Comments on CESR's draft Advice on the Clarification of Definitions concerning Eligible Assets for Investment of UCITS

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

I. Treatment of "structured financial instruments"

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used in determining whether financial instruments whose underlying involves products of varying degrees of liquidity and/or which 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.

Is the fact of admission of trading on a regulated market as foreseen in Art. 19 (1) (a) to (d) sufficient for them to be considered "transferable securities" Art. 1 (8), eligible for investment by UCITS?

In view of other considerations contained in the UCITS Directive, are there other factors which should be taken into account?

BOX 1

1. To be an eligible asset for a UCITS under Art. 19 (1) (a) to (d), a transferable security must fall within the definition of "transferable security" in Art. 1 (8) of the Directive. 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. Volume and turnover in transferable security will need to be considered in assessing liquidity. In addition, for price-driven markets, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument. In assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.

   - Valuation – There must be accurate, reliable and generally independent valuation systems available in relation to the instrument. Pricing in the instrument should ideally be readily available, regular and independent of the issuer. 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 portfolios of the product in question.

- Transferability – The manager should assess whether the security:
  - is offered on a limited basis;
  - has constraints on who may buy and sell the security.

  These factors will clearly affect the transferability of the security.

- 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.

3. When a structured financial instrument includes a derivative element, Art. 21 (3) of the Directive applies.

Questions:

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

ALFI answer

We have the following comments:

- Whilst we agree that a UCITS cannot invest in securities for which the loss could be unlimited, this should not preclude a UCITS from investing in securities where the loss could exceed the amount paid for them.

  For instance, securities partly paid are specially allowed by Art. 41 (2) of the Directive.

  Moreover, we believe that a UCITS may invest in securities where the loss could exceed the amount paid for them when the potential loss is limited and quantifiable and at the condition that such potential loss be adequately reflected in the risk management framework of the UCITS, thus ensuring that the possible leverage resulting from such investment does not exceed the total leverage of the portfolio as foreseen by EU recommendations.

- Regarding the additional requirements suggested in point 2. of Box 1, we are of the opinion that the Directive, by making a distinction between listed transferable securities and other transferable securities, recognizes the presumption of liquidity for listed transferable securities which, as such, should be considered as eligible investments without further conditions.

  Furthermore, we consider that transferability is a given for securities listed on a stock exchange or traded on a regulated market within the meaning of the Directive.

Factors listed in point 2. of Box 1. should, to the extent required, be considered as conduct of business rules for UCITS management rather than compelling requirements.

- We agree with the content of the last sentence of paragraph 28 of CESR's advice stating that UCITS are responsible for ensuring that there is sufficient overall liquidity in their portfolio to meet their obligations arising from Art. 37 of the Directive.

  Overall liquidity should be assessed at portfolio level and not, as proposed for each security individually (see "Final Alfi comments" hereinafter). Again, to the extent required, we propose that this rule be introduced as a conduct of business rule.

- We agree with the provision of point 3. of Box 1 provided that the word "includes" be replaced by the word "embeds" within the meaning given to the latter in the third bullet point of our comments under Box 11.

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

ALFI answer

We see three major negative practical impacts of the proposed approach:

- To verify compliance with each factor listed in Box 1., point 2. at the level of every individual security, to the extent justified – quod non (see above) would imply that operational procedures be put in place which are extremely cumbersome.

- Furthermore, this would generate disproportionate costs for the UCITS and their service providers compared to the benefit for investors. Indeed, if compliance with these factors becomes a requirement for UCITS in relation to the acquisition of each individual security, fund managers would have to document compliance with each of these factors and report to the UCITS management in respect thereto.

- Paradoxically, the proposal may lead to different approaches taken by fund managers in assessing all the different criteria imposed for the eligibility of every investment for UCITS. This would lead to a result contrary to the purpose of the Directive, which was to create an harmonized definition for eligible transferable securities.

  As a conclusion, we suggest to replace the content of Box 1 by the following:

BOX 1

1. To be an eligible asset for a UCITS under Art. 19 (1) (a) to (d), a transferable security must fall within the definition of "transferable security" in Art. 1 (8) of the Directive. In addition, the potential loss of the UCITS in respect of holding the security cannot be unlimited and must be quantifiable.

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, to be able to comply with Art. 37 of the Directive, the overall portfolio of transferable securities must not compromise the overall liquidity of the UCITS. For instance, the following criteria may be considered by UCITS managers: volume and turnover in transferable

securities will need to be considered in assessing liquidity. In addition, for price-driven markets, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument. In assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.

- Valuation – There must be accurate, reliable and generally independent valuation systems available in relation to the instrument. Pricing in the instrument should ideally be readily available, regular and independent of the issuer. 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 portfolios of the product in question.

- Transferability – In case of doubt, the manager should give consideration to whether the security:
  - is offered on a limited basis;
  - has constraints on who may buy and sell the security.

  These factors will clearly affect the transferability of the security.

- 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.

3. When a structured financial instrument embeds a derivative element, Art. 21 (3) of the Directive applies.

II. Closed end funds as "transferable securities"

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice as to whether and under which conditions shares of closed end funds or different variants of closed end funds fall under the definition of transferable securities as provided for by Art. 1 (8), having regard to Art. 19 (1) (a) to (d) and other relevant considerations contained in the UCITS Directive.

BOX 2

1. The factors in Box 1 concerning listed transferable securities apply also to listed closed end funds. Where a listed closed end fund takes the form of a transferable security, as defined by the Directive in Art. 1 (8) and Art. 19 (1) (a) to (d), the UCITS should in addition:

   a) consider whether the transferable security in question may be engaging in cross-

holdings in other closed end funds that take the form of transferable securities in such a way as to cause unacceptable risks for the listed closed end fund, and through it, for the UCITS itself;

b) ensure that the asset management activity carried on by or on behalf of the listed closed end fund is subject to appropriate investor protection safeguards; and

c) not make investments in listed closed end funds for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive.

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?

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?

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).

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?

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

ALFI answers

- We propose not to differentiate the treatment of listed closed end funds and listed transferable securities. The promoter’s decision to create a closed ended fund rather than another type of company is driven very often by a tax or regulatory consideration.

  Units of US and Canadian closed end funds are considered in those countries as transferable securities. If the treatment thereof was different in Europe this would reduce the competitiveness of European products vis-à-vis US/Canadian products.

  As a result, the underlyings of the closed end funds must not necessarily be eligible assets and there is no reason to specifically take into account the level of underlying leverage of such closed end funds as such requirement is not imposed for another listed transferable security.

Furthermore, liquidity of the UCITS investments will derive from the stock exchange trading of the closed end fund, as for any transferable security.

Therefore, we believe that it is not necessary to look through the closed end fund except to make sure that the investments thereof comply with the investment policy of the UCITS:

- For instance, if a UCITS investment policy is to take interest positions through the investment in bonds, money market instruments, convertible bonds or to take interest positions through derivatives, we believe that such UCITS should be allowed to invest into certain types of closed end hedge funds, such as convertible bonds or fixed interest arbitrage listed closed end funds. Protection for the shareholders will be ensured by (i) the risk diversification criteria applied at the UCITS level and (ii) the fact that the leverage of the underlying closed end fund will not be passed on to the UCITS (the UCITS is only exposed to the limit of the amount invested).

- Similarly, when a UCITS investment policy is to invest in real estate companies, the investment choice cannot be dictated by the legal form of the target company. A listed REIT may offer as much liquidity as any other real estate investment company.

In general, listed REITs are subject to stringent disclosure requirements. Such requirements, together with the need to file reports with the regulatory authorities, contribute to a high level of transparency of the REIT market.

For instance in Hong Kong, in terms of the investment limits applicable to each listed REIT, the SFC considers that they should be equivalent to those applicable to securities in which SFC-authorised schemes are currently allowed to invest in. Applying more restrictive rules to European UCITS would reduce their competitiveness vis-à-vis other products.

- As there is no generally accepted definition of closed end funds, distinguishing closed end funds and other companies may be very cumbersome, depending of the local legislation in the country of issuance and may lead to different approaches taken by fund managers at the UCITS level. This would also lead to a result contrary to the purpose of the Directive, as mentioned above.

III. Other eligible transferable securities

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on any factors to be used to assets whether possible investments in transferable securities should be considered as falling within the scope of (i) transferable securities dealt in on a regulated market according to Art. 19 (1) (a) to (d) and (ii) “other transferable securities” under Art. 19 (2).

It is sufficient that a “transferable security” not be dealt in on a regulated market in order to fall within the scope of “other transferable securities” under Art. 19 (2)?

Are there any factors which should be taken into account in determining whether particular categories of transferable securities fall within the scope of Art. 19 (2) (a)?

BOX 3

1. For an investment in a transferable security to be eligible under Art. 19 (2) (a), it must be a transferable security that does not comply with the conditions respectively described in Art. 19 (1) (a) to (d)

2. The draft advice above in Box 1 in relation to transferable securities that fall within Art. 19 (1) (a) to (d) of the Directive, will also apply, as appropriate, to such transferable securities that fall within Art. 19 (2) (a). In CESR's view, non-listed closed end funds are highly unlikely to meet the requirements as stated in Box 1.

Question:

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?

ALFI answer

- The Directive makes a clear distinction between transferable securities listed on a stock exchange or traded on a regulated market and other transferable securities by limiting the latter to 10% of the UCITS net asset value. The wording of the Directive implies that the only requirement imposed for such securities included in that 10% ratio are that they should be transferable without any additional requirement for such securities to be liquid.

  If the intention of the European legislator was to impose to the non listed transferable securities the same liquidity [and reliable valuation] criteria than the one[s] imposed to listed transferable securities, there would be no need to limit investments in such securities to 10% of the UCITS net asset value.

- As detailed in the preceding section, closed end funds should be assimilated to transferable securities and therefore non listed closed end funds should be included in that 10% ratio provided that their units are transferable.

  For instance, under the Hong Kong Code, SFC-authorised schemes are allowed to invest in unlisted investments. In particular, SFC-authorised schemes may invest in unlisted companies by way of Chapter 7.3 of the Code, and in unlisted collective investment schemes by way of Chapter 7.11 of the Code. Since an SFC-authorised scheme has to ensure that it can meet the redemption requests of its investors on a timely basis, the SFC considers that there is already ample room for SFC-authorised schemes to invest in unlisted investments, and there should not be an additional provision to allow investments in unlisted REITs.

  As such, the SFC now clarifies that the unlisted investments that can be made under Chapters 7.3 and 7.11 include REITs in the form of companies and collective investment schemes respectively. As a result, market practitioners have the flexibility to invest in unlisted REITs up to the prescribed limits already laid down in the Code, without altering the liquidity profile of SFC-authorised schemes, as currently required by the Code.

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

1. General rules for investment eligibility

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine the eligibility of certain categories of money market instruments dealt in on a regulated market according to art. 19 (1) (a) to (d).
Is the fact that they are dealt in on a regulated market sufficient for them to be considered "money market instruments" meeting the general conditions specified at At. 1 (9) ?

In view of other considerations contained in the UCITS Directive, are there other factors/criteria which should be taken into account?

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:

- as far as the criteria "liquid" is concerned: the liability of the MMI must be taken into account in the context of Art. 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 unitholder. 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;

- 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 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 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.

- as far as the criteria "normally dealt in on the money market" is concerned, in addition to the above mentioned factors, 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.

2. Treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances will usually comply with that last criteria.

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. Given the clarification of the above definition of MMI, CESR's view is that there is no scope for gaining exposure to precious metals through the investment in such instruments.

3. Regarding the specific issue of the prohibition of uncovered sales, CESR is of the opinion that Art. 42 implies that short selling of MMI by a UCITS is not authorized.

2. Art. 19 (1) (h)

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the following issues:

- CESR is invited to clarify the pre-requisite of the 1st paragraph of Art. 19 (1) (h) requiring that the issue or issuer of such money market instruments other than those dealt in on a regulated market "*is itself regulated for the purpose of protecting investors and savings*", e.g. whether this pre-requisite should encompass other issuers than credit institutions. It should also be clarified how such pre-requisite can be complied with in addition with each of the four indents of Art. 19 (1) (h). For instance, how can such pre-requisite be combined with the additional criteria of the first indent, i.e. "*issued or guaranteed by a central, regional or local authority*[…]"?

- CESR is invited to clarify the concept of "*equivalent investor protection*", i.e. to clarify the factors referred to in Art. 19 (1) (h) fourth indent which need to be taken into account in deciding whether and under what conditions money market instruments other than those dealt in on a regulated market are "*issued by other bodies provided that investments in such instruments are subject to investor protection equivalent to that laid down in the first, the second or the third indent of Art. 19 (1) (h) and provided that the issuer is:*

  (i) a company whose capital and reserves amount to at least EUR 10 million and which presents and publishes its annual accounts in accordance with Directive 78/660/EEC;

  (ii) an entity which, within a group of companies which includes one or several listed companies, is dedicated to the financing of the group; or

  (iii) an entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line".

Where appropriate and necessary, these clarifications should consider the Recommendation on the use of derivatives by UCITS, where relevant.

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 memorandum providing information on both the issue and 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 independent authority;

   - whether this information has a minimum amount of EUR 150.000 or the equivalent in other currencies; and

   - whether free transferability and electronic settlement in book-entry form are possible.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the following issue:

- CESR is invited to provide advice on the factors to be used in deciding whether and under what conditions money market instruments other than those dealt in on a regulated market are "*issued by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be* <u>*at least as stringent*</u> *as those laid down by Community law*" as referred to in Art. 19 (1) third indent. In particular, CESR is invited (i) to clarify the concept of "*at least as stringent*" and (ii) to determine whether, and if yes, to which extent such criteria and the abovementioned pre-requisite of the 1st paragraph of Art. 19 (1) (h) overlap each other.

Whether appropriate and necessary, these clarifications should consider the Recommendation on the use of derivatives by UCITS, where relevant.

BOX 7

1. It is the responsibility of the UCITS to check that the requirements that prudential rules are at least as stringent as those laid down by Community law is met.

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 in-depth analysis of issuers.

Extract from the mandate from the Commission

DG Internal market requests CESR to provide technical advice on the following issuers:

In the case of the last factor above (i.e. "*entity which is dedicated to the financing of securitization vehicles which benefit from a banking liquidity line*") CESR is invited to clarify which instruments would be covered by this provision, for instance considering the questions of (i) whether and under what conditions it encompasses asset backed securities[1] and synthetic asset backed securities[2,] (ii) the quality of the "*banking liquidity line*" referred to therein and (ii) of the question as to which category of banks (credit institutions) are covered by term "*banking*").

Where appropriate and necessary, these clarifications should consider the Recommendation on the use of the derivatives by UCITS, where relevant.

BOX 8

1. Asset backed securities and synthetic asset backed securities do not fall in the category defined by the fourth indent of Art. 19 (1) whenever they are not dealt in on a regulated market. This does not prelude them from being eligible under the provisions of Art. 19 (1) (a) to (d) or Art. 19 (2) (a). Regarding entities that fall under the fourth indent of Art. 19 (1) (h), the banking liquidity line has to be secured by a financial institution which itself complies with the third indent of Art. 19 (1) (h). Credit providing this protection must have a rating that is at least equal to that of the program in question.

3 Other eligible money market instruments

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the factors to be used to determine the limit between money market instruments according to Art. 19 (1) and "other money market instruments" under Art. 19 (2).

Is the fact that they are not dealt in on a regulated market sufficient for them to be considered "other money market instruments" under Art. 19 (2)?

In view of other considerations contained in the Directive, are there other factors which should be taken into account?

BOX 9

1. Other money market instruments are those instruments that comply with the definition of a MMI as set by Art. 1 (9) of the UCITS Directive, i.e. are normally dealt in on the money market and fulfil the requirements of liquidity and accurate valuation, and which have been clarified above, but do not, however, fall in the categories defined by Art. 19 (1) (a) to (d) or (h).

[1] Securitized debts based on a "true sale" of assets from the originator of the securitization to a special purpose vehicle.

[2] Securitized debts based on a transfer of credit risks from the originator of the securitisation to a special purpose vehicle by the means of a credit derivative.

Question:

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.

ALFI answer

- We believe that the criteria outlined in Boxes 4 to 9 should be considered as rules of conduct by fund managers rather than additional requirements for UCITS imposed by the European legislator at level 2 or level 3 of the Lamfalussy procedure. Indeed, money market instruments are generally lower risk investments; imposing these additional criteria at level 2 or level 3 could restrict the eligibility of new categories of money market instruments in the future.

- We concur with CESR's definition of money market instruments as being instruments with a low interest risk, where they have a residual maturity up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months.

- In Box 4, point 1., first indent, we agree with the statement that the UCITS portfolio must retain sufficient liquidity so that the UCITS can repurchase its units at the request of any unitholder.

  In this context we believe that the responsibility of the UCITS to ensure that the liquidity criteria is met should be considered at the portfolio level and not instrument by instrument.

- We also agree with the presumption of liquidity for money market instruments traded on a regulated market as confirmed in point 1. of Box 5.

  However we believe that the factors defining liquidity in Box 4, point 1., first indent, should be viewed as indicative factors rather than compelling requirements for the reasons mentioned above.

- As far as points 2. and 3. of Box 5 dealing with instruments in precious metals and uncovered sales are concerned, Art. 19, 2. (d) and 42 of the Directive are sufficiently clear; introducing a new wording in respect thereto in CESR's advice would lead to misinterpretation thereof.

- In respect of Box 6, point 1.: see our comments in respect of Box 4.

- Point 3. of Box 6: we agree with the factors indicated to assess the eligibility of a money market instrument but are of the opinion that they can only be indicative factors rather than compelling requirements. We therefore strongly recommend replacing the words "The following key areas **should** be considered by the UCITS" by "The following key areas **could** be considered by the UCITS".

- Box 7: we suggest replacing the enumeration of the various countries by a reference to OECD countries.

- Box 9: see our comments in respect of Box 4.

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

Extract from the mandate from the Commission

DG Internal Market requests CESR to clarify the factors which need to be taken into account in determining whether and under what conditions certain instruments should fall under Art. 21 (2) 1st subparagraph as "*techniques and instruments relating to transferable securities and money market instruments*". In formulating its advice, CESR is invited to clarify the notions of "*used for the purpose of efficient portfolio management*" under Art. 21 (2).

Where appropriate and necessary, these clarifications should also take account of the Recommendation on the use of derivatives by 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 for the UCITS with an acceptably low level of risk.

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 Art. 21 (2), financial derivative instruments used under Art. 21 (2) must comply simultaneously with the provisions of Art. 19.

6. Art. 28 of the Directive defining the obligations concerning the information to be supplied to unit holders by UCITS implies that techniques and instruments relating to transferable securities and money market instruments can not result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its applicable sales documents.

ALFI Comments

- Box 10, point 2. : it is our understanding of the Directive that the concept of "efficient portfolio management" does apply to the techniques and instruments referred to in Box 10, point 4. but may also apply to financial derivative instruments notwithstanding that they are now considered as an eligible class of assets subject to specific restrictions.

- Box 10, point 3., second indent, last point: we suggest to replace the words "with an acceptably low level of risk" by "with an acceptable level of risk in accordance with the risk profile of the UCITS".

VI. Embedded derivatives

Extract from the mandate from the Commission

DG International Market requests CESR to clarify the factors which need to be taken into account in determining whether and under what conditions certain instruments should fall under the sub-category of transferable securities according to Art. 1 (8) as set out under Art. 21 (3), i.e. transferable securities "embedding a derivative element". This clarification could be used to determine the treatment of the derivative component of the "structured financial instruments" referred to above.
Where appropriate and necessary, these clarifications should also take account of the Recommendation on the use of derivatives by UCITS.

BOX 11

1. A hybrid (combined) instrument including a non-derivative host contract embeds a derivative if:

   - Some or all of the cash flows that otherwise would be required by the contract can be modified according to a specific interest rate, financial instruments 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. A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

3. In order to clarify the scope of the above definition, CESR considers appropriate to provide an illustrative and non-exhaustive list of structured financial instruments (SFIs) embedding a derivative:

- credit linked notes;

- SFIs whose performance is linked to the performance of a bond index;

- SFIs whose performance is linked to the performance of a basket of shares with or without active management;

- SFIs with a nominal fully guarantee whose performance is linked to the performance of a basket of shares, with or without active management;

- convertible bonds; and

- exchangeable bonds.

4. Given the two criteria developed above, collateralized debt obligations (CDOs) or asset backed securities using derivatives, with or without an active management, will generally not qualify as SFIs embedding derivatives, except if:

   - they are leveraged, i.e. the initial net investment is smaller than what would be required for other types of contracts that would be expected to have a similar response to changes in market factors, or

   - they are not sufficiently diversified.

5. A tailor-made hybrid instrument, such as a single tranche CDO structured to meet the specific needs of 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 an OPC derivative instrument, if the consistency of the Directive provisions is to be ensured.

6. UCITS using SFIs embedding derivatives must respect the following principles, as stated in the Directive:
   - Embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108(EC);

   - In compliance with the third indent of Art. 21 (3) of the Directive, "*when a transferable security or money market instrument embeds a derivative, the latter must be taken into account when complying with the requirements of (Art. 21)*". As a consequence, the UCITS must:

     - employ "a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio" (Art. 21 (1));

     - have a global exposure relating to derivative instruments inferior or equal to the total net value of its portfolio (Art. 21 (3));

     - comply with all the investment limits set by Art. 22 and Art. 22 a.: "A UCITS may invest […] in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the

investment limits set laid down in Article 22" (Art. 21 (3)). More specifically:

- UCITS using SFIs embedding derivatives should refer to the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments by UCITS in order to comply with the risk spreading rules required by Art. 22 of the Directive, as this Recommendation sets out how the underlying assets of financial derivative instruments should be taken into account when assessing compliance with the risk limits set by the above-mentioned article; and

- Embedded derivatives will generally not be taken into account when calculating counterparty limits, except if these products enable the issuer of the hybrid instrument to pass the counterparty risk of underlying derivatives over to the UCITS.

- Coherence must be ensured with the requirements set for financial derivative instruments, as developed below in this draft advice.

ALFI comments

- The definition of embedded derivatives as per points 1. and 2. of Box 11 derives from paragraph 10 of IAS 39. We do not believe that, in order to clarify a legislative document such as the UCITS Directive, EU/CESR should align themselves with IAS definitions which were developed in a totally different context, with a different objectives, i.e. the accounting recognition and measurement (valuation) of financial instruments.

  Indeed, IAS 32, paragraph 18, clearly states that "The substance of a financial instrument, rather than its legal form, governs its classification…". It would therefore be a paradox to align a legal definition to an IAS definition.

  The paradox can be illustrated in the following example:

  Following IAS 32, paragraph 18 (b), shares of open-ended mutual funds are considered as financial liabilities (regardless of their legal form) giving the holder the right to put it back to the issuer for cash ("a puttable instrument"). Moreover, paragraph 32 of the application guidance of IAS 39, developing on the embedded derivative concept, seems to imply that shares of an open-ended mutual fund would embed a derivative (the right to put the instrument back to the issuer). We do not believe that it was CESR intention to consider shares of UCITS as structured financial liabilities embedding a derivative as this would have severe, unproductive implications for UCITS investing in UCITS and the consequent application of the 4th alinea of Art. 21, 3. of the Directive would conflict with Art. 24, 2., second alinea of the Directive.

  Other similar examples could be given.

- It is therefore very important to distinguish between:

  - separate derivative contracts (which will have to comply with Art. 21 (risk management, global exposure), Art. 22 (issuer limits on the underlying) and Art. 19, 1. (g) (eligibility of underlying, counterparty, valuation…);

  - derivatives contracts embedded in another financial instrument (which will have to comply with Art. 21 and 22 but not with Art. 19); and

  - structured financial instruments not embedding a derivative where non of these requirements will apply.

- We therefore recommend that CESR sets up its own definition of embedded derivatives. As applying the provisions of Art. 21 and 22 of the Directive will be very cumbersome, the definition should be restricted to circumstances where the embedded derivative:

  - is materialised through a contract with a third party; and/or

  - adds additional risk to the instrument through leverage; and/or

  - modifies the instrument's inherent risk especially where there is no active management of the underlying.

  We do not believe that single-tranche CDO's structured financial instruments with no implied leverage, low exercise price warrants, exchangeable bonds or convertible bonds should fall under this definition as there is no leverage at the level of such instruments. Indeed, the cost of applying Art. 21 and Art. 22 to these instruments would be disproportionate in regards to the investor protection objective.

- We recommend that the intended use of such instruments be adequately described in the investment policy of the UCITS.

VII. Other collective investment undertakings

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation:

a. the "*other collective investment undertaking*" in question is subject to supervision "*equivalent to that laid down in Community law*" as referred to in Art. 19 (1) (e) first indent;

b. 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.

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",

2. 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 trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision;

    - availability of pricing information and reporting requirements;

    - redemption facilities and frequency;

    - restrictions in relation to dealings by related parties;

    - the management company of the target collective investment undertaking, its rules and choice of depositary 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.

3. 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.

ALFI comments

We agree with CESR's view that the outlined criteria should not be binding requirements to assess equivalence.

VIII. Financial derivative instruments

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation, a derivative financial instrument, especially a credit derivative instrument, falls within the scope of the definition of derivative financial instruments as set out in Art. 19 (1) (g).

Where appropriate and necessary, this clarification should take account of the Recommendation of the Commission on the use of financial derivative instruments.

1. Financial derivative instruments: general considerations

BOX 13

1. Operations in derivatives may never be used to circumvent the principles and rules set out in the Directive, as stated in Recital 13 of the Directive 2001/108/EC. As a consequence, underlyings of derivatives must be eligible assets.

2. In particular, eligible assets include:

    - a combination of eligible assets; and

    - financial instruments having one or several characteristics of eligible assets (e.g. interest rates, dividends or exchange rates).

3. Eligible assets exclude:

    - non-financial indices; and

    - commodities.

    Regarding investments giving an exposure to commodities, reference is made to point 2 of this draft advice concerning financial derivative instruments ("The eligibility of derivative instruments on financial indices").

2. The eligibility of derivative instruments on financial indices

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.

Question:

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.

ALFI answer

- We believe that the wording of Art. 19,1. (g) of the Directive does not leave any doubt as to its interpretation and allows the investment in derivatives on financial indices in addition to the investment in derivatives the underlyings of which are eligible assets.

  Art. 21, 3. of the Directive does not impose any specific conditions to be fulfilled by the index underlying a financial derivative instrument and does not make any specific reference to Art. 22a of the Directive which lays down eligibility criteria for an index in order to define an index replicating fund. Nevertheless, we agree with CESR's position to apply the criteria of Art. 22a, 1. to indices underlying financial derivatives in order to ensure that the principles and rules set out in the Directive cannot be circumvened by the use of index based financial derivatives.

  Please refer however to our comments relating to Box 18 regarding CESR's interpretation of the criteria of Art. 22a, 1.

- In addition to the above, we do not think that certain classes of assets should be excluded as underlyings to financial indices such as, for instance, commodities or hedge funds for the following reasons:

– Art. 19, 1. (g) of the Directive recognizes financial indices as authorized underlying for derivatives without further condition and does not require to look through the financial indices .

- UCITS can get exposed to certain classes of non-eligible assets such as commodities through the investment in normal companies stocks.
- Even within a same class of assets, the characteristics of the different indices could be very different. Therefore we believe that rather than looking to the underlying assets, we should perform the analysis at the level of the criteria to be complied with by the indices, to be eligible, as disclosed in Box 14.
- We do not believe that underlying asset classes should be strictly defined as financial derivative instruments are in constant evolution and it would not be appropriate to restrict the investment in certain classes at a certain point in time based on the market conditions at such particular time. We rather believe that the test should be performed on a case-by-case basis for each index following the criteria as in Box 14.

As a conclusion, we are of the opinion that derivatives on financial indices on commodities and derivatives on financial indices on financial instruments based on commodities would be considered as eligible assets as well as any other derivatives on financial indices of other classes of assets provided that the indices meet the criteria outlined in Box 14.

3. OTC derivatives

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. The valuation of the contracts by the UCITS should be made on a daily basis, and be compared with an estimate provided by an independent third party at least on a monthly basis.

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, and submitted to the supervisory bodies of the UCITS in order to set risk limits at least on a semestrial basis.

ALFI comments

Box 15, point 2.:

- While Art. 19,1. (g), last indent, requires that OTC derivatives be subject to reliable and verifiable valuation on a daily basis, it is sufficient that UCITS evaluate these instruments at a frequency that corresponds to the frequency of their net asset value calculation.

- The requirement of a monthly estimation to be provided by an independent third party is in our view not justified in the case of all OTC derivative instruments. Many OTC derivatives can indeed be valued in accordance with objective and straight forward criteria, for instance in the case of forward contracts or interest rate swaps.

  This requirement could therefore only constitute a best practice recommendation for the UCITS management, the need to require an independent valuation to be analysed on a case-by-case basis depending on the complexity of the instrument and its weight in the UCITS portfolio.

  On a subsidiary basis, we believe that the term "independent third party" would need to be clarified in order to define it as a party independent from the entity carrying out the first valuation and not necessarily a third party independent from the UCITS manager or the counterparty of the derivative.

4. Credit derivatives

BOX 16

1. A credit derivative is a financial instrument allowing the transfer of the credit risk of an underlying asset or assets, independently from the other risks associated with the asset (exchange rate risk, index risk, interest rate risk).

2. A credit derivative is an eligible asset for a UCITS provided that the following conditions are met:

   - The credit derivative complies with the conditions of eligibility of derivative instruments;

   - The end of the transaction can only result in the delivery or in the transfer of assets eligible for UCITS, including cash;

   - The UCITS has taken adequate measures in order to limit risks of asymmetry of information, especially when dealing with related parties;

   - A UCITS investing in credit derivatives can demonstrate that it has the organization and the means to allow for:

     - a daily estimate of the contracts by the UCITS, that will be compared with an estimate provided by a third party at least on a monthly basis;

     - a risk analysis realized by a department independent from commercial and operational units, and submitted to the supervisory bodies of the UCITS in order to set risk limits at least on a semestrial basis; and

     - an internal control independent from the operational units.

- Coherence is ensured with the requirements set for OTC derivative instruments including the requirements on valuation, as developed above in Box 15 of this draft advice.

Questions:

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.

ALFI answer

We are of the opinion that credit derivatives should be treated like any other derivatives.

Therefore see our comments made in respect of Box 15.

In our view it is not necessary to provide for additional requirements to be complied with by targeted credit derivatives.

In particular the potential risk of asymmetry of information does not only exist for credit derivatives but for any investments. The Directive specifically requests that counterparties to OTC derivatives be subject to prudential supervision. We therefore consider that the risk of asymmetry of information should be addressed in the rules of conduct applicable to such counterparties.

Even if the risk of asymmetry of information may be higher in respect of credit derivatives it is due to the fact that this market was initially undeveloped and opaque. However, most credit institutions have now implemented effective firewalls to keep their CDS operations entirely separate from their lending transactions.

We do not believe that we should focus on the situation of the market at a certain point time for such a market which is continuously growing and on which new products may develop. This might have as a consequence to limit the UCITS investments in a market in full expansion.

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 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?

ALFI answer

We do not believe that the potential risk of asymmetry of information between issuers and buyers of credit derivatives can be dealt with by limiting the nature of issuers to specific categories of issuers or a combination of the categories of issuers stated in CESR's advice. Indeed, we rather think that the risk of asymmetry of information can be considered as effectively reduced by the fact that the counterparties to such credit derivatives should be subject to an appropriate prudential supervision and appropriate code of conduct rules dealing with conflicts of interests situation.

IX. Index replicating UCITS

1. UCITS replicating the composition of a certain index

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation, a UCITS can be recognised as falling within the scope of the term of "replicating the composition of a certain index" of Art. 22a (1) having regard to the additional three criteria set out in the provision and the elements relating to overall limits in investment in securities issued by any one issuer.

BOX 17

1. A UCITS is deemed to replicate the composition of a certain index if it has the aim to replicate the composition of its underlying assets. This aim can be achieved through the use of derivatives, or any other techniques and instruments as referred to in Art. 21 (2) of the UCITS Directive.

Questions:

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.

ALFI answer

We believe that providing an estimate of the quality of the index replication should rather be considered as best practice for the UCITS. In our view, this estimate should not be a binding element of the investment policy of the UCITS as it depends of external criteria (dividend, changes to index composition,…) which are not under the control of the UCITS and which may have an impact on the tracking error.

However, best practice would be to disclose the tracking error on an ex post basis in the financial reports of the UCITS.

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?

Option A: The tracking error of the UCITS, based on the following formula:

$$TE=\sqrt{52}\sqrt{\frac{1}{N-1}\sum_{s=1}^{N}(R_s-\overline{R})_2}$$

Where:

- Rs denotes the performance error during weeks between the UCITS and its reference index, based on the evolutions of the UCITS net asset value and the index value from week s-1 to week s, that is:

$$R_s=\ln\left(\frac{UCITSassetvalue_s}{UCITSassetvalue_{s-1}}\right)-\ln\left(\frac{indexvalue_s}{indexvalue_{s-1}}\right)$$

- R is the average of the performance error over a year (N=52 weeks):

$$\overline{R}=\frac{1}{N}\sum_{s=1}^{N}R_s$$

When appraising the quality of the index replication, the following elements should be taken into account since they may increase the tracking error:

- The index is composed of securities quoted on markets with different closing hours;

- The quotation dates of the securities composing the index and the publication date of the UCITS net asset value do not match together;

- The securities composing the index are mainly securities quoted in different currencies;

- There is a time difference between the publication of the UCITS net asset value and the publication of the index value;

- The index and the UCITS net asset values are published in two different currencies; or

- The index replication involves the use of derivatives.

Option B: The percentage of the index replication of the UCITS, based on the following formula:

$$DP=100\%-\frac{\sum_{i=1}^{n}\left|W_i^I-W_i^P\right|}{2}$$

where:

DP= duplication percentage in %
n= number of equity classes in the fund and in the index (upper summation limit)
I= index
F= fund
W_i^I *= weighting of equity i in index I in %*

W_i^F = applicable weighting of equity i in the equity portion of the fund in %

ALFI answer

We believe that it should be left to the UCITS to choose to use either formula A or B. We also recommend that it should be possible to use other formula that are commonly accepted and which could, depending on the circumstances, be approved on a case by case basis by the national supervisory authorities.

- Regarding suggested option A: this formula should take into account the factors specific to the UCITS such as dividends or income received by the UCITS on its investments in the assets underlying the index, dividends paid by the UCITS to its unitholders, expenses at the level of the UCITS, foreign exchange exposure of the UCITS…

- Regarding option B: the impact of financial derivative instruments into which the UCITS may have entered should be taken into account.

Q 14: Should CESR suggest maximum thresholds as far as the estimates described above are concerned? If yes, what should these thresholds be? If you see the use of thresholds as problematic, please give practical examples of the possible impacts.

ALFI answer

We are not of the view that CESR should suggest maximum thresholds as far as the tracking error estimates are concerned because the tracking error largely depends on factors which are not under the control of the UCITS, as described in our reply to question 12 above.

Further, the tracking error may vary depending on the calculation of the method used. In this respect, please refer to our answer to question 13.

2. **Index characteristics**

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the following considerations:

a. factors to be taken into account in assessing whether the composition of the index is *"sufficiently diversified"* as provided for by Art. 22a (1) 1st indent;

b. conditions under which the index can be deemed to "*represent an adequate benchmark for the market to which it refers"* as provided for by Art. 22a (1) 2nd indent; and

c. the index is *"published in an appropriate manner"* as provided for by Art. 22a (1) 3rd indent.

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 the index represents and 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;

    - 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 a part of the same economic group with the existence of adequate Chinese walls.

ALFI comments

In our view, the diversification of the index must not necessarily respect the risk diversification rules applicable to the UCITS. Indeed, the composition of an index may change over time and a UCITS should be compelled to liquidate its portfolio in such circumstances.

CESR's advice recommends that the methodology of index providers should generally not result in the exclusion of a major issuer of the market to which the index refers. We believe that the fact that the index represents an adequate benchmark for the market should be a sufficient condition. Major issuers could be excluded from certain sustainable indices which, for instance, apply negative screening.

Finally, we do not believe that the index provider must be independent from the index replicating UCITS. Indeed the 3 conditions of Art. 22a, 1. of the Directive are sufficient to exclude tailored made indices.

Final ALFI comments

1) Art. 53a of the Directive allows for a clarification of its definitions by the European Commission, i.e. a more detailed explanation or description of legal concepts mentioned by the European legislator; this should not lead to the creation of (new) rights for or (new) obligations on market operators, supervisory authorities, Member States or any other legal person. Indeed it should be recalled that the definitions to be clarified have been laid down by a Directive, i.e. a legislation which has a binding effect for all the Member States but leaves to their national authorities the competence in respect of its implementation.

   Consequently powers of clarification should not, for the various reasons mentioned in our answers above, result in an exhaustive list of permitted investments for UCITS but should only outline criteria to enable Member States to decide whether an asset or a transaction complies with the provisions of the Directive.

2) Measures regarding eligible assets should in our view be considered as rules of conduct for UCITS managers rather than additional requirements for UCITS imposed by the European legislator at level 2 or level 3 of the Lamfalussy process; indeed, CESR's advice should be limited to give some guidance to Member States' supervisory rather than to provide new compelling rules; rules of conduct appear to be the most appropriate way to achieve that objective.

3) EC Directive 2001/107/EC already imposes a set of detailed rules in relation to risk management and controls to put in place by UCITS and their management companies. This safeguards the interests of investors. Bearing that in mind, there is no need for an enhanced regulation.

4) The use of innovative products in the future and the possibility to include less traditional assets in the composition of UCITS should not be restricted by too stringent criteria, as we developed it in our answers above in respect of particular types of targeted investments.

5) In addition, overregulation would penalize UCITS in favor of other products available to the public such as for instance insurance products which may not safeguard investors' interests to the same extent.

6) Cost/benefit analysis: several recommendations in CESR's advice lead potentially to additional cumbersome verifications to be made by a UCITS management. It would be advisable that these recommendations be analyzed in light of their cost/benefit , in order to avoid that the cost of the implementation thereof be out of proportion to the benefit for investors in UCITS.