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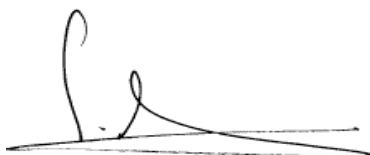
Dear Fabrice,

CESR Advice on Clarification of Definitions Concerning Eligible Assets for Investments of UCITS

We are pleased to send you EFAMA's comments in response to CESR's second consultation paper on the above-referenced subject. Our comments are illustrated by suggestions for new wording which are underlined & in red in the text. We are grateful to you for granting us the extra day in which to submit our response to you.

We hope that our comments will help you to take matters forward. Naturally, we stand ready to answer any further questions you might have in regard of the attached paper.

With kind personal regards,



Steffen Matthias
Secretary General

Enc.

EFAMA's RESPONSE TO
CESR'S SECOND CONSULTATION PAPER
CESR'S DRAFT ADVICE ON CLARIFICATION OF DEFINITIONS
CONCERNING ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

The European investment management industry, represented by EFAMA¹, welcomes the opportunity to respond to CESR's second Consultation Paper with Draft Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS.

GENERAL COMMENTS

EFAMA believes that the clarification of definitions concerning eligible assets for investments of UCITS is in the industry's best interest and wishes to thank CESR for its openness during the process and for taking into account many of the comments made by industry in the first round of the Consultation. In particular, we appreciate the separation of the advice into Level 2 and Level 3, and the higher level of flexibility reflected in the text.

Moreover, we are grateful that CESR accepted to provide for a second round of consultation (and the European Commission to delay accordingly the deadline for submission by CESR of its technical advice), which was not originally planned.

We fully agree with Mr. Biancheri's comments at the Hearing on 7 November stating that the UCITS Directive limits CESR's scope of action regarding eligible assets, and that changes to the Directive would be necessary in order to extend the choice of assets beyond what is now proposed. Indeed, we raised this issue also in our comments on the Commission's Green Paper.

Notwithstanding the general support for this draft advice, we have a number of comments, both general and more specific ones. We would like to begin by underlining that we are very much in favor of cost-benefit analysis, and we regret that only at this late stage CESR is requesting information to evaluate the cost implications for the industry. EFAMA believes that a cost/benefit analysis should become the

¹ EFAMA is the representative association for the European investment management industry. Formerly known as FEFSI, EFAMA represents through its member associations and corporate members about EUR12 trillion in assets under management of which EUR5.9 trillion managed through around 43 000 investment funds. For more information, please visit <http://www.efama.org/>

rule and be carried out much earlier in the drafting process, before regulation is proposed.

Finally, although this issue has been recognised by CESR, we wish to stress the importance for the industry – as well as for investors – of transitional measures for funds that might no longer be deemed UCITS-compliant as a result of the clarification.

SPECIFIC COMMENTS

Treatment of “structured financial instruments”

EFAMA greatly appreciates the modifications made to the text and largely agrees with CESR’s new definition of “Transferable Security”. The new text allows asset managers the necessary flexibility in the daily management of funds, without compromising investor protection.

We are still concerned, however, that the wording of Para. 1, fifth bullet point (“the security must be freely negotiable on the capital markets”) remains too restrictive and would exclude for example securities sold through a private placement, or only to qualified investors, or which may not be marketed to US citizens. We would therefore suggest modifying that bullet point as follows:

- The security must be transferable through negotiation on the capital markets, registration on the register of shareholders or other equivalent means.

Para. 2 (“In addition, the acquisition of any transferable security ...”: Some EFAMA members emphasize the importance of not excluding in the future the current market practice of using swaps combined with another underlying asset class to gain exposure to an asset class fully consistent with the stated investment objectives of the UCITS.

At Level 3, in Para. 5 we welcome the recognition of the presumption of liquidity for transferable securities traded on a regulated market. The second sentence in the paragraph, however, partly states the obvious (“The presumption does not apply if the UCITS knows ... that any particular security is not liquid”), and in part it is too vague (“The presumption does not apply if the UCITS knows or ought reasonably to know that any particular security is not liquid.”), thus creating legal uncertainty. We would therefore suggest deleting it.

Furthermore, with respect to the matters to be considered in the assessment of liquidity risk (Para. 6), we would suggest the following addition regarding market makers to the fourth (and last) bullet point:

- in assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered. There is however the presumption, but not a guarantee, of liquidity for transferable securities with at least one well-recognized market maker.

Other eligible transferable securities

While broadly agreeing with the new text proposal, we believe the following modifications are necessary to Box 2:

Para. 1, third bullet point:

- there must be a valuation of the security available on a periodic basis which is derived from information from the issuer of the security, from competent investment research, or from any other independent providers;

This would apply to OTC derivatives and fixed income instruments and aims at broadening the sources of valuation data.

Para. 1, 4th bullet point :

- there must be regular and accurate information available to the management of the UCITS on the security or, where relevant, on the portfolio of the security; and

It is sufficient if the information is available to the UCITS, and not necessarily to the entire market, since the securities under Art. 19(2) should not be subject to criteria as stringent as those applying to transferable securities under Art. 19 (1) (a) to (d). The current wording would exclude for example private placements. EFAMA believes that it would be possible for supervisors to have access to the information, even if it is not publicly available to the market.

Para. 1, 5th bullet point:

- The security must be transferable through negotiation on the capital markets, registration on the register of shareholders or other equivalent means.

Our same concern applies here as to Box 1, and we also believe that for transferable securities under Art. 19(2) the requirements should be less strict than for transferable securities falling under 19(1)(a) to (d).

Closed end funds as “transferable securities”

EFAMA agrees with CESR’s new approach in Box 3 and with Para. 2 in particular.

Regarding closed end funds in contractual form, we appreciate CESR’s intent to include them among eligible assets, but we must underline that corporate governance mechanisms for contractual closed end funds are at management company level, not at fund level. We therefore understand the term equivalent” in Para. 4 of Box 3 in the sense that the corporate governance mechanisms of the fund’s management company

can take into account the specificities of its legal structure (normally not a joint stock company) to guarantee investor protection, while following the spirit of company governance regulation.

Clarification of Art. 1(9) (Definition of Money Market Instruments)

BOX 4: EFAMA broadly agrees with CESR’s new proposal, but, in reference to Level 3 advice (page 21), wishes to reiterate that the factors presented should not be cumulative. CESR’s recognition in Para. 55 of the explanatory text that “... the fact that some of [these conditions] are not fulfilled does not imply that the financial instrument should be automatically considered as non-liquid” should be reflected in the Level 3 text of Box 4.

Furthermore, although such factors can be of help in ensuring liquidity in case of redemptions, they cannot ensure that “that UCITS will have sufficient planning ... in foreseeing cash flows”. We refer in particular to the following bullet points on page 21:

- unit holder structure and concentration of unit holders of the UCITS;
- purpose of funding of unit holders;
- quality of information on the fund’s cash flow patterns;

Visibility regarding cash flows depends on the type of investors (retail vs. institutionals), and is generally not given for the asset manager.

BOX 6: In reference to Para. 2, 3rd indent, we find the wording unclear. Following CESR’s comments at the hearing we understand that “independent body” might refer to a market committee still to be created. From EFAMA’s point of view, the use of an auditor or of a rating agency would be preferable. We therefore suggest the following modification:

- control of this information by an independent entity specializing in the verification of legal or financial documentation (such as, but not exclusively, an auditor or a rating agency) and not subject to instructions from the organization they belong and from the issuers;

Furthermore, should the creation of a new body be envisaged, transitional measures should be put in place to prevent the ineligibility of money market instruments due to non-compliance with this requirement.

BOX 8: We agree with most of the language in Box 8. However, the Directive does not require in Art. 19 (1)(h) that “credit institutions providing this protection must have a rating that is at least equal to that of the program in question” (Para. 1, last sentence), and that might actually be very difficult in practice. We therefore suggest deleting the requirement. The protection structure is one of the most important factors in the UCITS manager’s investment decision and the creditworthiness of the credit institution is already reflected in the rating of the instrument, therefore no further requirements are necessary.

Regarding Asset Backed Securities, EFAMA wishes to ensure that they remain eligible assets, whether they are considered transferable securities under Art. 19(1)(a) to (d) or money market instruments under Art. 19(1)(h). Although CESR brings the example of ABCP as the main source for the entities “dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line” referred to in Art. 19(1)(h), other Member States have used this article in reference to instruments with a different structure. For example the German Investment Act regards such ABSs as money market instruments regardless of a two-tier structure and regardless of the rating of the credit institution providing the protection. Although Art. 19(1)(h) does not offer a comprehensive regulation of Asset Backed Securities, at least some of them should be deemed to be covered by it. The wording of Para. 3 should reflect that.

Embedded derivatives

EFAMA reiterates its disagreement (expressed in the reply to the first Consultation Paper) with CESR’s definition of embedded derivative, based on IAS 39. Such rules should not be used to define embedded derivatives, as their main objective is the implementation of mark-to-market valuations, which are already used by UCITS. Therefore we are again proposing a different legal definition of embedded derivatives:

A transferable security or a money market instrument can be said to include an embedded derivative when:

- a) It embeds a derivative instrument materialized by a contract with a third party and
- b) It replicates all the characteristics of the derivative products or the underlying risk, that is:
 - i. It allows the full transfer of the underlying risk;
 - ii. Does not modify the inherent risk using methods such as mutualisation, credit enhancement, active management of the underlying.

In our opinion, transferable securities do not embed a derivative unless this derivative instrument is materialized by a contract with a third party (a criterion which excludes convertible bonds, for example). Furthermore, they do not embed a derivative when the underlying risk is modified by methods such as mutualisation (sharing of the risk with other holders), credit enhancement (subordination through tranching with different risk levels, use of a guarantor, use of cash collateral), active management of the underlying (i.e. there is no passive exposure to the underlying). We do not believe that this definition leaves out of the scope embedded derivatives with a significant impact on the risk profile of the UCITS. We also refer to our comments to the first Consultation Paper.

We highly appreciate the effort made by CESR to try and reduce the scope of the provisions, and therefore the impact on UCITS managers (Para. 1 last indent, Para. 6 last paragraph, as well as Para. 102 of the explanatory text), but more clarity would be

needed in order to estimate levels below which embedded derivatives do not need to be taken into account. Furthermore, the text is likely to lead to diverging interpretations. As a result, we doubt that CESR's language in Para. 6 can avoid a significant increase in the compliance burden for the industry.

Financial derivative instruments

BOX 14: EFAMA largely agrees with CESR's new text. We do not believe, however, that financial indices underlying derivatives must comply with the diversification ratios set by Art. 22a of the UCITS Directive, which only apply to the investment in shares and/or fixed income securities in order to replicate the composition of an index. In order for the derivatives to be considered eligible assets, it is sufficient that the underlying index comply with the criteria set in the first bullet point of Para. 1 of Box 14 (and already listed in the first Consultation Paper). The second bullet point of Para. 1 should therefore be deleted.

Regarding the index management process, point i) is too restrictive as far as liquidity of underlyings is concerned (These underlyings should be sufficiently"liquid, to enable users to replicate the full index if necessary"): we suggest the following wording in replacement: "These underlyings should be sufficiently"liquid to enable users to replicate a position in most underlyings, if necessary", as a few minor index components might be less liquid but should not compromise the possibility to use the full index as underlying to eligible derivatives.

EFAMA disagrees with CESR's decision in Para. 2 not to recommend that hedge fund indices be considered as financial indices. We fully recognize the complexity of the issue, but we do not believe that it is necessary to wait an additional 12 months to make a determination, and we are at CESR's disposal to help with technical details, if needed.

EFAMA believes that the issues raised by CESR in Para. 122 of the explanatory text do not apply in general to all hedge fund indices, but rather to non investable indices. However, since at least 2003, major index providers have created "investable indices" that do not warrant the traditional criticism about survivor bias, selection bias, consistency, backfilling and, by definition, investability. A careful analysis by CESR would reveal that investable indices can be accepted as underlying of derivatives according to the UCITS Directive. We therefore propose the following wording for Para. 2 of Box 14:

2. Indices based on hedge funds may be eligible, provided that they comply with the following criteria:
- a) The index provider or his affiliates must have no role in the management or the supervision of the hedge funds that are included in the index and provide a methodology that is publicly available and appropriate to represent the investment universe.
 - b) The index must be sufficiently diversified.
 - c) The index must be investable at any time.

- d) The index must be published in an appropriate manner.
e) The index must comply with the above-mentioned index management process and transparency rules.

OTC derivatives

While broadly in agreement with CESR's advice in Box 15, we have a few suggestions for text modifications.

Para. 2, 2nd bullet point:

- ... If no reliable up-to-date market value is available, fair value should be based on a pricing model based on an accepted methodology.

There is no reference in the Directive to a requirement to agree a pricing model with the depositary, and we feel that it is sufficient for the depositary to agree to the valuation process, which would include the type of methodology utilized for valuation of OTC derivatives.

Para. 3, 2nd bullet point:

- Which has the adequate means (both human and technical) to perform this valuation. This implies that the UCITS use its own valuation systems, which can however be provided by an independent third party. This excludes the use of valuation models provided by a party related to the UCITS (such as a dealing room with which OTC derivatives are concluded) which have not been reviewed by the UCITS. This also excludes the use of data (such as volatility or correlations) produced with a process which has not been qualified by the UCITS.

It is not the data itself, but the process that should be qualified by the UCITS.

EFAMA also suggests to add the following third option for the valuation to the first indent, second sub-indent of Box 15:

- ~ Or by requiring that the valuation be performed by an independent third unit within the UCITS, or, if the valuation is provided by the counterparty, that it be checked by such independent third unit within the UCITS.

Credit derivatives

EFAMA would like to repeat our prior comments regarding credit derivatives.

From a practical standpoint, the industry considers it very difficult to get hold of the information necessary to make a meaningful assessment of risk asymmetry. Therefore, we consider that CESR's proposals in this area to be unrealistic having taken into account the scarcity of [third party] information required to produce meaningful data for risk asymmetry measurement. We consider also that credit derivative instrument should not be singled out as to risk asymmetry.

We hope that our contribution will be of assistance to CESR. We are at your disposal should you have any questions regarding our comments.

21 November 2005