8 June 2005

Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

Dear Sirs

CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS – Consultation Paper

As the representative body for the UK-based investment management industry, we are grateful for the opportunity to comment on "CESR's advice on clarification of definitions concerning eligible assets for investments of UCITS".

IMA's members include independent fund managers, the investment arms of banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of about £2 trillion of funds (based in the UK, Europe and elsewhere), including authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent 99% of funds under management in UK-authorised investment funds and our members also manage funds elsewhere in Europe via EU based subsidiaries.

IMA welcomes CESR's attempt to resolve a number of differences in implementation of the UCITS Directive across the EU jurisdictions. IMA believes standardising the interpretation of the Directive will remove a number of difficulties arising when our Members attempt to passport their funds into other EU jurisdictions. This should also aid the simplified registration process of funds and prevent jurisdictional arbitrage. That said, IMA does however have a number of fundamental issues regarding the proposals of CESR's advice .

CESR Mandate

The CESR Mandate, as specified in Article 53(1), is mainly limited "to clarification of the definitions in order to ensure uniform application of this Directive throughout the Community". It is to the benefit of the majority of EU jurisdictions for uniformity to be achieved. However, IMA is concerned that CESR's advice goes beyond its remit

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and will increase the prescription of UCITS requirements beyond those ser out in either the original 1985 UCITS Directive or the subsequent amending Directives.

An example can be found under the "Treatment of "structured financial instruments"". The Commission's mandate to CESR is to determine if financial instruments "whose underlying involves products of varying degrees of liquidity and/or which may or may not be directly eligible for investment by a UCITS, meet the formal and qualitative requirements for recognition as a "transferable security" within the meaning of the UCITS Directive".

Unfortunately, CESR's advice in response has been to re-define "transferable security", placing a further layer of restrictions upon the Manager and potentially making certain investments which have to date been eligible, ineligible. This re-defining of "transferable security" will effect the eligibility of ALL such securities, not just structured financial instruments and IMA considers that such proposals exceed CESR's mandate.

IMA therefore strongly recommends that CESR should not attempt to redefine "transferable security", but restrict its advice on "structured financial instruments" to that of its mandate from Article 53 and the Commission.

UCITS Brand

IMA considers that CESR's advice is in a number of respects unnecessarily detailed and prescriptive. This prescription will reduce the attractiveness of UCITS products, stifle innovation, increase costs chargeable to funds and reduce the competitiveness of the European investment fund industry vis-à-vis other retail products e.g. life funds.

Whilst IMA accepts the need to protect the UCITS brand, this CESR advice is creating prescription over certain "eligible assets", whilst previous regulations from the Commission have provided UCITS with increased flexibility. A pertinent example is the UCITS Contact Committee recommendation that permitted UCITS to invest in one OTC contract, provided that the exposure to that OTC counterparty is mitigated by placing the required amount of collateral with the depositary. Although we appreciate that this flexibility was introduced prior to CESR becoming responsible for UCITS, it does appear to be inconsistent.

We therefore recommend that CESR reduces the detail and prescription of this advice and permits managers to retain responsibility for investment decisions. This would tie in to the requirements of the UCITS Management Directive, which places Conduct of Business obligations upon managers, whilst ensuring that the manager has sufficient capital to fulfil its requirements.

IMA strongly recommends that CESR reduces the level of detail and prescription in this advice, and replaces this with principle -based requirements on the manager to act in the best interest of investors in UCITS.

CESR's Advice – Level 2 or 3

There has been a great deal of discussion as to whether CESR's advice should be level 2 (measures implementing Directives and adopted by the Commission after advice from CESR and the European Securities Regulators) or level 3 (o-operation among regulators) Although there is legal uncertainty as to whether the UCITS Directive can have level 2 advice as it does not fall within the Lamfalussy procedure, IMA and the majority of its membership would prefer that any such advice is level 2, which requires a cost benefit analysis and would effectively be legally enforceable on all member states. That said, a proportion of the IMA membership believe that the majority of this advice to be level 3, thus providing an element of flexibility. However, with level 3 co-operation, there is a significant risk that some jurisdictions may take a more restrictive or liberalised approach to implementation of guidelines.

Consultation process

The Commission has asked CESR to deliver its technical advice in the form of an "articulated text" by 31st October 2005. Although IMA welcomes this proactive approach both by the Commission and CESR there is a concern, due to the complexity of some of the issues identified from CESR's advice, that this provides insufficient time for full consideration by the industry, its representatives, CESR and the Commission. IMA would be very disappointed if this valuable exercise was ineffective due to the unrealistic timetable.

An unrealistic timetable is likely to give rise to unintended consequences. IMA have already identified a number, of what we believe to be, unintended consequences which are documented in the enclosed paper. As an example, the redefinition of "transferable security" would appear to preclude investment in "unapproved transferable securities" for up to 10% of the fund.

IMA therefore strongly recommends that CESR request the Commission to extend the 31 October 2005 deadline to ensure full consideration is given to all the issues.

Ineligible UCITS

IMA members are concerned that CESR's advice will disallow investment in certain assets which have been eligible, certainly in the UK, since the implementation of the 1985 Directive. For example, investment trusts (closed-ended funds which are listed on the UK stock exchange which have to comply with additional requirements above and beyond other corporate requirements) have always been deemed to be eligible assets as they fall within the definition of "transferable security" in Article 1(8) and are dealt on a regulated market as required in Article 19(1)(a). However, the proposed CESR advice in Box 2 would mean that a number of UK listed investment trusts would no longer be eligible for investment purposes by UCITS.

This advice as currently drafted has implications for UCITS which currently invest in, for example, a small number of listed property investment trusts. It is our interpretation that such a UCITS would have to disinvest from these assets, which is likely to be wholly inappropriate for the fund's investment strategy and incur additional costs for investors, with no tangible investor protection benefits.

Where a UCITS' objective and policy is, for example, quite legitimately, to invest in property investment trusts, this fund in totality would no longer comply with the UCITS Directive. As the Directive stipulates in Article 1 (5) that "Member States shall prohibit UCITS which are subject to this Directive from transforming themselves into collective investment undertakings which are not covered by this Directive", it appears that the onlyonly option for such a fund would be liquidation. This would be wholly inappropriate for investors who are comfortable with the investment strategy and may quite unnecessarily be forced to crystallise a loss or create a tax liability, for no investor protection benefit.

IMA recommends that CESR consider the legal and ethical implications of a UCITS, in compliance with CESR's advice, no longer being able to retain UCITS status.

Transitional provisions

CESR's advice, as currently drafted, will require radical changes to manager's and depositary's processes and procedures for determining the eligibility of assets. In a number of cases the implementation of this advice will also require the reallocation of assets to comply with the new requirements which will potentially incur significant costs which will be charged to the fund and thus ultimately borne by the investor. .

IMA considers that re-allocating assets due to changes in CESR's interpretation of the Directive is in the most part unnecessary. However, if CESR is intent on introducing further prescription, we recommend that, to reduce the significant distribution, and to hopefully reduce the costs of reallocation IMA recommends that CESR provides a transitional period, at the end of which the UCITS must comply with the new requirements.

If you wish to discuss any of the points raised in our response please do not hesitate to contact me.

Yours faithfully

Ros Clark
Technical Adviser

Enc: IMA's response

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

IMA's detailed comments

A. Clarification of Art.1(8) (Definition of Transferable Securities)

1. Treatment of "structured financial instrument"

1.1 General Comments

CESR's advice should make it clear that the requirements in box 1 should only apply to "transferable securities" as defined in Article 19(1)(a) to (d). If the requirement were to apply to all "transferable securities" as defined in Article 1(8), this would preclude UCITS from investing up to 10% of the assets in unapproved transferable securities, which may be unlisted. **IMA recommends that CESR specify that any additional requirements placed upon transferable securities should be limited to "approved" (Art. 19(1)(a) to (d)) rather then "unapproved" (Art. 19 (2)) transferable securities.**

IMA is generally content with CESR's definition of "transferable security" in the second sentence, paragraph 1, of box 1, and specifically the requirement for the liability of a "transferable security" to be limited to the amount paid. This advice makes a clear distinction between what instruments are transferable securities and those that are derivatives.

IMA is particularly concerned with the requirement in the first bullet point of paragraph 2 of box 1 regarding liquidity. IMA's interpretation of Article 1(2) is that there is no obligation for each individual transferable security to be liquid,

although we note that this is contrary to CESR's interpretation. Article 1(2) of the original 1985 Directive stated "the sole object of which is the collective investment in transferable securities of capital raised from the public and which operate on the principle of risk-spreading," and therefore there was no liquidity requirement. IMA strongly believes that the addition of "and/or in other liquid financial assets" (inserted by the Amending Product Directive) does not place any liquidity requirements upon transferable securities. The liquidity requirement under Article 37 is for the UCITS to be liquid, in order that it can meet repurchase or redemption requests in normal market conditions, not for all the individual assets to be liquid.

IMA is unaware of any market failing with regards to a UCITS not being able to meet its obligations for redemptions, and therefore believe that this proposed new requirement for individual asset liquidity is completely unnecessary, goes beyond the Directive requirements and thus CESR's mandate. If CESR insists upon there being an additional liquidity requirement at individual asset level, then the fact that security is dealt on a regulated or equivalent market should provide a presumption of liquidity. The process of the manager identifying the exact liquidity of each individual asset would be time consuming and costly, as would the consequential need for the depositary to monitor the manager's compliance with these new requirements. **IMA strongly recommends that managers should only have to determine the liquidity of the UCITS rather than of each individual transferable security.**

IMA is concerned about the requirement for the valuation of "transferable securities" to be "accurate, reliable and generally independent". In general market conditions we consider that there should be a presumption that the market price of a transferable security dealt on a regulated or equivalent market is accurate. There may be circumstances beyond the manager's control where the price quoted on the market may not be accurate, especially in exceptional market conditions or where the security has not recently been traded and thus the market price is stale. As CESR is aware, UCITS managers may adjust the valuation of an instrument, where they believe that the instrument is incorrectly priced. Such fair value pricing is an appropriate tool for managers to accurately reflect what they believe to be the true price of the asset and to prevent market arbitrage. In any advice given by CESR it should be made clear that the manager may adjust the price to reflect changing circumstances with regards to the instrument or the market concerned.

IMA considers that when determining whether an asset is a "approved transferable security", reliance should be placed on its transferability and the requirement for the security to be dealt on a "regulated market" or a non-EU market where the Manager, after agreement with the Depositary, has determined its suitability. IMA believes that this, alongside the Manager's Conduct of Business obligations, (as required by the UCITS Amending Management Directive) provides sufficient investor protection. If there are concerns with regards to the eligibility of transferable securities dealt on an EU "regulated market", this should be resolved by means of changes to MiFID rather than by additional requirements placed on UCITS.

Transferability should be determined by the ability to transfer the security from one investor to another.

IMA cannot see any benefit in the requirement in paragraph 3 for a structured financial instrument which includes a derivative element to have suitable cover as required in the first sentence of Article 21(3). If the liability of the transferable security is limited to the amount paid as stated in paragraph 1, there is no need for cover. **IMA therefore recommends that paragraph 3 is deleted**.

1.2 Answers to CESR's specific questions

Q 1: Do you agree with the approach to the treatment of transferable securities and structured financial instruments outlined in this draft advice?

IMA does not agree with the approach to transferable securities as outlined in the draft. For IMA's detailed comments, see paragraph 1.1 above.

Q 2: What would be the practical effect in your view if such an approach were adopted?

IMA has provided examples of the practical implications and unintended consequences of this approach under paragraph 1.1 above.

1.3 Revised Draft Level 2 Advice

BOX 1

1. To be an eligible asset for a UCITS under Art. 19 (1) (a) to (d), a transferable security it must fall within the definition of "transferable security" in Art. 1 (8) of the Directive. These requirements do not apply to "transferable securities" as defined in Art 1(8) which also falls under Article 19(2). In addition, the potential loss of the UCITS in respect of holding the security must be limited to the amount paid for it.

2. The UCITS should take into consideration the following factors in deciding whether or not any security is a "transferable security" (as defined):

   - Liquidity – The UCITS should consider, on reasonable grounds, that if the transferable security is added to its portfolio, it will continue to be able to comply with Art. 37 of the Directive. The transferable security must not compromise the overall liquidity of the UCITS.

   Valuation – The UCITS's overall valuation must fairly and accurately reflect the value of its underlying assets

   - Information – The UCITS should assess the extent to which the issuer of the transferable security regularly makes information available to the market by providing accurate and comprehensive information on the transferable

security or, where appropriate on the portfolio of the product in question.

- Transferability – The manager should assess transferability based on the ability of a security to be moved from one investor to another.

- In addition, the acquisition of any transferable security must be consistent with the stated investment objectives of the UCITS. These objectives will, of course, have to be consistent with the requirements of the UCITS Directive.

- The UCITS should be able to assess on an ongoing basis the risk of the transferable security and its contribution to the overall risk profile of the portfolio.

2. Closed ended funds as "transferable securities"

2.1 General Comments

We note that there is a divergence of opinion within CESR with regards to the treatment of closed-ended funds and thus the proposed advice is a compromise reached between those the affected jurisdictions. However, IMA is strongly of the opinion that most closed-ended funds, including all UK investment trusts, fulfil the requirements of transferable securities as per Article 1(8) and 19(1)(a) to (d). IMA does not share CESR's opinion that such securities should be subject to additional requirements as stated in box 2.

IMA considers that provided closed-ended funds are listed on a "regulated market" or a market with equivalent requirements, they should be regarded as "transferable securities", provided that they meet the definition of transferable security and the listing requirements of the market concerned. IMA believes that this provides investors with the same investor protection rights as provided for by investing in any other transferable security. In fact in the UK, investment trusts have to comply with more prescriptive requirements than other listed securities.

IMA does not consider that CESR's mandate permits it to impose additional requirements on closed-ended funds as opposed to all other transferable securities. As noted in IMA's covering letter, this proposed prescription would mean that a number of UCITS currently in existence would become non-compliant. There is legal uncertainty as to what should subsequently happen to such funds, due to the legal requirement of "once a UCITS always a UCITS".

There was concern expressed at the CESR Hearing, held on 9 May, over the calculation of the net asset value of closed-ended funds. IMA does not accept that there is any relevant relationship between the net asset value of a listed closed-ended fund and its eligibility as a transferable security. As with any security, the price of the shares in a listed closed-ended fund, as opposed to an open-ended fund, is reliant on supply and demand and is thus not directly related to the NAV. That said, the assets of all UK investment trusts, irrespective of the underlying

investments, must be valued at least 6 monthly, and such valuation is published in their half-yearly and annual report and accounts. IMA considers that all UK investment trusts should be eligible for investment purposes by UCITS, irrespective of their underlying investment strategies.

Whilst IMA is aware that certain jurisdictions wish to prevent investment in their home state closed-ended funds, due to their illiquidity and toxicity, we can see no reason why legitimate closed-ended funds, such as UK listed investment trusts, may become ineligible due to the nature of their investments. Investment trusts are often utilised for investment in property, in order to gain liquidity from a generally illiquid asset and the current ability to invest in these products is a positive benefit for UCITS investors.

IMA strongly recommends that CESR continue to allow UK investment trusts, and other equivalent closed-ended funds, to be eligible investments for UCITS, irrespective of their investment strategy.

2.2 Answers to CESR's specific questions

Q 3: Does the reference to "unacceptable risks" in the context of cross-holdings require further elaboration, and if so, how should it be elaborated?

IMA considers that if a closed-ended fund meets the requirements of a "transferable security", then it should be eligible. If CESR retains the advice on closed-ended funds, we would recommend that no further restriction should be imposed by increased detail as to what are "unacceptable risks" in the context of cross-holdings.

Q 4: Do you consider that in order to be considered as an eligible asset for a UCITS, a listed closed end fund should be subject to appropriate investor protection safeguards? If so, do you consider the proposed safeguards sufficient and clear enough?

IMA considers that if a closed-ended fund meets the requirements of a "transferable security", then it should be eligible. If CESR retains this advice on closed-end funds, we would recommend that no further restriction should be imposed by increased detail as to what are "appropriate investor protection safeguards".

Q 5: Further to the requirements presented in Box 2 b), CESR is considering to clarify the investor protection safeguards with the following options:

- *the UCITS should verify that the listed closed end fund is subject to appropriate restrictions on leverage (for example, through uncovered sales, lending transactions, the use of derivatives) and that it is subject to appropriate controls and regulation in its home jurisdiction; or that*
- *the UCITS should consider the extent to which the listed closed end fund can leverage (for example, through uncovered sales, lending transactions, the use of derivatives).*

Please see IMA's response to question 4.

Q 6: Should/ should not UCITS be required to invest only in such listed closed end funds, that invest in transferable securities, that would themselves be eligible under the UCITS Directive?

Further to our commentary in 2.1 above, IMA considers that this approach is unnecessarily prescriptive.

2.3 Revised Draft Level 2 Advice

Box 2

(a)

Where a closed-ended fund meets the requirements of Article 1(8) and falls within Article 19(1)(a) to (d), such securities shall be eligible assets for UCITS.

3. Other eligible transferable securities

3.1 General Comments

IMA agrees that any transferable security, as defined in Article 1(8), which does not comply with the requirements in Article 19(1)(a) to (d), would consequently fall within the requirements in Article (2)(a), i.e. would be an unapproved transferable security in which 10% of the UCITS could be invested. IMA strongly recommends that in paragraph 2 of box 3, any reference to box 1 should be limited to the transferability of the instrument. Provided that an instrument is a security and is transferable, it should be an unapproved transferable security. There should not be any specific liquidity requirement, as this would prevent investment in unlisted transferable securities, which is a significant benefit to UCITS investors.

3.2 Answers to CESR's specific questions

Q 7: Are there any practical difficulties in your experience in defining the boundary between Art. 19(1)(a) to (d) and Art. 19 (2) (a)? Do you consider the suggested approach in Box 3 as appropriate?

Please see comments in 3.1 and proposed revisions to CESR's advice.

2.3 Revised Draft Level 2 Advice

Box 3

1. For an investment in a transferable security to be eligible under Art. 19 (2) (a), it must ,

- be a transferable security;
- be transferable as required in box 1; and
- not comply with the requirements in Art 19(1)(a) to (d)

2. In CESR's view, non-listed closed end funds are unlikely to meet the requirements for unapproved "transferable securities".

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

1. General rules for investment eligibility

1.1 General Comments

CESR's draft advice provides guidance on this definition, specifically on the meaning of 'instruments normally dealt in on the money market', 'liquid' and 'have a value which can be accurately determined at any time'. We deal with each of these in turn.

Instruments normally dealt in on a money market

CESR's draft advice defines 'instruments normally dealt in on the money market' as:

…the fact that the instrument has a low interest risk, where it has a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months should have to be taken into account.

We understand from parties who were involved the original Directive negotiations, that the phrase 'instruments normally dealt in on the money market' was simply intended to distinguish money markets from regulated markets. Because all MMIs are dealt in on money markets, but not all money markets are regulated markets, the phrase 'money markets' is capable of encompassing both MMIs that are dealt in on regulated markets and those that are not. The phrase was not intended to define those instruments beyond the subsequent requirements of Article 1(9) that MMIs be liquid and have a value which can be accurately determined at any time. We therefore recommend that this part of CESR's advice is deleted – there is no need to define the term 'instruments normally dealt in on the money market', and certainly no need to use a definition which potentially restricts the types of eligible MMIs.

However, if CESR persists with its advice, then we recommend a number of amendments.

We recommend that the phrase 'low interest risk' should be deleted from CESR's draft advice. This phrase is copied from a definition in a Regulation of the European Central Bank concerning the consolidated balance sheet of the monetary financial institutions sector[1]. The Regulation defines MMIs with low interest risk as those which 'have a residual maturity up to one year, or regular yield adjustments in line with money market conditions at least every 12 months'. CESR's draft advice is therefore repetitious since it repeats both the phrase low interest risk and its definition 'have a residual maturity up to one year…'. Worse still, this repetition risks implying that low interest risk is a separate criteria from 'having a residual maturity up to one year…', for example, that there should be a low risk of loss due to changes in interest rates, which in turn could imply that emerging market MMIs were excluded from Article 1(9).

We also recommend that the phrase 'at least every 12 months' be deleted from CESR's draft advice. By merely requiring this part of the definition to be 'taken into account', this condition appears to be illustrative rather than obligatory, in which case it adds little value. Furthermore, different jurisdictions have different timeframes for such adjustments, so it does not help to be prescriptive about this point.

Finally, we note that CESR has rejected other aspects of the definition given by the Regulation. We strongly support that decision. In particular, CESR is right to reject those aspects of the Regulation which define MMIs in terms of 'market depth' and 'low credit risk'. The definition of market depth given by the Regulation is highly qualitative and would be very hard to prove. The definition of low credit risk copies

[1] 2001R2423 – 01/05/2004

part, but not all, of Article 19 UCITS Directive, and consequently if it were incorporated into CESR's draft advice, MMIs which were permitted by Article 19 might become prohibited by Article 1(9).

Liquid

CESR's draft advice defines 'liquid' as:

> *…the liquidity of the MMI must be taken into account in the context of Article 37 of the UCITS Directive. The portfolio must retain sufficient liquidity so that the UCITS can repurchase or redeem its units at the request of any unit holder. At an instrument level, it must be possible to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), at limited cost, in terms of low fees, narrow bid/offer spread, and with a very short settlement delay.*

Elsewhere in its advice, CESR writes that "when assessing whether a given MMI is eligible... consideration must be given to the overall coherence of the provisions set by the UCITS Directive". In the context of liquidity, that means coherence with Article 37, which requires liquidity at portfolio level in order to enable a UCITS to re-purchase or redeem its units at the request of any unit-holder.

The definition of liquidity at portfolio level not only makes regulatory sense, but mirrors market practice. In the case of IMMFA-member money market funds, they must comply with a code of practice (copy enclosed) which establishes minimum liquidity at portfolio level by restricting the weighted average maturity of the fund to 60 days. Similarly, IMMFA's Industry Guide to Understanding Institutional Money Market Funds (copy enclosed) says:

> *…the liquidity needs of the investors of the fund must be understood. Funds that have high concentrations of shareholders or a highly unstable shareholder base should carry more liquidity to compensate for those risks.*

By contrast, the definition of liquidity at instrument level is secondary. We therefore recommend that the last sentence (commencing 'At an instrument level...') be deleted from CESR's draft advice.

However, if CESR persists in defining liquidity at instrument level as well as portfolio level, then we recommend an amendment to its draft advice. Typically, the portfolio of a money market fund comprises up to one hundred MMIs, and since they have relatively short maturity dates, the portfolio changes constantly. Evidencing that each MMI satisfies all of the liquidity conditions proposed by CESR will be costly, particularly given the subjective nature of some of those conditions (e.g. 'limited' costs, and 'low' fees). We do not believe that such exhaustive evidence will add any value over and above ensuring liquidity at portfolio level. In the interests of practicality, we therefore recommend that the list of conditions become optional rather than obligatory, as shown below:

> *…the liquidity of the MMI must be taken into account in the context of Article 37 of the UCITS Directive. The portfolio must retain sufficient liquidity so that the UCITS can repurchase or redeem its units at the request of any unit holder. At*

an instrument level, it must be possible to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), ***and/or*** *at limited cost,* ***and/or*** *in terms of low fees,* ***and/or*** *narrow bid/offer spread, and****/or*** *with a very short settlement delay.*

Also, if CESR persists in defining liquidity at instrument level, then we firmly believe that the fact that a MMI is dealt in on a regulated market means that it ought to be regarded as having satisfied the instrument level liquidity requirement of Article 1(9).

Having a value which can be determined at any time

CESR's draft advice defines 'having a value which can be determined at any time' as:

... UCITS should ensure that accurate and reliable valuations are available so as to meet the obligation by the UCITS Directive to calculate the NAV of the UCITS' units. The valuation of a MMI should be based on market data, when available and relevant, or on valuation models, such as models based on discounted cash flows. When using such models, any changes in the credit risk of the issuer must be taken into account. A method that would discount cash flows using the initial discount rate of the MMI without adjusting that discount rate to take into account changes in the credit spread of the issuer would not comply with these requirements.

We **strongly** recommend that the last two sentences of CESR's draft advice (commencing 'When using such models...') be deleted.

More importantly, CESR's definition does not reflect how significant portions of the European (and, for that matter, the global) money market fund industry prices its assets.

Triple-A rated institutional money market funds operated by IMMFA members value MMIs on an amortised cost basis. This is consistent with CESR's advice, which permits 'valuation models'. However, in order to ensure that valuation models do not deviate significantly from market price, CESR prescribes that '...any changes in the credit risk of the issuer must be taken into account'. IMMFA believes that there are other methods of ensuring that valuation models do not deviate significantly from market price other than that prescribed in CESR's draft advice. In particular, IMMFA's industry code of practice stipulates an alternative method:

IMMFA-member triple-A rated money market funds are a growing sector of the UCITS market, having increased in value from £68.9 billion funds under management as at November 2002 to £128.7 billion as at April 2005, an increase of 86.8%. CESR's draft advice threatens the viability of this sector. We do not believe that this is the intention of CESR's draft advice, and certainly do not believe that it is justified.

In any event, CESR's definition goes significantly beyond the equivalent definition given in the European Central Bank's Regulation which merely prescribes that '...their value can be determined at any time or at least once a month'. By deleting

the last two sentences of its draft advice as we have recommended, CESR will bring its definition closer to that of the European Central Bank, and eliminate an overly prescriptive definition which discriminates in favour of certain sub-sectors of the European money fund industry and against others.

We note that paragraph 1 of box 5 is effectively a replication of the requirements in the first bullet of paragraph 1 of box 4. **IMA recommends that the duplication in box 5 is deleted.**

IMA is concerned with paragraphs 2 and 3 of box 5, as they are not related to definitions and thus do not fall within CESR's mandate. With regards to paragraph 2 there is no requirement in the Directive to look through a MMI to see if there is an exposure to precious metals. IMA cannot identify any logic in a UCITS being able to invest in securities of a mining company in order to gain some exposure to precious metals, but not to be able to invest in a MMI of that same company. Regarding paragraph 3 of box 5, Article 42 prohibits uncovered sales but does not specifically prevent short selling in a particular currency. **IMA recommends that box 5 is deleted from CESR's advice.**

1.2 Revised Draft Level 2 Advice

Box 4

1. Factors to be taken into account when assessing whether a given instrument is a MMI as defined by Art. 1 (9) of the UCITS Directive are :

- At an instrument level, eligible MMI must be able, in normal market conditions, to be repurchased, redeemed or sold in a short period (e.g. 7 business days), or at limited cost, in terms of low fees, narrow bid/offer spread, or with a very short settlement delay;

- as far as the criteria "value which can be accurately determined at any time" is concerned: UCITS should ensure that accurate and reliable valuations are available so as to meet the obligation by the UCITS Directive to calculate the NAV of the UCITS' units. The valuation of a MMI should be based on market data, when available and relevant, or on valuation models, such as models based on discounted cash flows.

- as far as the criteria "normally dealt in on the money market" is concerned, in addition to the above mentioned factors, , where it has a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months should have to be taken into account.

2. Eligible MMI will include but are not limited to treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances.

Box 5

1. When assessing whether a given MMI is eligible under Art. 19 (1) (a) to (d) of the UCITS Directive, consideration must be given to the overall coherence of the provisions set by the UCITS Directive. The fact of the admission to trading on a regulated market of a MMI provides a presumption that the condition of "liquidity" (i.e " the MMI can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market") and "accurate valuation" are complied with. However, it is the responsibility of the UCITS to ensure that the liquidity criteria is met.

2. Article 19(1)(h)

2.1 General Comments

We appreciate CESR's draft advice in box 6 comprising of criteria which 'should be considered', rather than a prescriptive list. We also appreciate the emphasis on disclosure as the relevant mechanism for protecting investors and savings, rather than anything more interventionary. That said IMA has a number of suggested amendments to CESR's advice.

The reason for referring to 'the programme' in the first bullet point, is that information on MMIs often relate to a programme rather than an individual issue.

The reason for referring to information (rather than an "information memorandum"), and for requiring the information relate to *either* the issue, the programme *or* the issuer (rather than the issue, the programme *and* the issuer), is that certain forms of certificates of deposit are issued by institutions which may not themselves be 'credit institutions' in the terms of Article 19(1)(f) and so will fall under Article 19(1)(h) and therefore be effected by this draft advice. UCITS managers investing in such CDs (or any CD, for that matter) will not rely on an information memorandum on the issue, but rather financial information on the issuer.

The reason for referring to an independent entity (rather than an independent authority) is that there is no reason to require supervisors to control (i.e. audit) information on MMIs. This would otherwise exclude European Commercial Paper.

The reason for deleting the last two bullet points, is that these do not have anything to do with the protection of investors and savings.

Article 19(1)(h) third indent permits UCITS to invest in MMIs not dealt in on a regulated market which are:

…issued or guaranteed by an establishment subject to prudential supervision, in accordance with criteria defined by Community law, or by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law…

The reason for deleting the first paragraph in box 7, is that the Directive clearly places the requirement to ensure that prudential rules are at least as stringent as those laid down by Community law, with the competent authority rather than with the UCITS.

The reason for referring to members states of IOSCO (rather than the EEA and G10) is that this would otherwise contradict other parts of CESR's draft advice (i.e. box 12) which deems funds operating in member states of IOSCO as having equivalent supervision to that laid down in Community law. This change would therefore enable states such as Australia to be deemed equivalent.

The reason for referred to a risk assessment (rather than an in-depth analysis) of issuers is to remove some of the subjectivity of this requirement.

IMA appreciates that it is CESR's intention in box 8 to clarify that synthetic asset backed securities relates to specific French Special Purpose Vehicles. However, there is a general concern that this may be interpretated by some jurisdictions as preventing all investments in such instruments, not just those arising from the French instruments. **IMA requests that CESR clarify this point and has provided suggested amendments to CESR's advice**

2.2 Answers to CESR's specific questions

Q 8: Do you agree with this approach, and especially the proposal that one of the conditions for the eligibility of asset backed securities and synthetic asset backed securities under article 19 (1) is that they be dealt in on a regulated market under the provisions of Art. 19 (1) (a) to (d)? If not, please give practical examples of the potential impacts.

IMA is generally in agreement with CESR's advice regarding synthetic asset backed securities. IMA has suggested changes to the last sentence to state that the credit institution should have an "appropriate" rating.

2.3 Revised Draft Level 2 Advice

Box 6

1. The factors above in Box 4 concerning MMIs apply also to MMIs that are not dealt in on a regulated market.

2. It remains the responsibility of the UCITS to ensure whether a MMI that is not dealt in on a regulated market is an eligible asset.

3. The following key areas should be considered by the UCITS when assessing the eligibility of a MMI:

- whether an information providing information on both the programme or the legal and financial situation of the issuer is available prior to the issue of the MMI;
- whether this information memorandum is regularly updated (i.e. on an annual basis or whenever a significant event occurs);
- whether this information memorandum is subject to control by an independententity;
-

Box 7

2. There is a presumption that establishments located in the European Economic Area and G10 countries (USA, Canada, Japan and Switzerland) or having investment grade rating are subject to prudential rules at least as stringent as those laid down by Community law. Measures to guarantee compliance with the requirements by the UCITS can be tailored accordingly.

3. In all other cases, these measures should be based on an risk assessment of issuers.

Box 8

The fourth indent of Art 19 (1) (h) does not aim at covering all asset backed securities or other form of collateralised securities, as all these securities can be considered eligible under the provisions of Art.19 (1) (a) to (d) or Art.19 (2) (a). Entities that fall under the fourth indent of Art 19 (1) (h) are a specific category of asset backed securities that are secured by banking credit enhancement schemes, is the case for Asset Backed Commercial Paper and a wide range of banking conduits programs. For the entities to be eligible, the quality of the protection scheme has to insure that the credit quality of the instrument or program is at least equal to that of the financial institution that is providing the protection, and

the financial institution providing the protection has to comply with the third indent of Art. 19 (1) (h).

3. Other eligible money market instruments

3.1 General Comments

IMA is content with CESR's advice in box 9.

C. Clarification of scope of Art 1(8) (Definitions of Transferable Securities) and "techniques and instruments" referred to in Art 21.

IMA believes that CESR's advice is unnecessarily restrictive with regards to "techniques and instruments" relating to transferable securities used for the purpose of efficient portfolio management. Article 21(2) does not place restrictions as to the level of risk deriving from such techniques and instruments. We believe that efficient portfolio management should be interpreted broadly, in order to achieve the most flexibility, subject of course to an adequate risk management process as provided in the Directive. IMA considers that the reference to an "acceptably low level of risk" should therefore be deleted as it is over prescriptive as the manager already has an obligation to have and use a risk management process.

IMA considers that paragraph 6 should be deleted as it does not add any specific value as there is a general obligation upon the UCITS manager to comply with the investment objective and policy of the UCITS.

Box 10

1. Techniques and instruments relating to transferable securities and money market instruments should respect the general principle set out in Recital 13 of the Directive 2001/108/EC and may never be used to circumvent the principles and rules set out in the Directive. In particular, adequate measures should be adopted in order:

   - to ensure compliance with the requirements of an adequate risk management process, in line with Art. 21 (1) of the Directive, as well as with the detailed risk spreading rules specified by Art. 22 of the Directive; and
   - to avoid transactions which are not permitted by the Directive.

2. Techniques and instruments must be used for the purpose of efficient portfolio management.

3. UCITS are considered to use efficient portfolio management if they respect all of the following requirements:

   - The transactions are economically appropriate. This implies that they are

realized in a cost-effective way;
- The transactions are entered into for one or more of the following three specific aims:
  - the reduction of risk;
  - the reduction of cost; or
  - the generation of additional capital or income.

4. Based on the above-mentioned criteria, techniques and instruments relating to transferable securities and money market instruments include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending.

5. Regarding the coherence between Art. 19 and Art. 21 (2), CESR notes that currently only financial derivative instruments are subject to both articles, and that in accordance with the wording of article Art. 21 (2), financial derivative instruments used under Art. 21 (2) must comply simultaneously with the provisions of Art. 19.

6.

D. Embedded derivatives

General comments

IMA is unsure as to what paragraph 2 of box 11 of CESR's advice is intending to prevent or to clarify. Surely if a derivative is attached to a financial instrument and that derivative can be transferred independently of the financial instrument, the derivative should be treated as a derivative and the financial instrument as a financial instrument**. IMA recommends that this advice is deleted, or if retained for there to be further clarification as to it meaning.**

IMA believes that paragraph 3 of box 11 is too specific and to list instruments that must be treated as embedded derivatives is coming to CESR's mandate to provide principle-based requirements.

IMA is content with the IAS 39 definition of embedded derivatives. There is however a concern that CESR are requiring additional criteria for embedded derivatives which are CDO's. If a transferable security embeds a derivative it should be deemed to be a transferable security which embeds a derivative with no further additional eligibility requirements. We are unsure as to whether CESR are attempting to prevent CDOs from being eligible transferable securities which embed a derivative or are attempting to state that CDO's are transferable securities but not transferable securities which embed a derivative. IMA consider CDOs are transferable securities which embed a derivative and thus should be treated as such and be eligible for UCITS investment. **IMA thus recommends that paragraph 4 is deleted from box 11.**

With regards to paragraph 5 of box 11, IMA recommends that this should be amended to state that any listed hybrid instruments are eligible for investment. A hybrid investment which is unlisted but is not tailor-made for the UCITS could be treated as an unapproved transferable security which embeds a derivative and thus the UCITS could invest up to 10% of its value in such instruments.

IMA consider that as paragraph 6 of box 11 is purely a repetition of the UCITS Directive requirements and Commission's recommendations on the use of financial derivative instruments and does not provide any further advice that it adds no value**. IMA thus recommends that paragraph 6 of box 11 is deleted.**

Revised Draft Level 2 Advice

BOX 11

1. A transferable security which embeds a derivative is an eligible asset for UCITS if:

- some or all of the cash flows that otherwise would be required by the contract can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative; and
- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.

2. An unlisted tailor-made hybrid instrument which is not tailor-made specifically for investment by a UCITS should be considered as embedding a derivative from the Directive point of view. Such a product offers an alternative to the use of an OTC derivative, for the same purpose of achieving a diversified exposure with a pre-set credit risk level to a portfolio of entities. Its treatment should therefore be similar to that of unapproved transferable securities as defined under Article 19(2) and comply with the requirements in Article 21(3).

E. Other collective investment undertakings

General Comments

IMA on the whole considers that CESR's advice on which non-UCITS collective investments schemes can be deemed to have equivalent supervision for investment purposes by a UCITS is quite helpful. IMA are however unsure as to whom this advice is addressed. In the Directive it is the obligation of the 'competent authority' to determine if a collective investment undertaking is subject to supervision "equivalent to that laid down in Community law". **IMA recommends that CESR clarifies to whom this advice is addressed.**

There is however a concern that only those CIS from jurisdictions which require an independent trustee would be deemed to be eligible (third bullet point, paragraph 1 of box 12). IMA therefore presume that CIS, authorised and operated in Australia and USA will be ineligible non-UCITS schemes for UCITS investment purposes. IMA considers that this is an unnecessary restriction and recommends that CESR make alterations to their advice to allow investment in funds where the fund is supervised by independent directors or an independent entity.

IMA recommends that bullet point 6 of paragraph 1 of box 12 is amended to clarify that dealings with related parties is eligible provided there are restrictions to prevent conflicts of interest arising.

BOX 12

1. In CESR's view, the following matters can be used to assess whether a collective investment undertaking is subject to supervision "equivalent to that laid down in Community law", as provided in Art. 19 (1) (e), first indent. These factors are indicators of equivalence, which can be used to guide a decision on equivalence:

   - Memorandums of Understanding (bilateral or multilateral) and membership of an international organization of regulators, such as the IOSCO, to ensure satisfactory cooperation between the authorities;
   - rules guaranteeing the autonomy of the management of the collective investment undertaking, and management in the exclusive interest of the unit holders;
   - the existence of an independent custodian with duties and responsibilities in relation to both safekeeping an independent entity to the oversee the manager's activities ;
   - availability of pricing information and reporting requirements;
   - redemption facilities and frequency;
   - restrictions in relation to dealings by related parties to prevent conflicts of interest;
   - the management company of the target collective investment undertaking, its rules and choice of custodian have been approved by its regulator; and
   - registration of the collective investment undertaking in an OECD country.

Binding requirements to assess equivalence are in CESR's view not necessary.

2. In CESR's view, the following matters can be considered in deciding whether the level of protection of unit holders is "equivalent to that provided for unit holders in a UCITS", as referred to in Art. 19 (1) (e), second indent. These factors are indicators of equivalence, which can be used to guide a decision on equivalence:
   - the extent of asset segregation; and
   - the local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the collective investment undertaking.

Binding requirements to assess equivalence are in CESR's view not necessary.

F. Financial derivative instruments

1. Financial derivative instruments: general considerations

We feel that CESR has made its Draft Level 2 Advice in box 13 unnecessarily complicated.

Our view is that financial derivatives can only ever derive one or more (but rarely all) characteristics of an underlying eligible asset. Even a single stock future only derives certain characteristics of the underlying transferable security: it usually imperfectly replicates any significant income stream and conveys none of the governance aspects of ownership of the underlying such as a right to vote at an AGM.

It is therefore more consistent with reality, as well as simpler in definitional terms, to define a financial derivative instrument for UCITS as a derivative which derives one or more characteristics of an eligible asset or combination of eligible assets.

BOX 13

2. The eligibility of derivative instruments on financial indices

General comments

IMA notes that requirements in Article 22a purely relate to index replicator funds and relaxes the spread requirement when a UCITS replicates the composition of an eligible index. Although IMA considers that CESR has no mandate to apply these conditions to financial indices it seems appropriate that such financial indices are sufficiently diversified.

BOX 14

1. A financial index used as an underlying in an eligible derivative instrument must comply with the provisions of Art. 22a (1) of the Directive, that is:

   - be sufficiently diversified;
   - represent an adequate benchmark for the market to which it refers; and
   - be published in an appropriate manner.

Q 9: In addition to the criteria developed in the draft CESR advice, CESR is considering the following options:

- only financial indices based on eligible assets should be considered as eligible underlyings for derivatives; or that
- the wording of Art. 19 (1) (g) does not require UCITS to apply a look through approach when concluding derivatives on financial indices. These financial indices should nevertheless comply with the three criteria set down by Art. 22a.

In the context of the above, and as far as derivatives on commodity financial indices are concerned, it is considered, whether
- derivatives on financial indices on financial instruments based on commodities would be considered as eligible; or whether
- derivatives on financial indices on commodities would be considered as eligible.

Please give your view on the possible practical impacts of the different alternatives, based on your experience. Please give concrete examples of the impacts in terms of what kind of instruments would be actually left out/ taken aboard by the different alternatives. Please give quantitative examples of the impacts in terms of the sphere of eligible instruments for UCITS, if possible. 3 OTC derivatives.

IMA believes that financial indices should be eligible as underlying to a derivative instrument, without requirement to look through to the constituents of those indices and to the underlyings' eligibility for direct investment by the UCITS.

The Directive does not exclude any financial indices based either on non-eligible assets (for example commodities, real estate and hedge funds), or on financial instruments based on such assets. Furthermore, numerous indices exist that are based on such non-eligible assets, and

some of them (commodities indices for example) have been available for a considerable time and their underlyings are mostly very liquid. IMA recommends that CESR delete its advice in box 13.

3. OTC derivatives

IMA does not consider that that_CESR has a mandate to require additional requirements for the valuation of OTC derivative contracts. In particular OTC contracts should be valued on a daily basis. However, this would seem to imply that such contracts would need to be valued on weekends or bank holidays. IMA believe that OTC contracts should only have to be valued at the UCITS valuation point.

It is noted that in paragraph 2 of box 15 that CESR are requiring that valuation of the OTC Derivative Contracts should be compared with an estimate provided by an independent third party on a monthly basis. IMA considers that this requirement is prescriptive and unnecessary. OTC contracts are not only valued by the counterparty but also the manager, a further requirement for an independent third party to estimate the value is completely unnecessary. There is already on obligation upon the depositary to ensure that the manager has adequate systems and controls to provide an accurate valuation of the fund's portfolio. Another independent verification could be costly and pure duplication of work already being carried out.

IMA are unsure why CESR are requiring manager's to submit a risk analysis to the competent authority every semester. Unless competent authorities are to analysis this information it is completely unnecessary. **IM**A **therefore recommends that the last half of the bullet point 2 of paragraph 3 of box 15 is deleted.**

BOX 15

1. The fair value of an OTC derivative corresponds to the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

2. Any OTC derivatives should be valued at each valuation point of the UCITS.

3. The definition of the fair value of an OTC derivative combined with the general requirements set by Art. 21 (1) of the Directive on risk management imply that an adequate risk-management process for OTC derivatives has the following characteristics:
   - the UCITS must have taken reasonable care to determine that, throughout the life of the derivative, it will be able to value the investment concerned with reasonable accuracy at its fair value, on the basis of the pricing model which has been agreed between the UCITS and the depositary, or on some other reliable basis reflecting an up-to-date market value which has been so agreed. When doing so, reference should be made to an accepted methodology; and
   - the UCITS should have the organization and the means to allow for a risk analysis realized by a department independent from commercial and operational units.

4. Credit derivatives

IMA is of the opinion that UCITS can invest in derivatives provided that the manager has an adequate risk management process, there is global cover and there are no uncovered sales that there is no necessity for there to be additional requirements placed on credit derivatives. ***IMA therefore recommends that box 16 is deleted****.*

BOX 16

Q 10: What is your assessment of the risk of asymmetry of information in relation to the use of credit derivatives by UCITS? Which kind of measures should UCITS adopt in order to limit the risk of asymmetry of information? Please explain the arguments for your view.

IMA considers that the principle of limiting risks of asymmetry is adequate.

Q 11: Do you consider that the problem of a potential asymmetry of information between issuers and buyers of credit derivatives can be dealt with by limiting the nature of the issuers on which the credit risk may lie to:

- one or several sovereign issuers;
- one or several public international bodies, provided that at least one Member State is a member of the(se) public international bodi(es);
- one or several regional or local authorities of Member Sates;
- one or several legal entities, either issuers of bonds admitted to trading on a regulated market that have been graded at least once by a rating agency, or issuers of shares quoted on a regulated market; or
- a combination of the above?

IMA considers with CESR's total list should be considered "eligible issuers" with the exception of those described in the fourth bullet point. IMA believes that this definition is too wide and would include all corporate bodies provided that their shares are quoted on a regulated market. IMA therefore recommends that bullet point 4 is amended to read: "one or several eligible credit institutions or approved banks".

G. Index replicating UCITS

1. UCITS replicating the composition of a certain index

IMA has suggested some amendments to CESR's advice in box 17.

BOX 17

1. A UCITS is deemed to replicate the composition of a certain index if it has the

aim and practice to replicating the composition of that index.

Q 12: Do you consider that the CESR advice should require UCITS to provide an estimate of the quality of the index replication? Please give practical examples of the possible impacts of using estimates in this regard.

IMA is concerned over the suggestion that a fund can only be deemed to be an index replicator and thus utilise the more flexible spread requirements, if that fund meets a prescribed tracking error rate. The tracking error of an index replicator will vary due to a number of factors including the fund charges, taxation treatment in the home state, differences in the spreads of the underlying assets of different indices, any requirement to pay stamp duty, the size of fund (any fixed costs will have a greater impact on a smaller fund in comparision to a larger fund). IMA considers that provided it is clear that the investment objective and policy of the UCITS is to track the composition of the index that such a fund would meet the index replicator requirements.

Q 13: If your answer to the previous question is yes, which of the following two estimates would you consider appropriate, or would you consider both or another estimate necessary?

N/A

2. Index characteristics

IMA is generally content about CESR's advice in box 18, with the exception of the requirement not to exclude a major issuer of the market. This will prevent ethical index replicators where they may need to exclude a major issuer in order to comply with the ethical investment objective of the fund. IMA has therefore suggested an appropriate alteration to box 18.

BOX 18

1. A specified index can be eligible for replication by a UCITS if it meets the three conditions set by Art. 22a (1) of the Directive. These conditions should be interpreted as follows:

- An index is sufficiently diversified if it respects the risk dispersion rules set by Art. 22a of the Directive. In addition, UCITS should provide an appropriate information for the subscribers in the simplified prospectus, if the limit for investment in shares and/or debt securities issued by the same body is raised above 20% and to a maximum of 35% for a single issuer, in compliance with Art. 22a (2), in order to justify exceptional market conditions;
- The methodology of the index provider will as a rule ensure that the index represents an adequate benchmark for the market to which it refers. This methodology should generally not result in the exclusion of a major issuer of the market to which it refers unless this is contrary to the UCITS investment objective and policy;
- An index is published in an appropriate manner if:
    - it is accessible to the public; and

- the index provider is independent from the index replicating UCITS in question. This does not preclude them from forming a part of the same economic group with the existence of adequate Chinese walls.