

ELFA's response to ESMA's Call for Evidence On the review of the UCITS Eligible Assets Directive

Introduction

ELFA welcomes the opportunity to respond to ESMA's Call for Evidence on the review of the UCITS Eligible Assets Directive.

About ELFA

The European Leveraged Finance Association (ELFA) is a buy-side-only trade association comprised of European credit investors in the high-yield, leveraged loan, CLO and private debt markets. Its membership consists of more than 60 institutional fixed income managers, including investment advisors, insurance corporates, CLO Managers and pension funds. ELFA seeks to support the growth and resilience of the leveraged finance market while acting as the voice of its lender community by promoting transparency, improving standards and facilitating engagement among leveraged finance market participants.

Executive summary

ELFA fully supports the Undertakings for Collective Investment in Transferable Securities (UCITS) framework and its aims and considers the framework to be generally working well. It has brought European investors a wide offering of funds, along with provisions for investor protection. As stated in ESMA's Call for Evidence, UCITS are a key pillar of the European Union (EU) capital markets and the UCITS Directive has created a harmonised and well-functioning regime throughout the EU for the management and cross-border marketing of investment funds.


ELFA recognises that UCITS funds promote market efficiency through diversification in investments, transparency to investors and regulators, standardisation of requirements, and protection of investors. In particular, UCITS funds' adherence to regulations ensures a level playing field for investors fostering trust and liquidity in EU financial markets. ELFA considers UCITS funds to be crucial to the proper functioning of EU capital markets.

The leveraged finance market plays a crucial role in the EU economy by facilitating capital allocation, supporting business growth, and enabling investment. The leveraged finance market has consistently demonstrated strength and resilience, and the ability to adapt to market conditions and enhance market efficiency.

However, ELFA believes that the UCITS regime does not adequately take into consideration the specific characteristics of various assets within the leveraged finance universe thereby potentially depriving UCITS investors of their benefits. This in turn could pose a limitation on capital flowing into the broader EU economy.

ELFA maintains that the current UCITS eligible assets framework could be enhanced to allow for a more effective composition of assets, while maintaining the liquidity of the portfolio suitable to retail investors.

Existing position. The UCITS framework is currently highly prescriptive in terms of permissible asset classes. The permissible assets rules under Article 50 of the UCITS Directive permit investment in transferable securities that are admitted to or dealt in on an eligible market or which will be admitted to trading on an eligible market within a year of issue ("listed securities"). Such listed securities may include, for example, debt securities of privately held companies.



The eligible asset rules include a presumption of liquidity in respect of listed securities such that, in the absence of the UCITS management company having information suggesting otherwise, listed securities shall be presumed not to compromise the ability of the UCITS management company to comply with its obligation to redeem units at prices consistent with the daily asset valuations at the request of any qualifying unitholder. They shall also be presumed to be negotiable.

ELFA's consideration of existing position: It is ELFA's view that the presumption of liquidity for listed securities creates a risk that investments which may not in fact have a uniform liquidity profile are treated as equally eligible for portfolio inclusion. While it is true that some listed securities provide significant liquidity, other listed securities may not provide greater liquidity than frequently traded unlisted securities or liquid leveraged loans (discussed further below). As discussed in ESMA's Public Statement concerning the results of the 2020 Common Supervisory Action on UCITS liquidity risk management, a presumption of liquidity without the accompanying liquidity analyses and forecasts may not in itself ensure a liquid portfolio.

In many ways, listing requirements do not reflect the true underlying liquidity of the international high-yield bond market. The vast majority of high-yield issuers are required to supply regular information to investors far in excess of what is currently required by any European exchange. Furthermore, most institutional and professional investors would reject any bond issuer whose only disclosure was that which satisfied the listing exchange. It is difficult to envisage that any issuer would successfully place a broadly syndicated public offering based on that information alone.

In addition to meeting any listing requirements, we would also highlight that the overwhelming majority of trades continue to take place directly between broking banks and institutional clients and are not in fact actually trading on the exchanges where the securities are listed. In the past we have seen numerous examples of various instruments (both debt and equity) carrying listings but are in all other manners completely illiquid obligations held by a very small number of investors. Therefore, although these types of issues meet the UCITS requirements for a public obligation, they are essentially illiquid private investments.


Furthermore, the current rules also permit investment of no more than 10 per cent of the property of the UCITS in transferable securities and approved money-market instruments, other than listed securities. We fully acknowledge and appreciate the necessity of such prescriptive regulations to ensure that UCITS funds maintain a broad-based liquidity profile which has helped make the UCITS a globally recognised and accepted standard. While these instruments will most likely have liquidity profiles significantly less than other portfolio assets, they are nevertheless considered eligible assets (subject to the 10 per cent limit) and the overriding requirement to meet the redemption terms offered to investors. Unlisted securities are likely to be settled over an extended time period which may create a liquidity mismatch with investor redemption terms. While we acknowledge this risk, we consider that this statutory limit provides a fair trade-off between relevant investment opportunities, ensuring minimal criteria to overall portfolio liquidity profile.

However, we would like to highlight that the current eligible assets framework under the UCITS Directive presently prohibits a UCITS from lending money from its scheme property. This means that a UCITS is unable to participate in the initial funding of a syndicated loan either as an original lender or as a person who becomes a lender as part of the primary syndication of the loan. Consequently, UCITS-based investors are structurally disadvantaged compared with other investment vehicles.

ELFA's position: ELFA proposes for ESMA's consideration that where syndicated leveraged loans meet the eligibility criteria under the UCITS Eligible Assets Directive that relate to liquidity (it being freely transferable), valuations and negotiability, they be included under Article 50(2)(a) of the UCITS Directive,¹ subject to the 10 per cent limit applicable to unlisted securities, if ESMA deems the latter necessary or appropriate.

Deeming loans to be assets that are eligible for UCITS structures, while adhering to the limitations on non-listed investments, would also help eliminate the economic disadvantages between UCITS-based investors and other structures in the context of debt restructurings. ELFA considers this to be a relatively

¹ Article 19 of the Consolidated UCITS Directive.



minor modification that would help address a current imbalance. In a hypothetical example, a UCITS high-yield fund would be completely compliant in holding up to 10 per cent in non-listed equities (which are extremely illiquid and hard to price) from various restructurings but is prohibited in holding a more liquid loan from the same corporate entity, which is lower risk, carries more certainty around its valuation levels, and is more liquid than a comparable non-listed equity.

ELFA also considers that UCITS investors would also benefit from the rules expressly acknowledging that appropriately liquid collateralised loan obligation (CLO) notes that otherwise are deemed to be suitable for the UCITS qualify as eligible assets as these provide access to the underlying assets in rated and liquid format. Where the CLO notes are issued as securitisations within the scope of the EU Securitisation Regulation (EUSR), any issuance in which a UCITS may participate would need to comply with the requirements under the EUSR. CLO notes serve to insulate investors from idiosyncratic risk using well established portfolio techniques (diversification and credit enhancement) and cure mechanisms that protect investors. Furthermore, UCITS funds would be able to select from a range of rated CLO notes (from AAA to B) to suit their risk/return requirements.

ELFA observes that there is a lack of clear guidance as to whether CLO notes admitted to trading on a relevant trading venue (including those issued as securitisations) may be considered transferable securities that are not subject to the 10 per cent restriction by regulators in all EU jurisdictions and considers that clarification that they may so be considered would be welcome.

ELFA would also welcome clarification that a UCITS scheme may acquire interests in leveraged loans on the secondary market including where the transfer mechanism is novation, resulting in the UCITS becoming the lender of record, again, provided that the leveraged loan interests meet the eligibility criteria under the UCITS Eligible Assets Directive that relate to liquidity, valuations and negotiability (as further discussed below).

ELFA's response to question 1 of the Call for Evidence questions is provided below.



Questions

3.1 Convergence issues and clarity of key concepts

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

ELFA response: ELFA appreciates and acknowledges that the success of UCITS as a brand is largely due to the regulatory regime within which UCITS funds operate. ELFA wants this success to continue and welcomes the opportunity to bring to ESMA's attention the most pressing issue to address in the UCITS Eligible Assets Directive (UCITS EAD) from the perspective of ELFA's membership, representing the leveraged finance market buy-side.

Most pressing issue to address in the UCITS EAD

ELFA submits that, for the EU leveraged finance industry's buy-side, the most pressing issue is the prohibition of UCITS funds from investing in broadly quoted syndicated leveraged loans and CLO notes. We describe these assets below.

Broadly Quoted Syndicated Leveraged Loans. Leveraged loans (also known as senior loans) of this type are generally the most senior debt obligations in the capital structure of non-investment grade corporates. Additionally, senior loans are generally secured by collateral.

Leveraged loans are quite straightforward to understand, unlike certain of the complex products that are permitted under the UCITS framework. Leveraged loans allow corporates to diversify their funding sources beyond bank loans or bond issuances, thereby extending the availability of credit to corporates that may not be able to obtain advantageous rates with bank lenders, for example, due to banks' regulatory capital requirements. These loans are secured by collateral. For lenders, leveraged loans can offer attractive returns. The risk-return features of leveraged loans can also improve the performance of a diversified portfolio, since leveraged loans tend to have a low correlation with bond indices.

Leveraged loans – benefits

ELFA published an [Insights report](#) that elaborates further on why ELFA advocates the permissibility of leveraged loans under the UCITS framework. This is particularly important in the context of maximising recoveries from debt restructurings. By way of comparison, US 40 Act mutual funds (i.e., US retail fund products) are able to participate in debt restructurings by providing fresh capital in the form of loans or through holding unlisted securities. Furthermore, these funds can temporarily underwrite the provision of new capital but that is not currently possible under the EU UCITS framework.

ELFA believes that the alignment of the UCITS eligible assets regime with a comparable retail fund regime such as that of the US is desirable. The US provides an example of a jurisdiction with a sophisticated regulatory framework with high-quality retail investor protections. Greater alignment will ensure that EU financial markets are not at a competitive disadvantage and will also prevent regulatory arbitrage.

ELFA appreciates that striking the right balance between investor protection and proper market functioning is essential. However, ELFA considers the benefits that will accrue to the EU economy by extending eligibility to leveraged loans to be substantial. Apart from offering significant returns potential and superiority in the capital structure, senior loans also offer lenders the following benefits among others:

- low correlation to other asset classes
- interest payments that track the rate environment
- potential for higher returns
- sophisticated asset management systems customised to syndicated loan asset class

Existing Eligible Assets Rules result in inconsistent treatment of asset classes with a comparable liquidity profile

The UCITS Eligible Assets Directive² permits investment in transferable securities that are admitted to or dealt in on an eligible market or which will be admitted to trading on an eligible market within a year of issue (“listed securities”), subject to certain concentration limits.³

The UCITS Eligible Assets Directive also permits investment in transferable securities other than listed securities, subject to a 10 per cent overall limit, provided that such securities meet the criteria in Article 2(1) of the UCITS Eligible Assets Directive and that the investment does not compromise the ability of the UCITS to meet its liquidity obligations to investors under Article 76 of the UCITS Directive.

By contrast, the current eligible assets framework excludes loans, including broadly quoted syndicated leveraged loans. This exclusion prevents exposure to a potentially highly profitable asset class that in many cases has a liquidity profile that would be at least comparable to the liquidity profile of unlisted securities which are currently eligible assets, subject to the 10 per cent overall limit. In some cases, the liquidity profile of broadly quoted syndicated leveraged loans may be better than the liquidity profile of a small issuance of bonds that constitute listed securities.

Given that interests in broadly quoted syndicated leveraged loans are frequently traded and have significant liquidity, this exclusion seems inconsistent with the principles underpinning the eligible assets framework. The exclusion unduly restricts the investable universe of UCITS and may cause deflated investor returns. The inability to invest in broadly quoted syndicated leveraged loans with a liquidity profile that is similar or better than the liquidity profile of unlisted securities excludes investment in such loans, even where they may represent a better investment opportunity for the UCITS than listed or unlisted securities that are currently eligible assets.

Inability to participate in restructuring of investments

A consequence of the current eligible assets framework excluding loans is that UCITS are precluded from participating in investments where the capital structure of the issuer needs to be restructured. As the interest held by the UCITS are not majority interests, it is often the case that the UCITS is unable to influence the form that the restructuring of the issuer’s equity and/or share capital takes. Such restructuring often includes a senior secured loan (possibly among other instruments) and in some markets, including the US, the most common restructuring approach is to introduce a new senior loan.

In such circumstances, the new senior loan is typically the most secured investment with the best prospects of capital recovery. If a UCITS is unable to make loans it may either forfeit its initial investment altogether, realising a loss and foregoing any recovery of the initial investment, or, if available, be required to hold subordinated debt instruments that are structured as transferable securities.

Eligibility criteria


ELFA maintains the position that eligibility should be assessed with a view to the overall liquidity of the portfolio, with a view to the characteristics of the relevant asset class, and subject to the overarching obligation of the UCITS management company ensuring compliance with Article 76 of the UCITS Directive and the liquidity terms granted to investors. UCITS must assess the liquidity risk of an investment to ensure compliance with the liquidity requirements under the UCITS Directive.

The UCITS Eligible Assets Guidelines specify the following (non-exhaustive) factors to be taken into consideration:

- volume and turnover in the transferable security
- if price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy and timeframe to buy or sell
- (where necessary) bid and offer prices over a period of time and comparability of available prices
- quality and number of intermediaries and market makers dealing in the transferable security

² Commission Directive 2007/16/EC.

³ Consolidated Directive 85/611/EC.



ELFA proposes for consideration that additional eligibility criteria for broadly quoted syndicated leveraged loans be included, for example:

- size of the principal amount of the loan
- number of potential counterparties
- number of participants in the loan syndicate
- free transferability of interests in the loan
- collateral

Advantages of including broadly quoted syndicated leveraged loans as eligible assets

There are a number of advantages to UCITS funds and to the EU economy of broadly quoted syndicated leveraged loans:

- Diversification: investing in broadly quoted syndicated leveraged loans diversifies a portfolio beyond publicly traded and private stocks and bonds, which can reduce overall risk.
- Potential for higher returns: broadly quoted syndicated leveraged loans may provide better returns compared to traditional assets.
- Less volatility: broadly quoted syndicated leveraged loans are less affected by market fluctuations because they are not traded on public exchanges and because they are secured.
- Investment opportunities: broadly quoted syndicated leveraged loans allow for investment that is not generally available through public markets. These opportunities can be potentially lucrative.
- Facilitates capital allocation: capital allocation can be achieved more efficiently taking into account the wider and more nuanced needs of the market, borrowers and issuers.

CLO Notes. CLO notes are listed securities referencing underlying portfolios of syndicated loans. Investing in syndicated loans through an investment in CLO notes provides investors with access to the syndicated loan market. CLO notes often are comprised of non-investment grade corporate loans that fund leveraged buyouts conducted by private equity sponsors.

ELFA observes that there is a lack of clear guidance as to whether CLO notes admitted to trading on a relevant trading venue (including those issued as securitisations) may be considered transferable securities that are not subject to the 10 per cent restriction by regulators in all EU jurisdictions and considers that clarification that they may so be considered would be welcome. Other benefits provided by CLO notes are listed below.

- Regulatory oversight: CLO notes are listed securities with quarterly ESMA reporting.
- Transparency: CLO notes provide good transparency via monthly trustee reports.
- Portfolio oversight: CLO notes provide risk retention protection, professional asset selection and portfolio management.
- Risk mitigation: CLO notes provide low duration risk, a focus on sustainability, good liquidity, and rating agencies oversight.
- Strong operational infrastructure: CLO notes are traded through established sourcing and trading networks.

Eligibility criteria

ELFA considers the following eligibility criteria to be relevant for CLO notes:

- identity of arrangers
- identity of agent
- size of CLO manager (for example, greater than €10 billion AUM)
- minimum size of the relevant note
- credit rating
- liquidity



Advantages of including CLO Notes as eligible assets

There are a number of advantages to UCITS funds and to the EU economy of CLO notes:

- Diversification: investing in CLO notes provides exposure to a diversified portfolio of loans made to non-investment grade borrowers.
- Higher yield: CLO notes generally provide better returns compared to traditional assets.
- Structure of CLO notes: CLO notes are structured with different tranches, each carrying varying levels of credit risk. This diversification helps manage risk.
- Good liquidity: CLO notes are generally more liquid as they can be bought and sold in the secondary market.
- Professionally managed: the collateral manager is responsible for managing the loan pool that backs the CLO notes.



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