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CESR's draft advice to the European Commission on the eligible assets of UCITS

The Bank and Insurance Division of the Austrian Federal Economic Chamber welcomes the opportunity to comment on CESR's second consultation on its draft advice to the European Commission on the eligible assets for UCITS.

GENERAL REMARKS

In our comments on CESR's first consultation on eligible assets we pointed out a number of concerns around the clarity of advice CESR was putting forward, in certain cases highlighting that greater legal certainty was much needed. We welcome the distinction made by CESR in the second consultation paper between possible comitology measures at Level 2 and issues that would need to be addressed at Level 3. However, in general CESR's advice still leaves the possibility of differing interpretations of the same text which is highly undesirable from the perspective of creating a level playing field in the supervision of the investment fund industry. This is the case for example concerning the definition of "significant influence" or "financial index".

We are of the opinion that with regard to implementation in practice of the current draft advice doubts exist as to whether depositaries would be able to supervise compliance with these vague criteria regarding management companies and/or who else could be addressed by this regulation as this is a matter that is unclear in quite a number of cases.

Furthermore it can be noticed that CESR's statements, for example in connection with SFIs, closed end funds and derivative instruments are made subject to the proviso that principles, rules and requirements contained in the UCITS Directive may not be circumvented. This reference is problematic since the very objective of the present consultation process should be clarification of these principles and rules.

Furthermore we would like to ask CESR to set out its cost-benefit rationale to the proposed advice given that in some cases it was not clear in the first consultation process what the added value of its draft advice would be in terms of investor protection. We welcome CESR referring to this point in its second consultation. Cost-benefit analysis should be taken into account in all future consultations, not just on UCITS issues.

Concerning Box 6 and the Level 2 advice in respect of the criteria assets eligible for UCITS must meet under Article 19(1)(h), we are afraid that the eligibility criteria are drafted in such a way that precludes certain types of money market instruments that are not admitted to or dealt in on a regulated market that ordinarily would be expected to be eligible. Concretely, while the draft criteria would allow for European Commercial Paper (ECP), Certificates of Deposit issued by local authorities could in the opinion of the industry not be deemed eligible as the draft advice is currently presented. We understand that it is not CESR's intention to discriminate against such types of instrument so we recommend that the criteria be re-drafted appropriately widely to allow for such money market instruments.

In respect of embedded derivatives UCITS ought not to be obliged to calculate the embedded dormant risk to an undisclosed limit. Rather, we believe that a *de*

minimis limit ought to be established at 10 %. The administrative burden to calculate the embedded dormant risk for over 10 % of the investment in structured financial instruments is considered to be very high for little gain in investor protection.

We object transitional arrangements for UCITS funds which have been authorised as such by a Member State but which cease to be a UCITS as a result of the clarification of eligible assets in regards to hedge fund indices. These products enter the local market with the EU passport as retail products. The transitional period will mean for these funds to conduct business as usual amplified by the fact that CESR is reconsidering in 12 months. This would mean a three year delay period for Austria and vice versa a three year competitive advantage for other member states.

CESR's mandate is a legal clarification of the interpretation of the directive it shall not be targeted at practical and/or investment issues at the sphere of the fund manager. For the purpose of a common level playing field we ask CESR that if hedge fund indices are legal that either

- hedge fund indices are eligible in all member states, or
- that the local regulator is able to decide according to his experience.

Conclusion

In total, we consider the proposals included so far to be productive.

However, for efficient implementation of the proposed initiatives in practice the following considerations should be taken into account, which are necessary for reasonable implementation of the initiative.

Comments in detail

regarding Box 1

In connection with Box 1 the question arises whether hedge fund index certificates are eligible as transferable securities as defined under item 1 or not. On the one hand, this question can be answered in the affirmative if one argues that the underlying of such instrument is not relevant because there is no express prohibition. On the other hand, this question can be answered in the negative if one argues that hedge funds are not even eligible as underlying of derivative instruments and/or index components.

If the necessary degree of liquidity of the fund will be applied for determining the requirements for liquidity it has to be clarified – in order to avoid distortions of competition – whether Art. 37 of the UCITS Directive permits a limitation of redemption to two times a month or not (see Box 4 "*prospectuses guidelines on limiting withdrawals*"). In this respect we would like to refer to the solution applied in Luxembourg, where redemption may actually be limited to two times a month whereas Austrian funds have to redeem shares on a daily basis in order to maintain an appropriate degree of liquidity.

With respect to the requirement that transferable instruments must be freely negotiable, it should be clearly stated that certain restrictions on dealing (limited public offer, limitation to non-US investors) are not detrimental.

The last sentence of item 5 "*The presumption does not apply if the UCITS knows or ought reasonably to know that any particular security is not liquid*" should be deleted without replacement due to its vagueness.

With regard to SFI's that include an embedded derivative, CESR's advice refers to Article 21 (3) of the directive (Sec 30 of the explanatory text as well as Sec 4 of BOX 1). The scope of application of Art 21 with regard to embedded derivatives should be defined in a precise way. In our understanding Art 21 (3) of the directive does not have an impact on the eligibility of the underlying of the embedded derivative. The SFI as transferable security qualifies under the UCITS directive as

such. The reference to Art 21 (3) means that the risk of the embedded derivative has to be taken into account as well as the general principles of risk diversification are to be applied.

regarding Box 3

To the extent that separate rules are intended to be drawn up for closed end funds, a definition of the same is absolutely necessary, as has already been mentioned, because otherwise it would not be clear in practice whether an investment is to be regarded as a normal investment in shares or as an investment in a closed end fund which is subject to supervision. In our opinion fulfilment of the listing standards as defined in item 45 (a) is sufficient for proving appropriate investor protection safeguards; whether the listing standards differ sufficiently between the different types of funds cannot be answered until a definition of closed end funds has been provided. In the case that no clear and narrow definition of the concept of "closed end funds" is found, additional requirements would lead to an improper differentiation when compared to normal joint-stock companies, which would result in unreasonable costs for the UCITS.

It should be explained what constitutes a circumventing of investment limits in the opinion of CESR and what additional investigation duties the UCITS has with respect to the structure of the assets of a closed end fund. After all, the statements made in item 48, according to which closed end funds may also include real estate funds and private equity funds, lead to the conclusion that a UCITS-conform asset structure of closed end funds is not required by CESR. This means that it remains open under what additional special circumstances and/or with respect to what investment regulations, in the opinion of CESR, a UCITS may be reproached for circumventing investment limits by acquiring closed end funds.

We agree that closed end funds structured as transferable securities are eligible assets for UCITS. We believe that „appropriate investor protection safeguards" are met by meeting the standards for listing a security. We also think it is not possible

for a UCITS to circumvent the investment limits provided for UCITS by the UCITS Directive since in the unlikely case that a closed end fund is not diversified at all, i.e 100% of the closed end fund's portfolio consists of one security the UCITS will end up with the minimum UCITS diversification with the respective 10% and 5% limits which means that the UCITS is sufficiently diversified.

If closed end funds as transferable securities are eligible assets for UCITS the same must be true for open end funds structured as a transferable security. We do not recognize a difference here.

Example: A listed investment company with variable capital (open end fund)

regarding Box 7

The interpretation that only G 10 countries offer comparable investor protection for MMI's is only acceptable if this restrictive interpretation is not analogously applied to demand deposits with non-EU banks (Art. 19 (1) (f)).

regarding item 83

It should be clarified under what other provisions of the Directive asset backed securities could, in theory, be acquired in the opinion of CESR; according to our understanding asset backed securities may be acquired as structured financial instruments if the criteria for transferable securities are fulfilled. It would be desirable if this opinion could be confirmed by CESR and if the question of whether the exposure of an asset backed security is to be attributed to the SPV or the assignor (e.g., the bank assigning the claim) could be clarified.

regarding Box 10

In view of the high risk potential and the importance for management in practice this issue is not sufficiently dealt with in the CESR paper compared to other issues as, for example, MMIs. If the draft advice aims at safeguarding uniform and risk appropriate application of laws in the Member State it is not sufficient to make reference to the blanket clauses only but this issue should be dealt with in more detail. As an example, we would like to mention the problem that in connection with securities lending a UCITS as debtor could also circumvent the prohibition of short sale.

regarding Box 11

The vague criterion of "significant" impact leads to a certain facilitation of administration in spite of the wider interpretation, however, only partly, due to the fact that separate assets are taken into account, because for single investments with a clearly significant asymmetric risk (like, e.g., convertible bonds) the embedded derivative risks must be taken into account also if these assets make up only a marginal component of the fund assets.

Analogous to treatment of the liquidity requirements for transferable securities (Box 1), with respect to an exemption rule the impact on the entire fund should alternatively also be considered for the purpose of an overall view. Even if the asymmetric risk of an asset may be significant, it should be possible not to consider embedded derivatives risks if the proportion of such assets to the total assets is very small. The fact that such a rule is in line with consistency of the CESR advice can be seen from the example given by CESR in item 102, according to which the impact of an investment where the exposure does not exceed 2% of the total fund assets is not significant. Likewise the requirement of cost efficiency strongly emphasised in the Green Paper for Investment Funds is an argument against administrative efforts which are inexpedient in the end.

If SFI's are transferable securities they become eligible assets for UCITS. "Embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108/EC)" can only mean that the exposure to the underlying of the financial derivative instrument achieved via the embedded derivative has to be included into the calculation of the concentration limits laid down in Article 22 and the global exposure relating to derivative instruments shall not exceed the total net value of the UCITS portfolio on the basis of the commitment approach for non-sophisticated UCITS and according to a VAR/stress test approach for sophisticated UCITS (Article 21(3)). The conclusion is that only the host contract is being tested for eligibility but not the underlying of the embedded derivative. The underlying of the derivative is tested for concentration limits and global derivative exposure limits.

Example: Certificate linked to the price of oil

regarding item 122

The arguments brought forward under this item against recognition of indices based on hedge funds are not convincing.

regarding Box 14

We object the introduction of the IOSCO criteria as a level 2 advice since the IOSCO criteria shall be addressed to the Index Provider and not to the UCITS. The UCITS has no control on the index construction and therefore we think the IOSCO criteria is useful as a level 3 advice only.

Country indices that are recognised as being representative should be exempt from the requirement to fulfil the diversification rules defined in Art. 22a. In this way, particularities of the different countries could be taken into account. We do not see why the strict diversification rules of a managed portfolio should also be ap-

plied to a representative index, i.e. a pre-defined benchmark. The factual justification for these strict limits for managed portfolios cannot be applied to representative indices in the same way, since with respect to representative indices the focus is put on market conditions rather than on discretionary decisions, as it is the case with managed portfolios and customized indices.

The idea that recognised indices should be subject to the formal limits on issuers which were made for portfolio management seems to be no longer up-to-date when taking into consideration the statements of the Green Paper on Investment Funds, according to which it seems that the Commission considers abolishing of formal investment limits with respect to actively managed funds, i.e. in the very area of application of the limits on issuers. (see questions 13 and 19 of the Green Paper on Investment Funds).

For these reasons it would be desirable to delete the sentence „*Comply with the diversification rules (including ratios) set by Art. 22a of the Directive*“ from item 1.

We welcome CESR's clarification that indices based on financial derivatives on commodities are eligible. We do not understand why indices based on cash commodities shall not be eligible? The difference is only relevant for the hedging counterparty.

We need to apply the directive in a consistent manner. CESR should clarify the eligibility and interpretation of the directive. If commodity indices are financial indices so must hedge fund indices be. All other interpretation would be inconsistent. The decision if certain criteria such as IOSCO are met shall be the responsibility of the market practitioners. If diversification is the argument for commodity indices we wish to advice CESR that hedge fund indices provide more diversification benefits. We are of the opinion that hedge fund indices do also comply with the IOSCO criteria more than commodity indices do. Most stock and bond market indices use market capitalization weights but there is no market capitalization for commodity futures. The CRB index employs equal weights. In contrast, the GSCI uses “produc-

tion" weights. The DJ AIG index is rebalanced every year using a combination of production weights and liquidity considerations.

According to the draft advice also a commodity index may be a reliable financial index. This, however, raises questions that have not been dealt with in the advice: What criteria must be fulfilled by a commodity index in order to be recognised as a financial index? Does a commodity index have to cover the entire commodity market or would it be enough for the index to cover partial markets only? How many different products must be represented in order to represent the entire market (e.g., is petroleum an individual market, or is it not enough (crude oil futures, fuel oil futures); the next stage of a partial market would then be energy – different gas futures would then also be included, or is this still not enough and do other commodities also have to be included (wheat, sugar, coffee, cotton, etc.))?

In addition to the issue of the structure of a recognised commodity index, the question remains unanswered what share a commodity index may have in the entire index. Under the general rule a financial index could – subject to compliance with the issuer limits and the global exposures for derivative instruments – be the sole investment of a fund.

According to the statements contained in item 118 the reason given by CESR why such products are recognised is that they allow better risk diversification. However this would again mean that other commodities have to be included, although it is not clarified to what extent.

The requirement that a recognised financial index must be fully replicable (this means that every single index component must in fact be acquirable) can hardly be verified in practice, above all with broad indices. This requirement should be softened by including "to the extent possible" or "mainly".

Yours sincerely,

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