



FEFSI COMMENTS ON
CESR'S CALL FOR EVIDENCE
WITH RESPECT TO THE COMMISSION'S MANDATE FOR ADVICE
ON ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

The European investment management industry, represented by FEFSI¹, welcomes the opportunity to respond to CESR's call for evidence with regard to the Commission's Mandate on clarifications of definitions concerning eligible assets for investment of UCITS.²

GENERAL COMMENTS

FEFSI fully agrees with the Commission's remark that the even implementation and interpretation of EU legislation is a crucial dimension to the building up of the internal market in financial services and it was FEFSI that drew, as soon as the Common Position was reached on the UCITS product directive proposal, the Commission's attention to a number of issues which would need clarification. To this extent, FEFSI will fully support CESR in defining appropriate advice.

In general, we believe that the approach CESR takes when drafting technical advice should take into account the following principles:

1. Financial instruments have become highly innovative over the last number of years in order to allow for more efficient forms of financing, investing and managing assets. Approach, structure and definitions of the UCITS Directive can no longer fully accommodate these developments. It appears improbable that a reasonable clarification of eligible instruments can be achieved mainly through the definitions and product-related rules of the UCITS Directive.
2. When assessing the eligibility of particular instruments it may be helpful, if not necessary, to refer also to the goals of the directive: indeed, one should not forget that the UCITS Directive was drafted originally for two reasons:³
 - to approximate the conditions of competition and to make cross-border marketing of fund units easier (single market creation);
 - to ensure a more effective and uniform protection for unitholders.

¹ FEFSI, the European Fund and Asset Management Association, represents the interests of the European investment management industry (collective and individual portfolio management). Through its member associations from 19 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, FEFSI represents the European asset and fund management industry, which counts some 41,100 investment funds with EUR 4.7 trillion in net assets under management. For more information, please visit www.fefsi.org.

² CESR/04-586 of 28 October 2004

³ See 3rd "whereas" of Directive 85/611/EEC

3. In terms of investor protection, the relevant provisions for UCITS, such as diversification, redeemability, refer to the fund (portfolio) as a whole and should not be ensured by the isolated consideration of individual assets of the fund. In addition, investor protection can be ensured by other means than solely product regulation, and UCITS III already puts much more focus on investor protection by means of disclosure and requirements for the manager (e.g. risk management procedures).
4. The risk averseness of many private investors over the past years has moved UCITS product development increasingly towards products offering absolute return and capital protection. Many of the instruments discussed in CESR's call for evidence have become integral part of these trends in product innovation.
5. It is essential that UCITS managers remain able to offer these products since fund managers do not act in an isolated environment. On the contrary, they live in an increasingly competitive environment, where their products compete with retail savings products that are less regulated, less transparent and less supervised than UCITS.

Thus, a very careful balance needs to be struck, but an unnecessarily detailed and restrictive regulation would make UCITS less competitive with respect to other products, prevent managers from offering the products which investors want and could ultimately impair significantly the European investment fund industry. By contrast, an interpretation of product rules that avoids unnecessarily rigid interpretations will increase investors' choice of regulated and supervised savings products.

SPECIFIC COMMENTS

General aspects regarding transferable securities (3.1.1/3.1.3)

We believe that the key question raised in the call for evidence constitutes the Commission's assumption that Article 1(2) requires the UCITS' financial assets to be liquid. In our eyes a security that is admitted to or dealt in on a regulated market and can be freely transferred must be regarded as a liquid instrument.

In practice, however, there are different degrees of liquidity in terms of number of potential counterparties, trading volumes etc., but we do not believe that this constitutes a basis for any reasonable distinction between eligible and non-eligible assets.

We do acknowledge, nonetheless, that for the UCITS management the degree of liquidity of its eligible assets has to be taken into account with a view to ensuring the key characteristic of redeemability for the investor. The key issue, however, is the liquidity of the fund as such (as opposed to each instrument/security individually).

The requirement for there to be a prudent spread of risk also plays an important part in this context.

The need for a UCITS to invest in liquid transferable securities (in view of ensuring the key characteristic of redeemability for the investor at any moment) is addressed by the mechanism provided for in Article 19. If the transferable security is traded on an eligible market it is deemed to be adequately liquid and so it and other such transferable securities may be invested in within the generic investment limitations of Article 19(1). Where transferable securities are not traded on such a market they can only represent up to an aggregate 10% of the UCITS under Article 19(2).

Structured financial instruments (3.1.1)

We believe that structured instruments meet the formal requirements for eligible assets when they are securities that are transferable and listed/traded as stated earlier.

Article 1(8) explicitly refers to “bonds and other forms of securitised debt”. There is no reason to consider that structured financial instruments do not fall within the definition of transferable securities. We do not believe that underlyings need to be subject to the same requirements as transferable securities as such.

What is decisive is that the fund manager takes care that the use of the underlying in an eligible security does not affect the characteristics of that security in a way that is not in line with the investment objective of that fund, its risk profile as well as the general principles of the UCITS Directive.

Therefore, a “look-through” approach would be appropriate with regard to investment restrictions and issuer limits. We do not believe, however, that a general principle prohibiting underlyings that would not be eligible instruments directly is justified. A securitised instrument that embeds a commodity index is not the same as a commodity index! Moreover, a UCITS may invest in many equities and bonds of issuers which themselves invest in assets that are not directly allowed, such as real estate.

In Europe the market for securitisation is becoming more and more important. Due to easier transferability, the largest part of the issues comes into the market in synthetic form. Therefore, Asset Backed Securities (ABS), Collateralised Debt Obligations (CDO), Collateralised Debt Securities (CDS), Credit Linked Notes (CLN), and Mortgage Backed Securities (MBS), including so-called synthetic ones, should be regarded as normal corporate bonds without the necessity to conduct a splitting or a review of the underlying derivatives, provided these instruments do not imply risks additional to those that would be found in a traditional bond.

Listed closed-ended funds (3.1.2)

In general, FEFSI believes that listed closed ended funds fulfil the basic criteria of a transferable security in the meaning of Article 1(8) of the UCITS Directive and should continue to be treated as such. Moreover, with the exception of Article 2(1) of the UCITS Directive there is no other provision in the directive that would propose a particular treatment of closed ended funds.

Once more though, investment in such securities must comply with the fund's objectives and risk profile, general diversification rules, the redeemability requirement, etc. Regarding the underlying of such funds a comparable consideration as for the underlying of structured financial instruments should be applied.

Money market instruments (3.2.1/3.2.2)

We believe that for money market instruments the same principles should apply as for securities. If money market instruments are dealt in on a regulated market they should be regarded as instruments that are liquid and able to be valued accurately. Also, with regard to any underlying instruments that may be embedded in money market instruments we refer to our comments to 3.1.1.

Money market instruments not dealt in on a regulated market can be, in our eyes, eligible instruments if the issue/issuer can be regarded as able to fulfil its obligations. The qualifications of issues/issuers given in the indents of Article 19(1)(h) set out criteria that concretise this general principle. Based on these rules, the fund manager will have to ensure that the portfolio of instruments invested in complies with fund objectives and other general obligations.

Notwithstanding this general comment the industry would appreciate some investment criteria for money market instruments other than those dealt in on a regulated market. In this context, CESR might focus on criteria for equivalent regulation and investor protection, quality of issuers etc. We believe CESR should take into account securitisation structures and vehicles that are relevant in the market, which should be admitted as eligible instruments if they comply with the more general criteria set out in Article 19(1)(h).

Techniques and instruments referred to in Article 21 (3.3)

We believe the purpose of efficient portfolio management should be defined in broad terms and include techniques and instruments the use of which support the achievement of the investment objectives of the fund, all the while, of course, taking into account the risk profile, general requirements like redeemability etc.

As the mandate itself refers to Article 21(3) 2nd subparagraph (transferable securities embedding derivatives), we refer to our comments made above on structured financial

products. We believe these provisions clarify that if a fund invests in transferable securities that embed derivatives, the fund manager has to ensure that this is in line with the investment objectives (“efficient portfolio management”), that the risk profile of the fund is supported (which requires, in turn, an adequate risk management procedure) etc.

More generally, we would like to underline that from our point of view, the directive does not prohibit such structured financial instruments, but it intends to ensure consistency of requirements when compared to a derivative that is not structured in such a way.

As a principle, from FEFSI’s point of view, two elements are key:

- fund managers must demonstrably understand the product in which they invest, in particular if and when the structured financial instruments may affect the risk profile of the fund; and
- in the interest of investor protection, UCITS investment limits should also be followed with these products, which essentially in this respect makes a look-through approach necessary.

Other collective investment undertakings (3.4)

On the issue of equivalent supervision, we have no special comments at this stage as CESR has the widest experience and insight to determine criteria in this area.

Concerning the level of investor protection, we believe it should be considered to set out a list of criteria relevant to achieve adequate investor protection and to assess the level of investor protection of UCITS on this basis. We believe that the FEFSI High Level Principles, that take into account the relevant provisions of the UCITS Directive (in particular Article 5h) as well as the MiFiD and work carried out by IOSCO, would provide a good starting point for this work.

The final step would be an assessment of other collective undertakings on a case-by-case basis. We also believe that reciprocity criteria should be given consideration when defining the eligibility of CIUs from other legislations.

Derivative financial instruments (3.5)

With regard to derivative financial instruments dealt in on a regulated market, we suggest that our previous comment on the definition of a transferable security and its relationship with Article 21 is also relevant here.

With regard to over-the-counter derivatives, the criteria according to which they are to be regarded as eligible assets are quite clearly set out in the indents to Article 19(1)(g). The third indent defines the requirements for the instrument to be regarded as “liquid”, which will have to be assessed on a case-by-case basis.

Having said this, we believe that credit derivatives constitute a useful tool to manage risk (credit and duration) in relation to bond portfolios and therefore their use as a technique and instrument falling under Article 21(2) is not in doubt.

Index replicating UCITS (3.6)

We believe that on the question of whether the composition of an index is “sufficiently diversified” the UCITS Directive itself already addressed the issue by specifying the particular investment restrictions that would apply to a UCITS designed to replicate an index.

We would wish to see a clarification of whether the investment limit of 40% in Article 22(2) generally applies to index replicating funds.

Finally we believe that where an index is published through any widely available media, whether print or electronic, that index is “published in an appropriate manner”.

Should you wish to discuss any particular aspect of our comments in greater detail, we remain entirely at your disposal for further information.

Wolfgang Mansfeld
President

Steffen Matthias
Secretary General

30 November 2004
04-4044