



London
STOCK EXCHANGE

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Dear Fabrice

MODIFICATIONS TO THE UCITS DIRECTIVE - ELIGIBLE ASSETS

Thank you for the opportunity to comment on the Commission's 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.

We remain convinced that the issue of the definition of transferable securities is vital for the continued relevance of the directive and its ability to accommodate new structured products. CESR is to be applauded for the facilitative approach that has been adopted in the advice. By providing a framework within which UCITS may apply discretion in assessing the appropriateness of non-traditional products, CESR not only allows the expansion of UCITS investment into current products, but also will also allow for the inclusion of new types of product as they are developed.

However we have a particular concern over commodity securities. We believe that there is residual uncertainty over their treatment and that clarification of their suitability for UCITS investment would be beneficial to UCITS investors by allowing further and more efficient diversification of UCITS portfolios, while avoiding the problems that the prohibition on holding physical commodities in the original directive was intended to address.

Commodity securities are transferable securities

The directive permits investment in transferable securities unless otherwise prohibited. There are currently two commodity securities traded on the ISD regulated market of the London Stock Exchange: Gold Bullion Securities and Oil Securities. Both are constituted as bonds – with the issuer holding a quantity of the asset and then issuing a debt security. Although the credit-worthiness of the Issuer is enhanced by the issuer granting a fixed charge over the underlying asset, the asset belongs to the issuer and not to any holder. Clearly, as debt securities that have been admitted to trading on a regulated market, they will qualify under Article 19(1)(a) of the directive unless otherwise prohibited. We are seeking explicit confirmation in the advice that they are not so excluded.

Gold bullion securities

The directive does not permit investment in precious metals or certificates representing precious metals. The policy motivation behind this prohibition was not based on any view that the economic returns from precious metals were not acceptable for a fund, but rather to prevent funds from investing in something which was not a transferable security - it was the transferability that was the issue. Had the precious metal exclusion not been included in the directive, some funds might have argued that physical metal was in fact a transferable security (e.g. gold is transferable and it is secure). At the time, many investors would invest in precious metals which would be held in a custodian's vault and a certificate would be issued on that physical asset, hence the prohibition of certificates representing precious metals.

Clearly, Gold Bullion Securities do not conflict with the policy motivation of the original prohibition as they are easily transferable securities (traded on the SETSmm platform), and do not amount to certificates representing precious metals as intended by the directive. Gold Bullion Securities, and any other future commodity securities based on precious metals, are therefore rightly classified as transferable securities under Article 19(1)(a).

Oil and other commodity securities

The directive also does not allow for investment in other physical commodities or derivatives on physical commodities. Once again this is for reasons of transferability. Physical commodities, and derivatives on them which raise the possibility of physical delivery conflict with the directive's intention to ensure that UCITS only invest in transferable securities. Oil Securities and any future issues of commodity securities, are clearly transferable as they are traded on the London Stock Exchange, and do not give rise to any risk of taking delivery of the underlying commodity (unless specifically requested by the individual investor - although UCITS would be prohibited from doing so). They are also therefore classified as transferable securities under Article 19(1)(a).

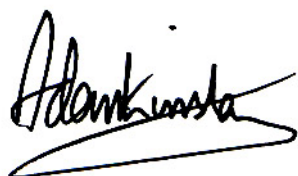
The advantages of commodity securities over alternatives

The spirit of the UCITS directive is to provide protection to investors while allowing them to efficiently diversify their portfolios. As discussed, investment in precious metals and other commodities was excluded based on their physical attributes rather than to exclude their economic exposure. Also, the market for transferable securities which track the price of commodities was not significantly developed when the original UCITS directive was written.

Securities which track the price of commodities and precious metals do now exist, and they are highly transferable. Allowing investment in a transferable security linked to commodities or precious metals is consistent with the spirit of UCITS in that it promotes diversification into an asset class which is negatively correlated with equities and bonds, and is less risky in that commodities are not exposed to corporate malfeasance or corporate risk such as financial risk, operational risk and management risk.

I hope that this response helps in CESR's consideration of this issue and I look forward to reading your advice.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Adam Kinsley', with a long horizontal flourish extending from the bottom.

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