

29 November 2004

Committee of European Securities Regulators  
11-13 Avenue de Friedland  
75008 Paris  
France

Dear Sirs

### **CESR - Call for evidence on the definitions of eligible assets**

As the representative body for the UK-based investment management industry we are grateful for the opportunity to comment on the CESR's call for evidence on the definitions of eligible assets for investment by UCITS.

IMA's members include independent fund managers, the investment arms of banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our IMA represent 99% of funds under management in UK-authorized investment funds (i.e. unit trusts and open-ended investment companies) and our members also manage funds elsewhere in Europe.

We would be concerned if the result of a review of the requirements relating to eligible assets were to lead to greater prescription or limitations on existing investment rules. We believe that it is important to maintain sufficient flexibility to allow managers to innovate in order to meet customer needs and compete with other products. If existing requirements are to be made more stringent, a very strong case would have to be made for CESR's intervention, particularly since there could be significant implications for funds which have already been authorised.

If you wish to discuss any of the points raised in our response please do not hesitate to contact me.

Yours faithfully

Sheila Nicoll

Enc: IMA's response

## CESR Call for Evidence – IMA’s response

### Formal mandate to CESR for advice on possible modifications to the UCITS Directive in the form of clarification of definitions concerning eligible assets for investment of UCITS

#### 3.1 Clarification of Article 1(8) (definition of transferable securities)

##### 3.1.1 Treatment of “structured financial instruments”

DG Internal Market requests CESR to provide advice on the factors to be used in determining whether financial instruments whose underlying involves products of varying degrees of liquidity and/or which may not be directly eligible for investment by a UCITS, meet the formal and qualitative requirements for recognition as a ‘transferable security’ within the meaning of the UCITS Directive. Is the fact of admission to trading on a regulated market as foreseen in Art. 19(1)(a) to (d) sufficient for them to be considered “transferable securities” of Art. 1 (8), eligible for investment by UCITS ? In view of other considerations contained in the UCITS Directive, are there other factors which should be taken into account?

IMA suggests that when considering the definition of “transferable security” CESR should look at the individual definitions of both ‘transferable’ and ‘security’ from first principles.

‘Transferable’ can be interpreted as the ensuring that the title of the investment can be freely transferred. If the instrument can not be freely transferred or there is a requirement for the consent of a third party the instrument would not be transferable.

The UCITS Directive does provide some guidance as to the definition of “security” which includes:

- “Shares in companies and other securities equivalent to shares in companies;
- Bonds and other forms of securitised debt;
- Any other negotiable securities which carry the right to acquire any such transferable security by subscription or exchange;

excluding the techniques and instruments referred to in Article 21.”

There is a additional layer of investor protection in that in order for a “transferable security” to be approved is also needs to be:

- listed on a regulated market as defined in the Investment Services Directive;
- listed on a regulated market in a member state which operates regularly and is recognised and open to the public; or
- admitted to official listing on a stock exchange or listed on a regulated market n a non EU State which operates regularly and is recognised and open to the public

provided. (requires approval by competent authority or disclosed in instrument of incorporation).

When implementing the UCITS Directive in the UK, the Financial Services Authority, further defined "transferable securities" as an investment where the debts of which are limited to the amount paid for that investment. This further clarification of has then provided a clear line between the definition of 'derivative' and 'transferable security'. Therefore in the UK a investment fund can invest in transferable securities which embed a derivative provided that the liability is limited to the price paid for that instrument and there is no additional liability. There may be situations where it is beneficial to the fund to gain exposure to derivative via a transferable security embedding a derivative rather than investing directly in the derivative such as taxation considerations for example collateralised debt obligations.

As there is currently no requirement to look through the transferable security to underlying structured financial instrument there is the possibility of circumventing the UCITS spread restrictions. However, all UCITS must abide by the overarching principal for the fund to be subject to prudent spread of risk and to comply with its investment objectives and policy as disclosed in the instrument constituting the scheme and the scheme prospectus.

IMA therefore considers that with the over-arching requirements, that the instruments in which a UCITS invests be transferable and liquid, and that the fund be subject to prudent spread of risk, provide appropriate protections without further detailed requirements needing to be introduced. IMA recommends that the flexibility, with the inherent investor protection in this definition, should continue to be provided.

### 3.1.2 Closed end funds as "transferable securities"

DG Internal Market requests CESR to provide technical advice as to whether and under which conditions shares of closed end funds or different variants of closed end-fund fall under the definition of transferable securities as provided for by Art. 1 (8), having regard to Art. 19 (1) (a) to (d) and other relevant considerations contained in the UCITS Directive.

Funds which create or cancel shares or units on demand, at a price directly related to the net asset value of the fund assets, should be regarded as "open-ended" and should thus be required to comply with the relevant regulatory regime for such schemes.

Within the UK, closed ended funds take the form of investment trusts which are clearly "transferable securities" falling within the appropriate definitions of the UCITS directive and IMA sees no reason why this approach should be questioned. Closed ended investment companies are like any other company but just happen to have an object of making investments, rather than, for example, producing cosmetics. The price at which shares are bought and sold in these companies is not directly related to the net asset value of the property held by the company, but rather is related to the relative supply and demand of those shares on the market. The shares in such companies may therefore be traded at a premium or discount to the net asset value of the assets of the company. We believe, therefore, that they are quite different from open ended funds for these purposes. IMA would

recommend that CESR takes into consideration the informal commentary accompanying the original UCITS Directive (the 'Vandamme commentary') which states:

"the restrictions in (a) and (b) above do not apply to investment in the units of collective investment undertakings of the closed-ended type." "This is entirely justified since the units of the undertakings of the closed-ended type (which normally have a stock exchange listing) are similar to any other transferable security, and from the standpoint of the Directive's rules on investment, they have to follow the general rules applicable to transferable securities".

We do not believe that circumstances have changed such as to question this. To change practice which has been established since the original UCITS directive was first implemented could cause considerable disruption to the existing market, without clear reason.

Defining closed-ended funds as "transferable securities" would also tie in to other EU Directives which place requirements on closed-ended funds while providing special provisions for open-ended funds such as UCITS e.g. the Prospectus and Transparency Directives.

### 3.1.3 Other eligible transferable securities

DG Internal Market requests CESR to provide technical advice on any factors to be used to assess whether possible investments in transferable securities should be considered as falling within the scope of (i) transferable securities dealt in on a regulated market according to Art. 19 (1) (a) to (d) and (ii) "other transferable securities" under Art. 19 (2). Is it sufficient that a 'transferable security' not be dealt in on a regulated market in order to fall within the scope of "other transferable securities" under Art. 19 (2)? Are there other factors which should be taken into account in determining whether particular categories of transferable security fall within the scope of Art. 19 (2) (a)?

The UCITS Directive provides for up to 10% of the scheme property to be invested in transferable securities which do not comply with all or some of the criteria laid down in Article 19(1)(a) to (e). However, the overarching requirement is that the instrument is "transferable" i.e. freely transferable without the consent of a third party.

As noted for question 3.1.1 when implementing the UCITS Directive, the Financial Services Authority, further defined "transferable securities" as an investment which the debts of which are limited to the amount paid for the that investment, which limits the liabilities of such instruments.

IMA therefore considers that with the requirements for such instruments to be transferable and for the exposure to be limited 10% of the scheme property provides adequate investor protection.

## 3.2 Clarification of Article 1(9) (Definition of Money Market Instruments)

### 3.2.1 General rules for investment eligibility

DG Internal Market requests CESR to provide advice on the factors to be used to determine the eligibility of certain categories of money market instrument dealt in on a regulated market according to Art. 19 (1) (a) to (d). Is the fact that they are dealt in on a regulated market sufficient for them to be considered "money market instruments" meeting the general conditions specified at Art. 1 (9)? In view of other considerations contained in the UCITS Directive, are there other factors/criteria which should be taken into account?

IMA is content that provided money market instruments are listed on a regulated market, the value can be accurately determined and are liquid, the instrument should be eligible for UCITS investment.

IMA is unaware of any other factors or criteria that need to be taken into consideration when determining the eligibility of money market instruments.

### 3.2.2 Article 19(1)(h)

DG Internal Market requests CESR to provide technical advice on the following issues:

- CESR is invited to clarify the pre-requisite of the 1st paragraph of Art. 19 (1) (h) requiring that the issuer of such money market instruments other than those dealt in on a regulated market "is itself regulated for the purpose of protecting investors and savings", e.g. whether this pre-requisite should encompass other issuers than credit institutions. It should also be clarified how such pre-requisite can be complied with in addition with each of the four indents of Art. 19 (1) (h). For instance, how can such pre-requisite be combined with the additional criteria of the first indent, i.e. "issued or guaranteed by a central, regional or local authority [...]?"
- CESR is invited provide advice on the factors to be used in deciding whether and under what conditions money market instruments other than those dealt in on a regulated market are "issued by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law" as referred to in Art. 19 (1) (h) third indent. In particular, CESR is invited (i) to clarify the concept of "at least as stringent" and (ii) to determine whether, and if yes, to which extent, such criteria and the abovementioned pre-requisite of the 1st paragraph of Art. 19 (1) (h) overlap each.
- CESR is invited to clarify the concept of "equivalent investor protection", i.e. to clarify the factors referred to in Art. 19 (1) (h) fourth indent which need to be taken into account in deciding whether and under what conditions money market instruments other than those dealt in on a regulated market are "issued by other bodies provided that investments in such instruments are subject to investor protection equivalent to that laid down in the first, the second or the third indent of Art. 19 (1)(h) and provided that the issuer is:
  - (i) a company whose capital and reserves amount to at least EUR 10 million and which presents and publishes its annual accounts in accordance with Directive 78/660/EEC;
  - (ii) an entity which, within a group of companies which includes one or several listed companies, is dedicated to the financing of the group; or
  - (iii) an entity which is dedicated to the financing of securitisation vehicles

which benefit from a banking liquidity line”.

In the case of the last factor above (i.e. “entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line”) CESR is invited to clarify which instruments would be covered by this provision, for instance considering the questions of (i) whether and under what conditions it encompasses asset backed securities<sup>9</sup> and synthetic asset backed securities<sup>10</sup>, (ii) the quality of the “banking liquidity line” referred to therein and (iii) of the question as to which category of banks (credit institutions) are covered by the term “banking”.

Where appropriate and necessary, these clarifications should consider the Recommendation on the use of derivatives by UCITS, where relevant. 3.2.3

IMA agrees that the requirement in Article 19(1)(h) for the issue or issuer of money market instruments to be regulated itself and dealt on a regulated market would appear to prevent investment in money market instruments “issued or guaranteed by a central, regional or local authority” even though these are specified in this article. IMA recommends that clarification be given that the issue or issuer does not need to be regulated where the instruments are “issued or guaranteed by a central, regional or local authority”.

IMA would recommend that when considering money market instruments which are not dealt on a regulated market, the issuer should be “subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by community law” that CESR takes into account the approach adopted by the Basel agreements.

### 3.2.3 Other eligible money market instruments

DG Internal Market requests CESR to provide technical advice on the factors to be used to determine the limit between money market instruments according to Art. 19 (1) and “other money market instruments” under Art. 19 (2). Is the fact that they are not dealt in on a regulated market sufficient for them to be considered “other money market instruments” under Art. 19 (2) ? In view of other considerations contained in the Directive, are there other factors which should be taken into account?

IMA is content that unlisted money market instruments up to 10% of the scheme property can be eligible provided that they are transferable.

IMA is unaware of any other factors or criteria that need to be taken into consideration when determining the eligibility of such money market instruments.

### 3.3 Clarification of scope of Article 1(8) (definition of transferable securities) and “techniques and instruments” referred to in Article 21

DG Internal Market requests CESR to clarify the factors which need to be taken into account in determining whether and under what conditions certain instruments should fall:

- a. under Art. 21 (2) 1st subparagraph as " techniques and instruments relating to transferable securities and money market instruments". In formulating its advice, CESR is invited to clarify of the notions of " used for the purpose of efficient portfolio management" under Art. 21 (2).
- b. under the sub-category of transferable securities according to Art. 1(8) as set out under Art. 21 (3), i.e. transferable securities " embedding a derivative element". This clarification could be used to determine the treatment of the derivative component of the "structured financial instruments" referred to under 3.1.1 above.

Where appropriate and necessary, these clarifications should also take account of the Recommendation on the use of derivatives by UCITS.

Article 21(2) provides for the eligibility of "techniques and instruments relating to transferable securities and money market instruments" for the purpose of "efficient portfolio management". In the UK, "efficient portfolio management" has been defined as the use of such instruments in order to:

- reduce risk;
- reduce costs;
- generation of additional capital or income.

In the UK if such instruments are defined as derivatives there needs to be adequate global cover or if defined as transferable securities the liability is limited to the price paid for the instrument.

Where derivatives are used the manager of the UCITS must have an appropriate risk management process that is lodged with the competent authority and is provided to investors on request.

IMA considers that these considerations provide sufficient investor protection.

### 3.4 "Other collective investment undertakings"

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation (bearing in mind its relevance for the advice to be rendered under Art. 3.1.2 above):

- a. the "other collective investment undertaking" in question is subject to supervision "equivalent to that laid down in Community law" as referred to in Art. 19 (1) (e) first indent.
- b. the level of protection of unit-holders is " equivalent to that provided for unit-holders in a UCITS" as referred to in Art. 19 (1) (e) second indent.

IMA is aware that there are significant differences in how EU jurisdictions are implementing the flexibility to invest up to 30% of the fund in non-UCITS. IMA however considers that article 19(1)(e) second and third paragraph provides enough detail as to the definition of subject to supervision "equivalent to that laid down in Community law". The non-UCITS must comply with rules at least equivalent to the ones in place for UCITS with regard to diversification of the assets, short selling,

borrowing and lending and must also product report and accounts which document the assets and liabilities of the fund during the period.

Other considerations that could be taken into account in determining the eligibility of non-UCITS for investment purposes could that they are available to the public and are subject to regulatory oversight. IMA would recommend that CESR takes into consideration the IOSCO principles relating to collective investment schemes as the broad basis for equivalence testing. We note that compliance against the IOSCO principals has yet to be audited in all territories.

As there are divergences of interpretation by the various competent authorities IMA recommends that the competent authorities share information as to which jurisdictions and which types of funds in those jurisdictions they deem to be eligible. Sharing of this information should lead to competent authorities taking a more harmonised approach.

### 3.5 Derivative financial instruments

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation, a derivative financial instrument, especially a credit derivative instrument, falls within the scope of the definition of derivative financial instruments as set out in Art. 19 (1) (g).

Where appropriate and necessary, this clarification should take account of the Recommendation of the Commission on the use of financial derivative instruments.

Article 19(1)(g) sets out three main conditions for financial derivative instruments which are not dealt on a regulated market:

- the underlying assets should be financial indices, interest rates, foreign exchange rates or currencies provided these are in line with the investment objectives of the UCITS;
- the counterparty of an OTC derivative should be subject to prudential supervision; and
- the OTC derivative should have a reliable daily valuation, be liquid and capable of being closed out at any time at a fair value.

With regards to the second requirement relating to prudential supervision, IMA believes that CESR should take into account the approach adopted by the Basel agreements.

With regards to liquidity, Article 19(1)(g) already requires that financial derivative instruments that are dealt off exchange are liquid. We, therefore query why CESR wishes further to define "other liquid financial assets". The liquidity requirement is that the OTC derivative transaction can be closed out at any time at a fair value. As the underlying must be liquid and as it is common for "termination options" to be included in OTC derivative contracts entered into by UCITS this does not appear to pose any particular problems

Specifically with regard to credit default swap (CDS) IMA considers that provided these instruments are liquid, with appropriate termination options, there should not be any particular problems relating to their eligibility. A CDS can best be compared to an insurance policy against the occurrence of a credit event, ie. bankruptcy and/or default. The buyer of the protection in a CDS is insured against a credit event while the protection seller receives income for taking the credit risk. The protection buyer pays a regular premium and will receive in return a contingent payment in case of a credit event which will typically be the nominal value of a bond in exchange for the bond. If there is not a credit event, like any other insurance contract the protection buyer will receive nothing. As such the protection buyer is actually hedging credit risk.

Liquid is defined in the "Commission Recommendations on the use of financial derivative instruments for undertakings for collective investment in transferable securities (UCITS)" which states that

"In the context of the application of Article 42 of Directive 85/611/EEC, Member States should consider as "liquid" those instruments which can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market. Member States are recommended to ensure that the respective cash amount be at the UCITS' disposal at the maturity/expiry or exercise date of the financial derivative instrument."

IMA considers that this clarification on liquidity is sufficient but recommends that CESR provides clarification that CDSs are eligible UCITS investments.

### 3.6 "Index replicating UCITS"

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation, a UCITS can be recognised as falling within the scope of the term of "replicating the composition of a certain index" of Art. 22a(1) having regard to the additional three criteria set out in the provision and the elements relating to overall limits in investment in securities issued by any one issuer.

In this regard, CESR is invited to provide advice on the following considerations:

- a. factors to be taken into account in assessing whether the composition of the index is "sufficiently diversified" as provided for by Art. 22a (1) 1st indent;
- b. conditions under which the index can be deemed to "represent an adequate benchmark for the market to which it refers" as provided for by Art. 22a (1) 2nd indent; and
- c. the index is "published in an appropriate manner" as provided for by Art. 22a (1) 3<sup>rd</sup> indent.

IMA is unaware at this stage of any specific inconsistencies as between different Member States relating to the implementation of the increased flexibility pertaining to spread for those UCITS which replicate the composition of a certain index and believe that there are other issues which need the attention of CESR.

We believe, for example, that there is inconsistency and uncertainty with regard to the spread requirements of UCITS index replicators. There is lack of clarity in Article

22a as to whether the restriction on investment in shares or debt instruments issued by the same body is restricted to a single or multiple issuers. This needs clarification.

There is also uncertainty as to the interpretation of the term "to replicate the composition of a certain stock or debt securities index". We understand that in some jurisdictions the competent authority is interpreting this provision as also including replicating the performance of the index while others are interpreting it literally as requiring the fund to invest in the securities in the index with the relevant weightings.

Article 21(3) third paragraph provides that where a UCITS invests in index-based financial derivatives the spread requirements in Article 22 do not need to be complied with. As there are no specific regulatory requirements as to what determines the eligibility of an index-based financial derivative, IMA believes that it is important for CESR to include this point in their considerations of the position of index based funds.

As regards the criteria to determine the eligibility of an index, we do not believe that there are major problems of inconsistency and recommend that it is left to the individual member states competent authorities to evaluate and recognise individual indices.