

14th December 2004

CESR Call for Evidence on the Eligible Assets of UCITS

The International Primary Market Association¹ is pleased to submit its response to CESR's Call for Evidence on the mandate for advice on possible modifications to the UCITS Directive in the form of clarification of definitions concerning eligible assets.

IPMA wholeheartedly welcomes the Commission's intention to make use of the delegated powers conferred by Article 53a of the UCITS Directive to clarify some of the definitions of eligible assets which are contained in the Directive. The text of the definitions is unclear in several areas and contains, in Article 1(9)(h), confusing language. These infelicities have led to confusion in certain Member States and, when combined with reluctance on the part of some regulators and national central banks to open their domestic money markets to "foreign" commercial paper and certificates of deposit, have resulted in an increased fragmentation of the European Union's money markets.

IPMA's response will be limited to matters relating to the definition of money market instruments, the area where our experience and expertise lies.

In working with the definitions of eligible assets in the field of money market instruments it is essential that one begins with the clear understanding that the purpose of the Amending UCITS Directive (Directive 2001/108/CE) was to expand the number and nature of eligible assets for UCITS and to include money market funds in the UCITS Directive (Directive 86/611/EEC).

There is abundant evidence of this purpose in the travaux préparatoires, the recitals in the Directive and in contemporaneous commentary.

1. Commission's Amended Proposal of 1994 – Recitals 2 and 3:

Recital 2: "Whereas money market funds and funds of funds have shown a considerable growth in certain Member States in recent years; whereas these two categories of funds, given their operational features and investment object, may be regarded as very close to

¹ IPMA is the trade association which represents the interests of the international banks and securities firms which underwrite and distribute international debt and equity securities in the primary market. It has 52 members representing the leading underwriters and dealers in all of the world's major financial centres.

UCITS; whereas it is desirable to bring these fund within the scope of Directive 85/611/EEC since the attainment of this objective will facilitate the removal of the restrictions on the free circulation of the units of these funds in the Community and such coordination is necessary to bring about a European capital market;”

Recital 3: “Whereas the inclusion of money market funds is achieved by allowing UCITS to invest freely in money market instruments while preserving the guarantees necessary to give adequate protection to investors; whereas money market instruments cover those classes of transferable instruments which are normally dealt in on the money market, for example treasury and local authority bills, certificates of deposit, commercial paper and bankers’ acceptances; whereas Member States should have the option of choosing the list of eligible money market instruments on the basis of objective criteria to take account of the existing structural differences in the money markets of different countries;”

2. DG Internal Market announcement of Proposal for Directive amending Directive 85/611/EEC, 17 July 1998:

“One proposal focuses essentially on the ‘product’ (the investment fund). It would extend the range of financial assets in which collective investment undertakings benefiting from the single licence may invest. In future, UCITS would be permitted to invest not only in listed shares and bonds, but also in bank deposits (cash funds), money market instruments (money market funds), standardised option and futures contracts dealt on regulated exchanges and in units of other collective investment undertakings (so-called ‘funds of funds’).”

3. Ecofin press release after adoption of Common Position, 5 June 2001:

“UCITS I aims in particular to extend the limits on assets in which UCITS may invest beyond those transferable assets referred to in the original Directive, and to define the details involved.

Assets in which investments would be authorised include the following financial instruments : units of authorised UCITS and/or other collective investment undertakings within the meaning of the Directive, deposits with credit institutions, financial derivative instruments dealt in a regulated market or over-the-counter and money market instruments.”

4. *Echos de l’Europe*, 23 September 2002:

“The first widens the investment objective of undertakings for collective investment in transferable securities.

....

It introduces a definition of ‘money market instruments’, which are ‘instruments normally dealt in on the money market which are liquid and have a value which can be accurately determined at any time’.”

5. Recitals 2 and 4 of the Directive:

- “(2) Taking into account market developments, it is desirable that the investment objective of UCITS be widened in order to permit them to invest in financial instruments other than transferable securities which are sufficiently liquid; the financial instruments which are eligible to be investment assets of the portfolio of the UCITS are listed in Article 19(1); the selection of investments for a portfolio by means of an index is a management technique.
- (4) Money market instruments cover those transferable instruments which are normally not traded on regulated markets but dealt in on the money market, for example treasury and local authority bills, certificates of deposit, commercial paper, medium term notes and bankers’ acceptances.”

Paragraph 3.2.1

IPMA firmly believes that money market instruments that are submitted to the official list of or admitted to trading on a regulated market should automatically be considered to be money market instruments meeting the general conditions specified in Article (9). Several Member States have adopted this interpretation, e.g., Spain and France.

There is very little activity in the secondary market for money market instruments because of their short maturities. In the largest money market in the world, the United States commercial paper market, over one half of commercial paper has a maturity of one to four days. In the largest domestic market in the European Union, France, a very large proportion of billets de trésorier is comprised of overnight paper. There is little secondary market activity because the nature of money market investors is generally buy and hold to maturity.

The average maturity of Euro commercial paper, the largest market in Europe with outstandings at 30 November 2004 of €361 billion, is 65 days and a small, but increasing proportion of Euro commercial paper is overnight paper. Investors almost always hold money market instruments to maturity. This is because they can match the maturity they desire with a complete range of maturities on offer. In addition, the short maturities of money market instruments make them less volatile than longer term debt instruments. Therefore, there is little opportunity for trading profits and no incentive to trade.

On the rare occasion when an investor wants to sell a money market instrument it will ask the dealers appointed by the issuer (commercial paper) or the bank which issued the instrument (certificate of deposits) to give it a bid to repurchase the paper. Dealers and issuing banks usually comply with such requests.

The characteristics of money market instruments described above make it clear that the additional considerations (liquidity and ability to determine the values) are ipso facto satisfied. Liquidity is provided by the short-term nature of money market instruments and the value can be determined at any time by asking the dealers appointed by the issuer or the issuing bank for a price.

IPMA is working with Euroclear to prepare a daily pricing index which will be published and available to the public. In addition, the STEP project includes a daily pricing service which,

initially, is expected to be published by the European Central Bank. IPMA has worked actively with ACI Euribor on the STEP project, strongly supports it and provides two members of the Euribor ACI Short Term Paper Task Force.

Paragraph 3.2.3

The pre-requisite of the first paragraph of Art. 19(l)(h) (“is itself regulated for the purpose of protecting investors and savings”) has been identified as a major source of confusion and a potential barrier to accomplishing the Directive’s purpose of expanding the categories of eligible assets.

The problem arises because the pre-requisite appears to be drafted to apply in addition to the four indents which fall under the first paragraph because of the words “and provided that they are:” (“et pourvu que”). The words “and provided” have inadvertently created serious confusion. The Commission’s intent was to have alternative criteria, i.e., the investor protection criteria and the four specific classes of issuers in the four indents.

Unfortunately, the drafting fails to make this clear.

IPMA raised this lack of clarity with the Commission in 2001 and with the European Parliament in July 2001. The Commission declined to clarify the language on the grounds that it “arose a long time ago” and the European Parliament decided not to vote a correcting amendment in order to avoid reopening the political debate, but declared in the report of Economic and Monetary Affairs Committee:

the “compromise reached in Council is a fragile one and he feels that it would not serve anybody’s interest to open the Pandora’s Box of detailed, technical and/or politically sensitive amendments. To propose further amendments, in particular in the sensitive areas covered by Article 21 *et seq.* would almost inevitably lead to conciliation which would not only delay this long overdue overhaul of fund legislation, but also risk that they’ll never see the light of day.

....

An example of this unclear language is Article 19.1.h which contains the undefined concept ‘regulated for the purpose of protecting investors and savings’. Although some market actors tend to interpret this as meaning credit or deposit guarantees in the strictest sense (i.e. banks only), it is clear from the context and from the discussions in the other institutions that this is meant to have a wider meaning, that is that a given MMI or the issuer thereof must be subject to either initial or ongoing supervision, e.g. by a stock market regulator. Additionally, any other interpretation would render the following four indents would be completely superfluous.”

The European Parliament’s interpretation must be the correct one because any other interpretation would limit the eligible money market instruments unduly to those issued by banks and insurance companies – issuers who are regulated for the purpose of protecting investors and savings – and make nugatory most of the four indents. As CESR points out, it is impossible to reconcile the pre-requisite with money market instruments issued by a central, regional or local authority or the European Central Bank. Similarly the second and third indents largely overlap with the general pre-requisite.

The four intents specify conditions under which money market instruments can be treated as eligible for investment. All of the intents specify conditions designed to ensure that there is adequate investor protection in relation to investment in those instruments, even though they are not admitted to trading on a regulated market. If an issuer meets the criteria in one of the four intents, that is sufficient to make money market instruments it issues eligible investments under the Directive.

Unfortunately, some Member States in transposing the Directive have ignored the liberalising intention of the Directive and the European Parliament's report. One country, with a large domestic market, has transposed the Directive so as to continue its exclusion of Euro commercial paper from eligible assets for its money market funds and has further ruled that London certificates of deposit are no longer eligible assets because it claims that the London certificate of deposit market is not a regulated market.

In another case, money market funds in one country have stopped purchasing Belgian billets de trésorier because of doubts about their acceptability under the transposition into the regulations of their national regulator.

We understand that another regulator believes money market instruments should be limited to certificates of deposit issued by licensed credit institutions.

It is essential that CESR advise the Commission that these interpretations be rejected, whether they are based on a misunderstanding of the Directive or a protectionist policy which is anti-communautaire.

The restrictive interpretation adopted by some Member States is causing several problems. UCITS are forced to invest only in domestic money market instruments. This means (1) that they have trouble diversifying their portfolios and increases the risk of loss and (2) the interest rate they earn on their investments is lower than they would earn if they could invest in a free market.

Europe as a whole suffers because it has a series of fragmented, national money market with many inefficiencies. The largest sector in Europe, the Euro commercial paper market, is excluded from several national markets or issuers are forced to list their commercial paper on a regulated market. This adds an expense and delay with no corresponding benefits.

The result is that Europe, with an economy that is as large as that of the United States has a money market which is about one third the size of the American commercial paper market: €361 billion versus \$1.4 trillion outstanding.

Paragraph 3.2.3

IPMA does not believe that Article 19(2)(a) should be interpreted as meaning that the sole fact that money market instruments are not dealt in on a regulated market requires them to be considered "other money market instruments" under Article 19(2).

The reasons set forth above are relevant to this analysis and a restrictive interpretation would be inconsistent with the purpose of the Directive to expand the eligible assets in which UCITS are permitted to invest.