invest in securitisations that meet the requirements of the Securitisation Regulation, though such investments are subject to the limits and risks set out in the UCITS Directive. These include a 10% concentration limit for debt securities issued by the same body.

Respondents to the Call for Evidence gave differing views on the general merits of UCITS investments in securitisations.

Those in support pointed out the benefits of such investments - enhanced returns, diversification during market stress, etc. as well as the opportunity to gain exposure to asset classes that are rarely available through traditional bond holdings.

These respondents supported

- reducing the Securitisation Regulation's due diligence requirements for institutional investors as being too burdensome for the value they add
- removing other regulatory requirements (such as retention rules) for UCITS investing in securitisations and
- removing the 10% concentration limit for debt securities, since securitisations already provide diverse credit risks exposures.

Other respondents, though, took the opposite view, highlighting the risks entailed with securitisations, such as performance of the underlying exposures, credit and counterparty risks and other risks related to exposure to loan-structured financial products.

These backed additional provisions such as

- listing requirements for debt instruments;
- the application of a look-through approach;
- limiting UCITS investments to instruments that qualify as simple, transparent and standardised ('STS') securitisations.

What does ESMA recommend?

ESMA notes the divergence between the respondents and

- as far as the policy suggestions put forward in relation to the Securitisation Regulation are concerned, ESMA believes these lie outside the scope of its current mandate.
- with respect to the investment limits and requirements set out in the UCITS Directive, ESMA suggests that this issue be discussed as a whole in the context of future amendments to the investment limits of UCITS on securitisations – the current 10% limit should, though, be dedicated to the broad category of debt securities as the limit helps ensure adequate risk-spreading and prevents UCITS from gaining excessive exposure to any single borrower, sector, or type of asset.

Further, ESMA recommends that the only requirements applying to securitisations should be those in the Securitisation Regulation.

Finally, ESMA recommends the Commission to consider amending Article 88 of the UCITS Directive so it refers to Article 50a. This would clarify that UCITS cannot grant loans or act as a guarantor on behalf of third parties.

What does Simmons think?

We support ESMA's recommendation that the only requirements applying to securitisations for UCITS should be those in the Securitisation Regulation.

On investment limits / spread, and while discussions around this will likely take place at a later date, ESMA's recommendation that the current 10% limit on UCITS acquiring more than 10% of the debt securities of a single issuing body is not entirely helpful. Monitoring against this limit in terms of securitisations is not straightforward and warrants further consideration.

While it is acknowledged that the UCITS Directive expressly prohibits the granting of loans, given the rise of alternative credit and particularly credit funds, and the potential benefits to retail investors of the income and returns profile of private credit, it is a shame that ESMA has not considered the potential benefits here and made recommendations more broadly to the Commission in this regard.

(xii) Alignment with MIFID II, Distributed Ledger Technology Pilot Regime Regulation and MiCA

The current position

The treatment of multilateral trading facilities (MTFs) represents a significant area for update.

MiFID I defined both the concepts of a regulated market and an MTF. Although MiFID II modified the rules applicable to these, it left the definitions unchanged, while introducing the new one of 'organised trading facility'.

The UCITS Directive envisages the category of 'another regulated market' in a Member State – this must fulfil the conditions of (i) operating regularly and (ii) being open to the public.

Where an instrument is dealt in on another regulated market, which is established outside the EU, the UCITS's NCA must approve the choice of that market or choosing the market should be provided for in the UCITS's rules or instruments of incorporation.

There was some support in the feedback to the Call for Evidence for aligning the UCITS Directive's definition of regulated market with that in MiFID II, while other respondents argued for treating EU MTFs as regulated markets (which aligns with ESMA's position in its Q&As on the application of the UCITS Directive).

In addition, there was agreement that the MiFID II equivalence rules should not apply to UCITS investments as this would unduly limit the universe of UCITS eligible assets – UCITS, respondents felt, should be allowed to invest in a third-country market which meets the conditions set out in the UCITS Directive, whether or not the Commission has made an equivalence decision from a MiFID perspective.

Respondents also provided feedback on two questions concerning whether a financial instrument should qualify for investment by a UCITS, namely .

- financial instruments issued using Distributed Ledger Technology (DLT) as UCITS eligible assets, and
- the eligibility of crypto-assets that qualify as financial instruments under MiCA.

The concept of financial instruments under MIFID II includes those issued through DLT so such instruments could be traded on the markets under the existing framework.

Crypto-assets that qualify as financial instruments (either under MiFID II or the AIFMD) fall outside the scope of MiCA nor are crypto-assets explicitly eligible for direct investments under the UCITS framework.

What does ESMA recommend?

ESMA agrees that EU MTFs could be considered an eligible trading venue for UCITS and recommends that the Commission should

- introduce the definition of regulated market and MTFs by cross-referencing to MIFID II and
- amend the UCITS Directive and EAD to include EU MTFs as an eligible trading venue for UCITS.

ESMA agrees that the ability of a UCITS to invest in third-country markets should not depend solely on a Commission equivalence decision made under MIFID II / MIFIR - a ManCo wishing to invest in a non-EU market should carry out an assessment centred on the eligibility criteria that the instruments must meet as well as all other criteria relevant to the investment. Where an equivalence decision has been adopted for a given market, though, the ManCo should take this into account as part of its due diligence on the planned investments.

- [DLT](#)

ESMA recommends that the same criteria for assessing a financial instrument should be the same for those issued by means of DLT as for other instruments - the technology used should not, of itself, prevent assets from being eligible.

- [MiCA](#)

ESMA's view is that a crypto-asset may be eligible for investment by a UCITS on a case-by-case analysis taking into account whether

- it qualifies as a financial instrument under MIFID II and / or other EU legislation, e.g., AIFMD
- it meets the criteria and conditions to be an eligible asset under the UCITS Directive and the EAD
- the UCITS can comply with all applicable UCITS Directive requirements and those in other regulations.
- [Updating cross-references](#)

Finally, ESMA's drafting proposals include a number of provisions updating references in the UCITS Directive so they refer to MiFID II rather than (as now) MiFID I.

What does Simmons think?

Increased Investment Universe for UCITS

- The explicit inclusion of EU MTFs broadens the pool of potential trading venues for UCITS, potentially allowing them access to a wider range of securities and improving liquidity.

Enhanced Due Diligence for Non-EU Markets

- UCITS managers will have a more active and direct responsibility for assessing the suitability of third-country markets. This means less reliance on broader EU equivalence decisions and a greater emphasis on specific, ongoing due diligence by the fund manager.

Technology Neutrality for Financial Instruments

- The clarification on DLT-issued instruments is crucial. It means that UCITS can, in principle, invest in financial instruments that leverage new technologies, as long as the instruments themselves meet the traditional UCITS eligibility standards (e.g., liquidity, negotiability, proper valuation). This embraces technological innovation without compromising investor protection.

Cautious Opening to Certain Crypto-Assets (Indirectly)

- While not a green light for direct broad crypto-asset investment, this opens a narrow, highly conditional path for UCITS to potentially invest in crypto-assets that are clearly classified as *financial instruments* under MiFID II (e.g., tokenized securities). This will require rigorous individual assessment and compliance with all UCITS rules, maintaining the high bar for investor protection.

Modernisation of UCITS Framework

- The overall effect is a modernisation of the UCITS Eligible Assets Directive, aligning it more closely with MiFID II and acknowledging the evolution of trading venues and financial instruments, while reinforcing the core principles of investor protection, liquidity, and diversification that define the UCITS brand.

(xiii) Short positions

The current position

Although UCITS cannot engage in uncovered sales of transferable securities or other financial instruments, they can build up synthetic short positions e.g. through the use of derivatives or delta-one instruments.

What does ESMA recommend?

ESMA's recommendation – in line with the majority of respondents to the Call For Evidence – is that there is no need for legislative change in this area. This would mean that UCITS could continue to build short positions through derivatives or other financial instrument or techniques, provided all requirements and limits set out in the UCITS framework are met.

The Final Report recognises that short positions can expose UCITS to additional risks (and, theoretically, unlimited losses) but ESMA feels that these issues should be carefully considered in the operational and risk management processes of UCITS ManCos, in line with existing guidelines.

ESMA also flags the need for there to be adequate disclosure to investors, including as to whether the UCITS intends to take long or short positions (or both) and the associated risks.

What does Simmons think?

ESMA's recommendations represent no real change to the existing position.

It is not obvious, however, that covered physical shorts should not be acceptable trades for UCITS. To the extent that it is more efficient, from a best execution perspective, for a UCITS to trade a physical covered short rather than a synthetic (derivative) equivalent, this would have been a helpful tool for managers. While Article 89 of the Directive prevents physical shorting, it may have been helpful for ESMA to challenge the status quo on this with a recommendation to ESMA.

What happens next?

The Commission will now consider ESMA's advice with a view to adopting a legislative proposal.

This proposal will be scrutinised by the Council of the EU and the European Parliament which will, through trilogue negotiations, agree a political text. This will, in time, be published in the Official Journal.

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