

08 June 2005

M. Fabrice Demarigny
Secretary General
The Committee of European Securities
11-13 Avenue de Friedland
75008
Paris
FRANCE

Dear M. Demarigny

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

Schroders is a global provider of investment services with over €140 billion under management and offices in 30 countries. With regard to the UCITS Directive we have fund ranges in two EU jurisdictions. In Luxembourg we currently have three UCITS qualifying SICAVs and of these, our flagship product; the Schroder International Selection Fund, is registered in 13 EEA jurisdictions and 22 countries world-wide. In the United Kingdom we have a range of UCITS qualifying unit trusts which is sold to both UK retail and institutional clients

Given our business, we welcome the opportunity to provide comments on the draft advice to the Commission and support the aim to provide a common interpretation of the Directive. Unfortunately we have some fundamental issues with the contents of certain parts of the draft advice.

At a very high level we have concerns that the advice provided on the definition of "transferable security" suggests the UCITS Directive should be interpreted on a new legal basis. This seems to have been done without reference to what the Directive says. We would consider that such a fundamental change would have been signposted, or at least hinted at, in the recitals to the amending directives, but we have found no such reference. So, we reiterate the comment we made to the call for evidence. The Directive has a simple, widely understood mechanism for providing support to Article 37. That is the 90/10 rule, where, provided 90% of the fund's assets are traded on a regulated market, or equivalent, the remaining 10% may be invested in assets that are not so liquid. By attempting to link the definition of transferable security with what is essentially guidance on a 'good' listing, the result will be to add costs to the management of a UCITS without any particular investor protection or market failure concern.

We also believe that the shape of any final advice should take into consideration the need to provide as level a playing field as possible between different products that may be sold to the retail public. As such CESR should be looking to provide as much flexibility as possible, using disclosure where necessary, given the absence of detailed eligible asset rules in banking and insurance legislation.

Having attended the CESR open hearing it appeared that there were a number of arguments put forward for the need to interpret the Directive in the way the draft advice suggests.

One argument seemed to be that an investor would either find their previous investment in a UCITS I fund being transformed into something completely different or be somehow misled into investing into a UCITS III fund believing it to be open-ended, properly valued fund providing a right of redemption but find their investment was actually an illiquid, poorly valued product that they could not exit at a fair price. This seems to ignore the checks and balances the UCITS Directive has in place. A UCITS manager could not transform a grandfathered UCITS 1 in such a way since at the very least the original scheme documentation would be misleading and the management company would not be acting in the best interest of unitholders. In practise either a meeting of unitholders or advance notice of any change to investment objectives or policy is needed. Similarly, any new UCITS would need to ensure its documentation fully reflected the investment objective and policy.

Furthermore the Directive contains many more rules than the few pure asset-based ratio articles. Requirements such as those requiring the management company: to

- act in the interest of unitholders;
- have adequate financial resources;
- have appropriate rules ensuring conflicts of interest are managed,
- have its principle operations overseen by an independent 3rd party;
- provide investors with information before and during investment;
- provide for a right of redemption at net asset value,

result in a highly transparent product which any investor, be they a private customer or large institution, can have confidence in. Extending the UCITS framework to allow for greater investment flexibility came with the need for increased risk management processes and proper disclosure of risks to investors. It would appear that certain members of CESR appear to want to reign in the flexibility provided without any detailed analysis over who purchases UCITS and the safeguards the UCITS product has when compared to other products that can be sold to retail customers.

It was also suggested at the open meeting that the use of closed end funds and investment in financial indices not based upon asset classes allowed under the Directive meant that the Directive was being somehow subverted bringing into doubt its usefulness. In response we would also point out that it could be argued that the recent Commission Recommendation on Derivatives in the area of collateral arrangements which provides flexibility in managing counterparty exposure could be viewed as rendering the counterparty rules redundant. Nevertheless the Commission, following work in the UCITS Contact Committee where work was delegated to a sub-group comprising of regulators with expert knowledge, specifically permitted such structures.

Finally, we note the comments made by the European Securities Committee (ESC minutes 15/12/04), specifically; that:

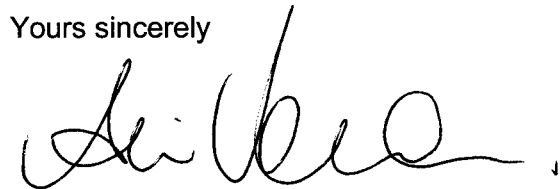
- overregulation should be avoided;
- any legislative initiative (which we believe would include any level 2 work) should be subject to proper impact analysis before implementation; and
- the need for avoidance of over-prescription by all parties.

Leaving aside the issue of whether much of this advice is within the narrow level 2 comotology powers of the Directive, we query how the Commission or the ESC could accept this advice without cost benefit/market failure analysis.

We appreciate and understand that CESR may produce the majority of this material at level 3 under the Lamfalussy arrangements, but those regulators which are subject to cost/benefit and market failure disciplines domestically may not, in the final analysis, be capable of supporting the proposals in their current form.

Our detailed response to the questions are attached.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Simon Vernon', with a stylized, cursive script.

Simon Vernon

Clarification of Article 1(8) Definition of transferable security

1. Treatment of “structured financial instruments” (Box 1)

Q1 Do you agree with the approach to the treatment of transferable security and structured financial instruments outlined in this draft advice?

We would accept (as stated in paragraph 31) that the UCITS Directive is aimed at ensuring the investments of a UCITS scheme are adequately liquid and compliant with the stated investment objectives. However, we do not think that certain parts of CESR's advice in Box 1 particularly add clarity to the current requirements of the Directive.

The two key tests in the definition of a transferable security is whether it is transferable and whether it is a security. We therefore agree with paragraph 1 and would not disagree with paragraph 3. However, we have difficulties with paragraph 2. We would argue that at the very least the issues of liquidity, ease of valuation and information on the security (paragraph 2, bullets 1 to 3) are not a fundamental element to the definition of a transferable security so at a legal level the references made are outside the scope of Article 53a comotology powers. Whilst 'transferability' would seem to be capable of being within the level 2 powers, its current wording seems overly restrictive and could be interpreted at not permitting certain securities such as IPOs being invested in.

We would repeat the comment we made in our response to the call for evidence, that the Directive already has a simple mechanism to ensure adequate liquidity, ease of valuation and appropriate information on the transferable security. That is that 90% of the transferable securities of a UCITS must be traded on an eligible market (be that a regulated market as defined by reference to other community law, or a market deemed to be acceptable in terms of operating regularly, recognised and open to the public). Otherwise the UCITS is limited to having only 10% of its portfolio in such transferable securities. The overarching requirement for the manager to act in the best interests of unitholders and to avoid conflicts of interest should mean that assets are valued correctly at arm's length and on normal commercial terms.

We therefore disagree with the draft advice CESR provides in this respect as it seems to provide guidance on the characteristics of a listing rather than clarifying the definition. So, we consider the wording of bullet points 1 to 3 should be deleted from any level 2 advice.

If they are not deleted, we would query the wording used. For example, in 'valuation' the first sentence appears to be directed at the transferable security (why is it referred to as 'the instrument') and the last sentence appears to be referring to the valuation of the scheme which is not relevant to answering the question posed by the Commission. Perhaps a solution would be to provide such advice as guidance on Article 37?

We suggest drafting improvements to Box 1 in the annex to this response.

On the specific question raised we would therefore disagree with CESR's approach.

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

We believe that investors will be no better protected given such financial instruments will be able to be used in other products that could be sold direct to retail investors. Therefore CESR could be seen to favour one form of retail product over another without any apparent investor protection reasons.

2. Closed end funds as “transferable securities” (Box 2)

As a general comment, we do not see why CESR takes the view that closed end funds constituted as transferable securities are only ‘**potentially**’ eligible assets, given the Directive is clear that transferable securities **are** eligible assets.

We are mindful of the recent CESR consultation on MiFID in respect of the admission of financial instruments for trading on regulated markets which seemed to lump all closed end funds as a sub-set of collective investment schemes. Clearly CESR seem to be worried that you can get a ‘bad’ listing on a regulated market but we would suggest that the solution to this issue lies in an appropriate regime in MiFID.

Q3. Does the reference to “unacceptable risk in the context of cross-holdings require further elaboration, and if so, how should it be elaborated?

We think that this advice is unnecessary, outside the comotology powers and suggest it should be deleted in Box 2 (i.e. deletion of 1(a)).

Q4 Do you consider that in order to be considered an eligible asset for a UCITS, a listed closed end fund should be subject to appropriate investor protection safeguards? Is so, do you consider the proposed safeguards sufficient and clear enough?

We do not believe that there is any doubt over the eligibility of closed end funds structured as transferable securities. Where a closed end fund is not structured as a transferable security, rather it is a collective investment scheme, the Directive sets out the criteria that the collective investment scheme needs to meet in order to be eligible for investment. If the scheme fails these tests then it is ineligible for investment. So we suggest this guidance at Box 2, 1(b) is superfluous and should be deleted.

Q5 Further to the requirements presented in Box 2b), CESR is considering clarifying 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).

Q6. 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?

Regarding especially questions 5 and 6, please give your view on the possible impacts of the different options, 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 options chosen. Please give quantitative examples of the impacts in terms of the sphere of eligible instruments for UCITS, if possible.

Q5 is not a question, though presumably CESR is asking which option is favourable. We would repeat that this guidance is not relevant to a closed end fund that is a transferable security. There is no requirement in the Directive to look through as suggested by this advice. To seek listing, any closed end fund would need to meet the listing requirements of the regulated market. If it did not it would be unapproved

and subject to the 10% rule on unapproved securities. We suggest deletion of Box 2, 1(c), meaning that only the first sentence on Box 2 should remain.

We believe that the practical effects of this guidance will mean that firms that have the ability, will use alternative vehicles to UCITS in offering retail investors investment solutions to meet their needs. As such these proposals will not protect investors.

3. Other eligible transferable securities (Box 3)

Q7. Are there any practical difficulties in your experience in defining the boundaries between Article 19(1)(a) to (d) and Article 19(2)(a)? Do you consider that the suggested approach in box 3 as [is] appropriate?

We have no difficulty with the current boundaries.

We would therefore accept the wording of Box 3 paragraph 1 and 2 first sentence provided the advice in Box 1 is amended. We do not however agree with the last sentence of paragraph 2 of Box 3. If the closed end fund is not listed but is structured as a transferable security then it and similar investments will be limited to 10% of the UCITS NAV. We see little need to further restrict such investments in the absence of any market failure analysis. Our drafting suggestion at the annex would mean Box 3 could be deleted.

Clarification of art 1 (9) (Definition of Money Market Instruments)

1 General rules for investment eligibility (Box 4 & 5)

We generally support the proposed advice in Box 4, though we support EFAMA's drafting improvements set out in their response. In terms of Box 5, whilst we appreciate that the Commission requests CESR's advice on other factors to take into account, we do not see any need for paragraph 2 and 3 of Box 5 which seem to repeat the Directive. We therefore support EFAMA's suggested redrafting of that box as well.

2. Art 19(1)(h) (Boxes 6 to 8)

We believe that the draft advice contained in Box 6 is generally acceptable. However, we support the minor drafting improvements suggested by EFAMA in their response.

In terms of Box 7, we point out two facts. Firstly, the Commission requested advice on factors relevant in consideration of prudential rules considered to be at least as stringent as those set down in community law. CESR's response does not answer that request. Secondly we point out that the Directive places specific duties on the competent authorities. In the draft advice at paragraph 1, CESR seem to place responsibility on the UCITS. In at least one member state this would be considered to be an illegal sub delegation of regulatory powers. We would therefore suggest paragraph 1 is deleted and paragraph 2 makes clear that it is the competent authorities who have to make the presumption.

We would suggest that paragraph 3 cannot be aimed at the UCITS, rather individual competent authorities. We would suggest that a list be maintained by CESR at level 3 that can be added to over time to provide a consistent and harmonised approach.

Q8. Do you agree with this approach, and especially the proposal that one of the conditions for 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 Article 19 (1) (a) to (d)? If not, please give practical examples of the potential impacts.

We accept the approach and therefore the fact that should asset backed securities fall outside Article 19(1) (a) to (d) they will nevertheless be capable of investment up to 10% given Article 19(2) of the Directive.

We support the drafting suggestions provided by EFAMA in terms of Box 8.

3. Other eligible money market instruments (Box 9)

We have no comment on Box 9

Clarification of scope of Art 1 (8) (Definition of transferable Securities) and “techniques and instruments” referred to in Art. 21.

Box 10

Paragraph 1, 2, and 6 seem to add little to what is already stated in the Directive or Commission Recommendation. Specifically, paragraph 1 seems to repeat recital 13, paragraph 2, the wording found in Article 21(2) first paragraph, and paragraph 6 provides the same result as the wording of the second paragraph of Article 21(2).

The wording "acceptably low level of risk" in paragraph 3 should be deleted.

We welcome the clarity provided by CESR in relation to paragraph 4.

Embedded Derivatives (Box 11)

We found the advice somewhat unclear given what we understood the reason behind Article 21(3) was for. We thought it was to ensure a UCITS could not obtain more exposure or leverage to a particular asset through a structured financial instrument which embedded a derivative than if the derivative was being used on its own. The advice provided seems to do more than that and we question the need to link the advice to IAS 39. Perhaps a more principle-based approach at level 2 is needed.

We consider that such an approach needs to bear in mind that the risk management process requirements in Article 21(1) are in part aimed at managing derivative positions where exposure to losses exceeds the amount paid by the UCITS. For a transferable security or money market instrument embedding a derivative, the maximum loss is the amount paid for the transferable security or money market instrument – otherwise they would fail the definition referred to earlier in the proposed advice. With Article 22(2) referring to EPM, it seems the most relevant parts of Article 21 is paragraph 3, indents 1 to 3. Paragraphs (1) and (2) are linked to exposure – which in this case will be limited to the amount paid for the transferable security or money market instrument. This therefore seems to leave paragraph 3 as the most relevant part of the article.

Other collective investment undertakings (BOX 12)

We welcome the advice provided at Box 12 but seek clarification over who this guidance is aimed at. The Directive's wording imposes an obligation on the regulator in each Member State to undertake this work. Specifically it states: "...that are considered by the **UCITS' competent authorities** to be equivalent" The guidance by CESR presumably is therefore aimed ultimately at the Commission producing level 2 text aimed at competent authorities. If not we would refer you to our response to Box 7 where a similar point arises.

If so, perhaps it would be useful for CESR in addition to this advice, to produce at level 3, a list of jurisdictions which are considered to provide equivalent supervision and unitholder protection. This would provide certainty and mean regulatory arbitrage was kept to a minimum and, being level 3 guidance, be flexible enough to add to over time.

Alternatively, the use of a common industry standard maintained by, for example, domestic trade bodies could be tacitly accepted by regulators and reference to that fact could be made in the guidance.

Financial derivative instruments

1. Financial derivative instruments; general considerations (Box 13)

We welcome the general advice contained in Box 13 and the proposal that further guidance is provided on financial indices, OTC derivatives and credit derivatives.

2. The eligibility of derivatives on financial indices (Box 14)

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.

We believe that CESR should attempt to provide the broadest meaning possible to the concept of “financial indices”. The directive does not say that the “financial indices” in question must be with reference to an underlying asset in which the UCITS can invest directly. Actually, the directive says quite the contrary by providing that *“the underlying consists of instruments covered by this paragraph, financial indices, interest rates, foreign exchange rates or currencies, in which the UCITS may invest according to its investment objectives as stated in the UCITS fund rules or instruments of incorporation.”* It does not restrict the financial indices to “financial indices on underlying instruments covered by this paragraph” (as it could have done). Therefore, financial indices should not need to be interpreted with reference to an underlying asset in which the UCITS could invest directly and there is no justification for exclusion of indices based on non-eligible assets (for example commodities, real estate or hedge funds) or on financial instruments based on such assets.

So, we agree with the principle-based approach of Box 14 and would support the view that the wording of Article 19(1)(g) does not require a look through approach. Provided the index meets the criteria set down in Article 22a there should not need to be any further qualification. It should be clear from the name, the stated investment objectives and policy of the scheme and the relevant risk warnings – or a combination of the three – that the UCITS invests, or could invest in such a way.

By requiring a look through, this will in no way protect the retail public from being offered these vehicles through an insurance or banking product and therefore CESR

would be discriminating against UCITS operators who are not part of a larger financial group.

3 OTC derivatives (Box 15)

In paragraph 2 we would question the need for daily valuation of such assets although we note the Directive refers to a risk management process that measures the risk 'at any time'.

We also appreciate CESR's comments at the open hearing that the last part of the final indent of paragraph 3 is to be deleted.

4 Credit derivatives (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.

We are supportive of measures that increase the transparency of asymmetric risk but do not see why this should apply only to credit derivatives and not to other types of derivatives.

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 bod(ies);*
- *one or several regional or local authorities of Member States;*
- *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.*

We do not think that limiting the nature of the issuers, i.e. an asset-based rule, would solve this issue.

Index replicating UCITS (Boxes 17 & 18)

We question the usefulness of Box 17. The aim of the Directive in this area is to relax the spread limits for a fund aiming to replicate the composition of an index meaning the 5/10/40 limit may be ignored if an index has a particular weighting towards one or more instruments. Box 17 states that the aim to replicate composition can be met by the use of derivatives. But we point out that if a UCITS uses a derivative based on a financial index to replicate performance, this derivative does not need to be looked through to ensure the constituent parts meet the relevant spread rules given Article 21(3) 3rd indent states "The Member States may allow that, when a UCITS invests in index-based financial derivative instruments, these investments do not have to be combined to the limits laid down in Article 22."

Is Box 17 intended to state that if derivatives are used to gain exposure to certain relevant underlying assets which form part of the index being replicated, then this is acceptable practise?

We would suggest in answer to question 12 is Yes and that either method of estimation is appropriate.

We support EFAMA's suggested redraft in response to Box 18.

Drafting suggestions

BOX 1

1. Admission to trading on a regulated market or equivalent market as provided for in Article 19(1) (a) to (d) is not directly relevant to the definition of 'transferable security' in Article 1 (8) of the Directive.
2. To be an eligible asset for a UCITS a transferable security must fall within the definition of 'transferable security' in Article 1 (8) of the Directive but the UCITS should take into account the following factors in determining whether or not any security is a 'transferable security' (as defined):
 - Transferability – the manager should assess transferability by looking at the possibility of a security being moved from one investor to another by registration on the register of shareholders or equivalent means.
 - Limited liability – the potential loss to the UCITS in respect of the holding of the security must be limited to the amount paid for it.
3. Where a structured financial instrument includes a derivative element, Art 21 (3) of the Directive applies to the derivative element, but otherwise the instrument is treated as a transferable security or money market instrument as the case may be.
4. Where a closed end fund is structured so as to fall within the definition of transferable security the factors above also apply to the closed end fund.

BOX 2

Delete (by virtue of amended Box 1 paragraph 4 above)

BOX 3

Delete (by virtue of Box 1, applying to all transferable securities)