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

The Bank and Insurance Division of the Austrian Economic Chamber¹ welcomes the opportunity to comment on the "CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS" (Consultation Paper).

Principal statement:

By all means the depositary banks should be involved in the decision-making process.

re BOX 1 "Treatment of structured financial instruments"

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

We are in favour of the fact that alternative investments (AI) are permitted as part of structured products. Thus, we kindly request a clarification to the effect that structured financial instruments (SFI) which have been designed as transferable securities may also include AI as underlying assets.

¹ The Bank and Insurance Division legally represents all Austrian Credit Institutions and UCITS.

In addition, the CESR should specify in more detail the criteria listed in Box 1 for eligibility of a security as a transferable security. For the purpose of specification examples of application of market practices should be provided with respect to the individual items.

Regarding the "liquidity" criterion, an EU-wide interpretation of whether the obligation to redeem units according to Art. 37 of the UCITS Directive may be limited to the dates stipulated in Art. 34 of the UCITS Directive or if a daily obligation to redeem units exists instead, is necessary in order to avoid competitive disadvantages.

We only agree with item 1. in Box 1, i.e. that the potential loss of the UCITS in respect of holding the security must be limited to the amount paid for it.

All securities defined in Art. 1(8) are transferable; portfolio management means to select the securities according to defined risk basket.

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

CESR should clarify that shares are not considered SFIs and that, for shares, a look-through approach is not required.

re BOX 2 "Closed end funds as transferable securities"

A separate category of "closed end funds" is not necessary because they are anyhow eligible only in the form of "transferable securities" (normally shares) and, thus, have to fulfil the criteria stated in Box 1. For lack of a definition of "closed end fund" as opposed to other shares it would not be possible to administer the envisaged regulation. Closed end funds are neither covered by the definition of UCITS nor by the definition of derivative financial instruments but have to be treated like any other share. In particular, there is no need to check in what

instruments a closed end fund invests because with shares this is generally not obligatory.

If listed closed end funds comply with the liquidity criteria of transferable securities, they should be considered equivalent to listed shares. In the case of listed shares the risk is not spread (example: a bank share with commodity exposure (e.g., gold), leverage, short positions is considered a security and there is no risk-spreading) Investor protection safeguards already exist due to information duties, liquidity and market pricing.

Question 4:

A listed closed end fund should not be subject to appropriate investor protection safeguards.

Question 6:

UCITS should not be required to invest only in listed closed end funds that invest in transferable securities.

re BOX 3 "Other eligible transferable securities"

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?

Since closed end funds have to be transferable securities as defined in Box 1, the above constitutes a sub-case of Box 1.

re BOX 6 "Art. 19 (1) (h)"

The first three prerequisites (information memorandum) should not be applicable if money market instruments do not have to publish a prospectus according to EU Directive 2003/71/EC.

Question 8:

We do not agree. Asset backed securities and synthetic asset backed securities need not be dealt in on a regulated market.

re BOX 11 "Embedded derivatives"

Credit linked notes, convertible bonds and all structured financial instruments with guaranteed principal are not to be classified as structured financial instruments that are subject to the principle of risk spreading laid down in Art. 21 (3) of Directive 2001/108/EC. These products are simply structured products where the risk level of the fund's investment is not substantially increased due to the derivative component. Risk-spreading with regard to the products will not lead to any additional benefit for the investor; the requirement of additional protection is not necessary or negligible in case of these products. The general risk-spreading limits of the UCITS Directive are sufficient. This opinion is supported by the fact that also according to *Oesterreichische Nationalbank* [Austrian central bank] convertible bonds are actually not considered structured products and that risk spreading is not recommendable or, in some cases, not possible at all.

(http://www.oenb.at/de/img/Structured_Products_HB_tcm14-16320.pdf)

2. Often the percentage of structured financial instruments in portfolios is very small or negligible. With regard to an efficient portfolio management, and given that separating a derivative from its host contract does not have any additional benefit for the investor, and that there is no further need for investor protection, we recommend not to separate a derivative from its host contract provided that these structured instruments account for a minor percentage of the portfolio's total assets (these structured products must not bear any obligation to make further contributions). We think that this percentage of structured products should not exceed 10 percent of a UCITS's assets (de minimis rule). Up to this limit of 10%, the contribution of a derivative embedded in a structured product to a portfolio's overall risk profile can be ignored.

The view expressed in items 1 and 2 is in line with the idea of total management responsibility of investment companies for portfolios (an idea recently favoured by

the competent supervisory authorities) and is supported by the statutory Code of Conduct. ("Liquid financial instruments may be acquired provided they are consistent with the investment objective and the risk profile of the respective portfolio.")

It should not be possible to consider structured products "embedded derivatives" when the cash flows of the underlying assets are not changed, i.e. where the economic characteristics and risks are identical to those of the underlying assets. Example: index-based certificates without guaranteed principal, certificates on baskets of shares with no guaranteed principal.

re BOX 12 "Other collective investment undertakings"

The criteria listed in Box 12 under indents 2 through 7 under "Equivalence of supervision" would have to be classified under "equivalence of legal protection".

According to the first indent of Art. 19 (1) (e) of the UCITS Directive the presence of this criterion, contrary to equivalence of legal protection, must not be assessed by the management company but is to be assessed by the supervisory bodies. (*arg.:...considered by the UCITS competent authorities to be equivalent to that laid down in Community law...*). However, a fund-specific examination of eligibility by the supervisory authorities does not seem to be practicable.

re BOX 14 "The eligibility of derivative instruments on financial indices"

Not only financial indices based on eligible assets but also those financial indices that are based on alternative investments like commodities should be considered eligible underlying assets for derivatives. Art. 19(1)(g) of the Directive correctly provides that a look-through approach is not necessary when considering derivatives on financial indices (index-based financial derivative instruments). Moreover it should be possible to invest in derivatives on financial indices of commodities-based financial instruments as well as in derivatives on financial indices directly based on commodities.

Commodity indices, hedge fund indices, and, in general, indices which measure developments of economic values should be considered financial indices. Since a look-through approach as defined by Art. 19(1)(g) of the Directive is not to be applied to indices, derivatives and structured products whose underlying assets are financial indices are to be considered eligible instruments for UCITS funds. Commodity indices based on derivatives on commodities or commodity indices directly based on commodities are to be considered identical and, thus, derivatives and structured products are to be considered eligible for such indices.

re BOX 15 "OTC derivatives"

According to Art. 21(1) of the UCITS Directive the investment company has to provide for a valuation procedure which enables precise and independent valuation of the OTC derivatives. CESR's demand in item 2 of Box 15 that the valuation of the OTC derivatives be audited by "independent third parties" is not clear (auditing of the procedure by the fund's auditor should be deemed sufficient).

Question 10:

No measures are needed. The risk of asymmetry of information is part of the general risk basket.

Question 11:

No limiting of the nature of the issuers (see Q 10).

Question 14:

CESR should not suggest maximum thresholds.

Yours sincerely,

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