



BVI · Eschenheimer Anlage 28 · D-60318 Frankfurt am Main

CESR The Committee of European
Securities Regulators
11-13 avenue de Friedland

75800 Paris
France

Bundesverband Investment
und Asset Management e.V.

Contact:
Alexander Kestler
Phone: +49.69.154090.253
Fax: +49.69.154090.153
alexander.kestler@bvi.de

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BVI COMMENTS ON

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CESR'S CALL FOR EVIDENCE WITH RESPECT TO THE COMMISSION'S MANDATE FOR ADVICE ON ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

The Bundesverband Investment und Asset Management (BVI¹) welcomes the opportunity to comment on the Consultation Paper issued by CESR, and strongly supports the objective to clarify some of the definitions pertaining to eligible assets which are contained in the UCITS Directive. In this respect we would like CESR to consider in its advice to the European Commission our following views:

General aspects on transferable securities (structured financial instruments, 3.1.1)

We appreciate that the European Commission and CESR consider to allow the investment in financial instruments whose underlying involves products of varying degrees of liquidity and which may not be directly eligible for investment by a UCITS. As representative of the German investment fund industry we feel that in this area is a particular need for clarification.

Director General:
Stefan Seip
Managing Director:
Rüdiger H. Päsler
Rudolf Siebel

¹ BVI Bundesverband Investment und Asset Management e.V. represents the interests of the German investment fund and asset management industry. Its 76 members currently manage more than 7,600 investment funds with assets under management in excess of € 980 bn. The units of these funds are held by some 15 million unit holders. For more information, please visit www.bvi.de.

Eschenheimer Anlage 28
D-60318 Frankfurt am Main
Postfach 10 04 37
D-60004 Frankfurt am Main
Phone: +49 69 15 40 90 - 0
Fax: +49 69 5 97 14 06
info@bvi.de
www.bvi.de

In determining whether such structured financial instruments are eligible for investment by UCITS, the Consultation Paper primarily points to the aspect of liquidity and the pre-requisite that the instrument must be dealt in on a regulated market. We fully agree that these are important factors that have to be taken into account.. Additionally, we suggest to clarify in the context of this advice clarify the treatment of certain specific structured financial products which we consider as of outmost importance for the fund industry.

In particular the market for securitisation becomes more and more important in Germany and Europe. Here, due to the easier transferability, the largest part of the issues in Germany comes into the market in synthetic form. Therefore, ABS, CDO, CLN, and MBS (also so-called synthetic ones) should be regarded as normal corporate bonds without having to conduct a splitting or review of the underlying derivatives, provided these instruments comply with normal corporate bonds regarding their risk. This is also in accordance with the current practice at certain financial market places.

At least practicable regulation would be required, to what extent (credit) receivables or CDS and CDO on (credit) receivables are classified as permitted underlying, particularly in consideration that these structures do not basically differ from true-sale-transactions with respect to their risk.

In detail:

Credit Linked Notes

Credit Linked Notes may be issued by a so-called Special Purpose Vehicle (SPV) or a Bank/Company; formally they are bonds.

CLN carry the following risk: If a defined credit event occurs (e.g. certain bonds or loans of a specified borrower are not paid back in time), the issuer repays to the holder not the notional amount but a lesser amount (alternatively: the issuer transfers to the holder of the CLN a previously defined number of certain bonds, which have a lesser market value due to the occurred credit event).

Purchase by the Investment Fund:

- (1) First of all the purchase by an investment fund should only be allowed if the investment fund is allowed to acquire bonds of the issuer of the CLN, i.e. only if these are securitised and traded on a regulated market.
- (2) a) If the issuer is a SPV which is liable for the repayment with its whole assets, the kind and quality of the underlying should not be decisive. This also applies if the bonds are issued in different classes (in relation to priority / subordination).

b) If the issuer is a bank or another company, which is not liable for the repayment with its whole assets, it is emanated from an embedded derivative, i.e. the investment fund will be allowed to purchase the CLN only in case it would be allowed to acquire the underlying risk of the issuer.

However, it should not be required that the receivables against the specified borrower, to which the CLN refers, are securitised and may be purchased by the investment fund. It should be sufficient that the specified borrower has generally issued securities which may be acquired by investment funds.

However, in this case investment funds should credit the underlying contingency risk of the CLN against the respective issuer limits (5%/10%/40%). If several contingency risks are securitised in a CLN, a practicable answer has to be found in individual cases. E.g., it seems to be appropriate regarding a first-to-default construction to credit the potential contingency risk at first against any relevant specified borrowers. With respect to a second-to-default construction it also seems to be appropriate to credit the potential contingency risk against any relevant specified borrowers, but prior to the default of the first borrower not to the full amount.

Asset Backed Securities:

The same considerations as for CLN apply with the following deviation:

With the purchase of an ABS tranche the following risk is assumed: If it comes to a loss in a defined portfolio of receivables or other assets higher than the tranche can bear, the issuer repays to the holder not the notional but a lesser amount.

If the issuer is a SPV, it should not be decisive if the SPV purchases the receivables portfolio from the originator ("true sale") or if, e.g., it invests in assets without risk and assumes the risk of the receivables portfolio from the originator by way of a swap or a guarantee ("synthetic ABS"). The difference concerns only the transactions concluded by the issuer, which are also not relevant regarding to other issuers; these transactions are not to be considered as of any particular relevance only because the issuer of the bond is not a "normal" company but a SPV.

- Many ABS deals are characterised by the issuer not being liable for the repayment with its whole assets and
- the asset pool being diversified (min. 20 assets) and
- the issue being a tranche (ranking by cash flow or loss risk).

Tranches of such ABS deals should be eligible as fund investment if it is eligible as a corporate bond and the underlying risk type is eligible for the fund.

Concerning fund limits such ABS tranches should be treated as corporate bonds, not looking at the underlying asset pool, structure of the issuer, its balance sheet or contracts.

Certificates:

Formally certificates are bonds, whereas the repayment sum is linked to an outer circumstance, e.g. it is linked to the current rate of a certain index. In other words, a certificate is a bond with an embedded derivative on the respective index.

An investment fund should only be allowed to acquire such a certificate, if it would be allowed to purchase bonds of the issuer. In addition, by purchase of the certificate the fund must not assume a risk which does not comply with the investment policy communicated to the investor.

The investment fund should credit the market value of the certificate against the issuer limits of the issuer. Furthermore, the issuer risks, which may affect the performance of the value of the unit in a fund via the embedded derivative, should be credited against the respective issuer limits (this does not apply, if the index to which the certificate refers, is sufficiently diversified; the index can be deemed sufficiently diversified if it is an accepted index).

Liquidity of the Instruments

While it is certainly true that the liquidity of the instruments is one of the decisive factors that have to be considered, it will be very difficult to define the liquidity required in a formal and revisable way. Often the named instruments will only be taken back by the issuer or the company that initiated the formation of the SPV, while at the regulated market, in which the instruments are included, virtually no sales take place. However, in practice it is often easier to sell these named instruments with a fair market value than certain shares (even if they are included in a large index, but in particular second-line stocks) or certain corporate bonds at the stock exchange.

Therefore, the question if an instrument is sufficiently liquid, should remain the responsibility of the fund manager. At best a wording would be possible, which obliges the fund manager to pay attention to a sufficient liquidity of the assets purchased, whereas this provision should apply with respect to any assets and not only with regard to structured products.

Aspects on closed end funds (3.1.2)

Before determining whether and under which conditions shares of closed end funds are eligible assets which can be acquired by UCITS as “transferable securities”, the question arises what instruments qualify as closed end funds.

Businesses regarded as “normal companies” by the relevant local markets may be classified as closed end funds only for formal reasons. Particularly in the case of listed holding companies this problem can appear. Any schematic approach bears the risk that an investment manager is unduly restricted in his portfolio management possibilities. In case a manager is assessed against a certain benchmark or index, he might not be able to reflect the respective index in the portfolio because the title in question is part of the relevant index due to the local qualification, while it is formally considered a closed end fund and therefore not eligible for investment by a UCITS.

Therefore, in determining whether an investment is regarded as shares in a closed end fund or shares in a company, the relevant local qualification should be decisive, unless there is a clear intention to improperly avoid the restrictions of the UCITS Directive.

In case an investment is qualified as a closed end fund, we do support the proposition that shares of closed end funds should fall under the definition of transferable securities within the meaning of Art. 1 (8) and thus be eligible for investment by UCITS, provided they comply with all the relevant conditions contained in the directive.

Yours sincerely

BVI Bundesverband Investment und Asset Management e.V.

signed:
Alexander Kestler
Senior Vice-President

signed:
Stephan Weinandy, LL.M.
Associate