

10 June 2005

M. Fabrice Demarigny
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11-13 Avenue de Friedland
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Dear M. Demarigny

CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS – Consultation Paper CESR/05-064b

Overview

The International Primary Market Association is pleased to respond to this Consultation Paper.

IPMA is the trade association which represents the interests of the international banks and securities firms which underwrite and distribute international debt and equity securities in the primary market. It has 52 members representing the leading underwriters and dealers in all of the world's major financial centres.

The focus of our response is on the eligibility of money market instruments, as defined in Article 1(9) of the Directive, which are transferable instruments, not normally listed on regulated markets. The markets we are particularly concerned about are the Certificates of Deposit market, and especially the Euro-Commercial Paper (ECP) market, of which around 25% of outstandings are issued by Asset Backed Commercial Paper Vehicles. Consequently, the critical draft CESR advice from our perspective is set out in Boxes 4, 6 and 8, and the comments in our response relate to these three boxes.

We welcome the Commission's decision to ask CESR for advice on this matter and, we hope, to reflect more generally on whether the intent behind UCITS 3 is being delivered in practice. In the case of the Eligible Assets criteria, it was clear to us at the time UCITS 3 was first conceived, that one of the motivations behind the new Directive was to provide a practical platform for giving flexibility for UCITS' investment in high quality, liquid, short-term assets. This motivation reflected a political desire to expand the range of eligible assets and so add to investor opportunities for return and risk diversification, but to do so in a way that did not compromise retail investor protection. Against a backdrop of an ageing European

population, and insufficient savings for retirement, this is clearly a sensible political objective. From an economic perspective, this policy also helps the development of deep and liquid European capital markets.

However, it has been clear for some time that, in practice, the intent behind UCITS 3 has been frustrated by two inter-related problems. In the first instance, the drafting of the Directive was sufficiently unclear that several quite different interpretations were possible. In particular, from our perspective, the drafting of Article 19 (1) (h), which covers the eligibility of money market instruments, not traded on a regulated market, is particularly problematic. In the second, the result of this poor drafting has been that certain member states have been able to use this ambiguity to specifically exclude certain major markets (including ECP) as eligible assets for the majority of funds in the UCITS in their jurisdiction. In our view, these exclusions cannot be justified from an investor protection perspective – for example, ECP is highly rated and there has been only one default in over ten years.

Given the size of the market (outstandings of €415 billion), investors in these countries are losing out in terms of choice, risk diversification and return, and European capital markets are losing out in terms of depth and liquidity. When compared to the US commercial paper market which currently has outstandings of \$1.5 trillion and where there is a more standardised regulatory regime, we believe that the ECP market is significantly under-developed. Based on the respective sizes of the economies, the ECP market could easily be two times or three times the size it is now.

Clearly, this restriction of development is not a good outcome from anyone's perspective and the request to CESR for advice, particularly on Article 19 (1) (h), is a good opportunity to rectify matters. Unfortunately, the proposed CESR advice does not offer significant improvement. Indeed, in places (particularly in the advice set out in Box 8 concerning the 4th indent of Article 19 (1) (h)), it has the potential to make matters worse. We think CESR (and the Commission) does have some capacity to improve matters, and we set out some suggestions below. However, we do think it is possible, but not ideal, that the only solution to the problem presented by the 4th indent of Article 19 (1) (h), is some revision to the Level 1 Directive.

Detailed points on the draft CESR advice are set out in the remainder of this response, along with a high-level summary of the ECP market. We are aware that at least some in CESR and the Commission do not have a strong working knowledge of this market and the instruments (illustrative in part of the fact that this market has functioned well for many years, and has not exhibited the investor protection problems that would bring it to regulators' attention). Consequently, we propose to put together a presentation for both CESR and the Commission (either jointly or separately), as soon as can be arranged. We will be in touch in the week beginning 13 June to explore prospective dates.

The Euro-Commercial Paper (ECP) Market

Euro-Commercial Paper is highly rated short-term promissory notes issued in a variety of currencies. It is not dealt in on a regulated market, although all the dealers and issuing and paying agents are regulated. Outstandings are €415 billion with an average maturity of 60 days. Asset backed vehicles issue around 25% of this paper, funding a portfolio of marketable securities or client receivables.

ECP provides a critical working capital source for corporate borrowers and a useful diversification vehicle for financial institutions. 12% of the market is accounted for by sovereign agencies: Austria, Ireland, Italy KfW and the EIB are examples of sovereign and supranational entities which have established funding programmes.

Investors are from across Europe and are a mix of corporates, institutional buyers, and funds. These include UCITS (but only in those Member States where a purposive approach to implementing UCITS has been taken), some of which have very large proportions (>60%) of their funds invested in ECP.

The market is dominated by high investment grade paper, with 90% of issuance having a short term rating of A-1, P-1 or F1 or better 1 (A/AA long term equivalent.)). There has only been one default in the ECP market, which was back in 1994. Liquidity is inherent in the short-term nature of the paper. Over 90% remains 'buy and hold', with a very small portion on-traded by the initial investor. Information memoranda are clear and in a relatively standardised form. They set out the terms of a particular issuing programme of an issuer. Individual issues are then offered on a continuous basis off the back of this programme. Some examples of particular memoranda have been attached along with a separate Deutsche Bank presentation that goes into more details about the ECP market.

CESR Proposed Advice – Box 4

The CESR advice in this box relates to the extent to which a given instrument is a money market instrument as defined by Article 1 (9) of the Directive. We support the draft advice set out in this Box and believe it to be a sensible and flexible approach to determining what the criteria on 'liquidity', 'value which can be accurately determined at any time', and 'normally dealt in on the money market', should be taken to mean. We also welcome the clarification in Point 2 in that box that commercial paper will usually comply with the criteria 'normally dealt in on a money market'.

CESR Proposed Advice – Boxes 6 and 8

The CESR advice in these boxes relates to the Commission request for advice on Article 19 (1) (h) – in particular the first paragraph and the fourth indent. In our view, it is clear from legislative history and the Recitals to the Directive, that the purpose of Article 19 (1) (h) is to allow UCITS to invest, in high quality, liquid, money market instruments that are not dealt in on a regulated market. ECP easily falls into this category. However, the draft advice set out in these boxes would frustrate UCITS access to this market, although the difficulties with Box 6 are easily remedied.

Box 6

The advice in Box 6 is broadly headed in the right direction, with a justifiable focus on the information memorandum as a key investor protection tool. We also support the Point 2 approach of making it the responsibility of the UCITS to assess the eligibility of a MMI, and the focus of Point 3 to set 'key areas ...(to be) considered' by UCITS rather than setting absolute criteria for eligibility. However, there are two points we would like to raise.

Point 3 – 1st indent

The advice needs to reflect the fact that the information memorandum of some money market instruments (including ECP), sets out the terms of a particular issuing programme of an issuer. Individual issues are then sold off the back of this programme. It is impractical and unnecessary, given the number of issues that are then sold off the back of a particular programme, to require an information memorandum to be published at the point of each new issue. In particular, as long as the information memorandum is updated to reflect significant changes, it makes no difference in terms of investor protection. This point is covered in the 2nd indent in Point 3 of Box 6 – which we support.

Consequently, we propose some minor re-drafting of the 1st indent in Point 3, and suggest the following: ‘whether an information memorandum, providing information on both the issue *or issuance programme*, and the legal and financial situation of the issuer is available prior to the issue of the MMI.’

Point 3 – 3rd indent

The proposed requirement for an information memorandum to be controlled by an independent authority does not reflect current market practice and is not a necessary regulatory requirement. While it is possible that market practice may evolve to provide the optional use of an independent authority, the case for it to be a regulatory requirement across all money market instruments has not been made. In particular, with respect to the ECP market, substantial due diligence on the information contained in the memorandum is already undertaken. More importantly, there has never been any suggestion that the information contained in the memorandum is deficient or misleading in any way. Therefore, there is no apparent cost-benefit case for introducing this as a regulatory requirement across all MMIs, rather than allowing market practice evolve naturally.

We suggest removing the third indent of Point 3.

Box 8

We fully support the comments made in the ACI-EFMLG joint response in respect of this proposed CESR advice, and for the sake of brevity will not repeat the points here, but would like them to be taken as our comments also. In addition, we have the following points to make:

- Asset Backed ECP is the first choice of asset for many UCITS, including many of the largest ones, because it represents an extremely robust security with a moderately good yield; hence offering an excellent risk/reward profile. The CESR advice, if followed, would prevent UCITS access to these instruments.
- There is no clear linkage between the CESR advice and the explanation leading up to it. Moreover, the substantial emphasis on the French market in CESR’s explanation is at odds with its relative overall size. In particular, the ABBT (asset-backed billets de trésorerie) market, has outstandings of around only €20 billion. This compares to the ABEC (asset-backed ECP) market which has outstandings of around €120 billion, and was not mentioned at all in

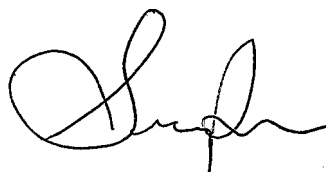
the CESR explanation. This suggests that CESR has not fully understood the relevant markets in this section of its advice.

- The impact of this advice on money markets is much greater than CESR suppose. In the ECP market alone, those UCITS currently able to invest in the ECP market would not be able to invest in ABECP and would see at least a 25% reduction in the paper available to them.
- CESR do not put forward an investor protection case for its advice. In our view, for the reasons set out above and to be illustrated further in the presentation we aim to make, there is no fundamental reason to exclude asset-backed and synthetic asset-backed securities, from the category of MMIs not traded on a regulated market that are eligible for UCITS purposes. Consequently, CESR risks a great disservice to investors (UCITS and underlying retail and wholesale investors) and to markets more generally, by not attempting to test the limit of the drafting of the 4th indent in Article 19 (1) (h).
- That said, we agree with the point made in the ACI-EFMLG response that CESR has limited room to manoeuvre within the drafting of the 4th indent of Article 19 (1) (h), and that the problem lies with the drafting of the level 1 Directive.

We suggest CESR needs to re-think its approach on this matter against a fundamental analysis of those asset-backed money market instruments that fit in to the CESR advice in Box 4 on Article 1 (9) definition of MMIs, and the nature of the investor opportunity and protection issues that arise through UCITS investments in these instruments. If, as we believe to be the case, there is a significant gap between what is permissible under the technical drafting of Article 19 (1) (h), and what should be permissible given the underlying regulatory intent of the Directive, then CESR should raise this matter openly in its advice to the Commission.

As always, I, or any of our members are very happy to discuss any of these points further with you.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'S. Barrass', with a stylized, flowing script.

Samantha Barrass
Head of Regulatory Policy