

Monday, 21 November 2005

Mr. Fabrice Demarigny
Secretary General of CESR
11-13, avenue de Friedland
75008 Paris
France

Dear Mr Demarigny

Barclays Capital's response to CESR's Draft Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS – 2nd Consultation Paper

Barclays Capital welcomes the opportunity to contribute to the debate on the regulatory standards and controls to be applied in Europe. The attached submission summarises our position with respect to the above CP.

Yours sincerely

Shachi Shah
Director
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Overview

The implementation of UCITS III and the CESR recommendations are critical to the growth and development of structured funds, which have become a key business for both asset managers and financial institutions as a response to significant investor demand.

Structured funds are funds that use financial derivative instruments to achieve precise investment objectives in terms of pre-defined returns and/or principal protection. Financial derivative instruments are tools that enable these types of products demanded by investors to be manufactured.

The common features of structured funds are:

1. Pre-defined returns in terms of capital appreciation at maturity or periodic coupons
2. Capital guarantees
3. Diversified investments
4. Represent and give access to an asset class with high degree of liquidity and transparency

Structured funds have grown significantly both in absolute terms and as a proportion of mutual funds largely due to investor demand for higher levels of protection in the form of capital guarantees, defined returns, diversification and transparency. Please find below information from an independent research firm that shows the growth in one sub-set of structured funds, namely capital guaranteed funds:

EURm	Q4 2002	Q1 2004	Q4 2004	% growth 2002-2004
France	40,700	61,600	67,100	64.9%
Belgium	25,028	31,546	35,303	41.1%
Spain	37,961	50,340	54,694	44.1%
Luxembourg	17,405	20,893	21,408	23.0%
UK	284	557	747	163.0%
Germany			7,096	na
Total of above	121,378	164,936	186,348	53.5%

Note: Data relates to capital protected /guaranteed funds only and not the entire capital protected or structured products market. German data not available for Q4 2002 or Q1 2004.

Source: Datamonitor, FEFSI, BVI

DATAMONITOR

	France	Belgium	Spain	Luxmbg.	Germany	UK
Number of capital protected funds	943	818	682	207	90	11
Total number of funds	7,908	1,347	2,559	6,855	1,218	1,884
Proportion capital-protected funds	11.9%	60.7%	26.7%	3.0%	7.4%	0.6%
Net assets of capital protected funds, EURm	67,100	35,303	54,694	21,408	7,096	747
Total mutual fund net assets, EURbn	1,006.5	93.4	233.1	1,025.0	224.7	380.9
Proportion capital-protected funds	6.7%	37.8%	23.5%	2.1%	3.2%	0.2%
Average size capital protected fund, EURm	71.2	43.2	80.2	103.4	78.8	47.9

Note: Data relates to capital protected /guaranteed funds only and not the entire capital protected or structured products market.

Source: Datamonitor, FEFSI, BVI

DATAMONITOR

Structured product providers, i.e. predominately financial and credit institutions, are the core manufacturers of capital guarantees and defined returns and therefore have a significant interest in the implementation of the UCITS III Directive.

Financial and credit institutions are major contributors to the development and managed use of derivatives for investment purposes, working alongside traditional asset managers. Asset managers widely recognise (see Data monitor report Capital Protected and Structured Products in Europe 2005) the growth in demand of structured funds by retail investors. Further evidence of this can be found in the enormous growth and depth in the securitised structured products business.

There is a definite convergence globally between traditional fund management and the structured products business. Investors prefer the combination of defined returns and the benefits of a fiduciary manager within a controlled regulatory environment.

KEY AREAS that are considered by Barclays Capital to be critical for the future of the European funds business.

Definition of financial derivative instrument (Question 13)

The amendment we would propose to this section is the deletion of point 2. Please see our explanation and rationale below.

The definition of financial derivatives should include all cash settled derivative contracts regardless of the underlying asset class (e.g. including commodities, with the sole exception of precious metals) and whether listed on recognised exchanges or traded over-the-counter.

Our reasons are as follows:

- Cash settled derivatives typically offer greater liquidity and lower transaction costs than investing directly in the portfolio of assets.
- Listed cash settled derivatives offer high transparency and independent pricing and are traded in regulated contracts on major recognised markets/exchanges
- OTC markets offer significant depth and liquidity. All OTC transactions are now governed by ISDA terms and conditions that provide consistency and objectivity. Financial institutions that offer derivatives are subject to significant regulatory scrutiny with regard to their derivative operations.
- The impact of restricting investment to cash equities and bonds is that capital guarantees, pre-defined return profiles and diversification cannot be achieved.

With regards to the commodity asset class this is now almost entirely a cash settled financial derivatives market with the characteristics and liquidity similar to other broadly invested financial instruments:

- The monthly turnover in the energy sector alone is approximately EUR500bio and across sectors is approximately EUR 1.4 trillion in just the listed contracts.
- Commodities offer significant diversification benefits; they are historically negatively correlated to bond markets and intrinsically provide inflation protection.
- They have a similar volatility to equity markets.

Lastly we do not understand the concept of non-financial indices. From an industry perspective all indices are financial indices as they represent the monetary performance of an asset class. Investment in an index can take many forms; the largest growth is in financial derivatives whose performance is linked to an index as these can be structured to provide defined returns and capital protection. Indices provide the easiest and most transparent method of accessing a range of asset classes in a diversified form.

The eligibility of derivative instruments on financial indices (Question 14)

The amendment we would propose to this section is the inclusion of the following text to point 2 of Level 2.

“2. Hedge Fund indices shall be considered financial indices provided that they comply with the above rules and where, at his discretion, the investment manager is satisfied that a financial institution that is an approved counterparty is able to provide sufficient liquidity such that the UCITS fund can meet its subscription and redemption obligations. However, CESR has a further 12 month period in which to further refine and monitor the application of this rule.”

Please see our explanation and rationale below.

We respond to CESR's key concerns set out in paragraph 122 of the consultation paper:

1. The majority of hedge fund indices have the following characteristics and would comply with the Level 2 requirements, with which we broadly agree:

- Hedge fund indices have now been established for over 15 years. There are many major providers in this asset class such as Standard & Poors, MSCI, HFRX, Dow Jones, FTSE, CSFP Tremont, etc.
 - The majority of hedge fund indices are calculated as investable indices and provide daily pricing. Prices are all published on public sources.
 - The indices are all diversified across strategies and managers.
 - The hedge fund indices do provide an adequate benchmark, they all are highly correlated and closely track each other.
 - Hedge fund Indices typically have low volatility.
 - The index management process is followed as described by CESR in Level 2 of Box 14.
2. The concerns relating to survivor bias, selection bias, sector differences, lack of track record, and investability are technical issues that relate to index construction and apply independently of the asset class. These types of issues are the core concerns of long standing and reputable index providers. Furthermore, these indices are used by institutional investors and hedge fund managers to measure and monitor returns of this asset class.
 3. Each of the major European countries now has domestic legislation that permits the investment in hedge funds:
 - France and Germany have legislation that enables mass market investors to access single hedge fund and fund of funds.
 - In the UK private investors can access hedge funds through closed ended investment companies and securitised products.
 - Italy allows high net worth individuals to invest in hedge funds.
 - Spain recently implemented legislation that permits mass affluent investors to invest in hedge funds.
 4. Indices offer greater investor protection than single hedge fund investments and fund of funds on the basis that they provide a much higher degree of transparency, daily pricing and publication. They are also typically investable and products linked to them generally offer daily or at least weekly pricing.

The remainder of this document addresses the other questions raised by CESR.

Q.1 Do you agree with the approach as suggested in Box 1?

We appreciate greater clarification on the definition of transferable security. However, as currently drafted this definition appears quite restrictive. Our understanding was that amendments to Article 19 were intended to broaden the investment capability of funds to take into account recent developments in capital markets.

We believe that the impact of the proposed guidance would prevent funds from investing in some of the more popular and common securities in today's capital markets traded directly by retail investors via the major European Exchanges. Some examples are given below (please note this list is not exhaustive):

1. Warrants.
2. Futures contracts - the bond futures market is now as liquid as the bond market itself and offers a very cost efficient way to access bond yields; currently UCITS funds cannot take advantage of this liquidity or cost savings.
3. Bonds which are single contribution rather than multiple contribution pricing but can easily be valued independently.
4. Securitised products that offer significant liquidity in numerous European countries and provide greater value and return potential for investors than direct investments in the underlying securities.
5. Certificates.
6. Securitised futures with stop loss features.

The impact of the current clarification would result in retail investors being unable to achieve diversification and pre-defined returns in a cost efficient manner via funds.

Level 3

Liquidity

We broadly agree that there is a necessity to have some definition around liquidity and CESR's proposal offers greater clarity. However, we are concerned that the current draft text may become too prescriptive and be interpreted as being the "rule" as opposed to guidance. We would suggest that the investment manager be given the discretion to determine that the investment assets have sufficient liquidity in order to manage the subscription and redemption flows.

Question 2 Do you agree with the approach as suggested in Box 2?

We believe the Directive was drafted to enable investments of up to 10% in, among others, instruments that were transferable according to the definition in the Directive. In our opinion, Article 19 (1) refers to other transferable securities, e.g. investment in unregulated funds, limited partnerships, to which the 10% limit would not apply.

Question 3 Do you agree with the approach as suggested in Box 3? What is your view of the options presented concerning the specification of the “appropriate investor protection safeguards?”

We agree with the proposed approach.

Question 4 Do you agree with the approach as suggested in Box 4?

We agree with the proposed approach.

Question 5 Do you agree with the approach as suggested in Box 5?

The ability to acquire precious metals or certificates representing them relates to the actual delivery of physical metals or instruments or certificates that represent the delivery of precious metals. Precious metals are now almost exclusively cash settled and are a vast instrument with significant liquidity, transparency and consistency.

All commodity listed futures contracts that are traded on major exchanges should be eligible assets. Given the objective of UCITS funds is to ensure stability and security of the investment, it would seem appropriate that fund should be able to invest in gold linked futures that are considered investments of last resource in shock scenarios. A retail investor would be able to access gold markets directly, therefore we believe that an investment manager should also be able to access these markets on behalf of the same retail investor.

Question 6 Do you agree with the approach as suggested in Box 6?

We agree that the investment manager should determine the eligibility of money market instruments.

Question 7 Do you agree with the approach as suggested in Box 7?

We would add all OECD countries since we see that more and more countries outside the EU seek to adopt or are already treating UCITS III as a benchmark for fund regulation. It would be preferable from an investors' perspective to be able to use local money market instruments.

Question 8 Do you agree with the approach as suggested in Box 8?

We broadly agree with the approach. However many securitised products could also qualify as money market instruments and we believe that the investment manager should have discretion in assessing whether such instruments are of sufficient liquidity and of superior credit quality to qualify as money market instruments.

Question 9 Do you agree with the approach as suggested in Box 9?

We agree with the proposed approach.

Question 10 Do you agree with the approach as suggested in Box 10?

We do not agree in the use of the recital as reason to prevent legitimate use of derivatives and investment in the underlying to which they relate. The Directive does not prohibit any asset class. The Directive provides protection by saying that the fund must be redeemable at any time and that the investment objectives of the fund are adhered to by the investment manager.

We do not agree with the assumption that asset classes such as commodities, hedge funds and real estate are automatically excluded or prohibited as this would lead to investors either being excluded from legitimate investments or being able to only invest in certain asset classes directly without the assistance of professional investment management. This would seem contrary to the primary intention of investor protection. Furthermore, some of these “prohibited” asset classes have been permitted via local regulation by many member states. It would seem an inconsistent approach that the countries represented within CESR have domestic legislation permitting such investments via domestically regulated funds or other securitised investments but not deem the same investments acceptable via UCITS III fund that are professionally managed.

We propose that all derivatives regardless of the asset class to which they are linked be permitted. The intention of the amendments to the Directive was to enable asset managers and thereby investors to invest in a broader range of asset classes, instruments and liquidity. The objective should be to ensure that such investments are made in a suitably-controlled environment – i.e. ensuring that investment managers are supervised appropriately.

Question 11 Do you agree with the approach as suggested in Box 11?

Non-capital guaranteed structured securities are generally valued, priced and traded at market value. For these types of securities the embedded derivative is already taken into account in the price of the security, so it is unclear how including this value as part of the global exposure calculation would assist in the risk assessment process. For capital guaranteed securities the proposed requirement would seem to be inapplicable.

Question 12 Do you agree with the approach as suggested in Box 12?

We would suggest that this be dealt with by including a list of domestic funds in regulated markets or markets where CESR is satisfied that the countries apply similar regulations. For example Italian domestic funds should be automatically admissible without the necessity to provide significant supporting evidence. Only funds that do not fall within a regulated market should be excluded from automatic eligibility.

Question 13 Do you agree with the approach as suggested in Box 13?

Please see our response at the beginning of this paper.

Question 14 Do you agree with the approach as suggested in Box 14?

Please see our response at the beginning of this paper.

Question 15 Do you agree with the approach as suggested in Box 15?

We agree with the proposed approach.

Question 16 Do you agree with the approach as suggested in Box 16?

Credit derivatives are extremely liquid instruments, and have a high degree of price transparency. We can provide information regarding this. There are very active and liquid credit derivative markets globally and in many instances they replicate over the counter bond markets in terms of depth and liquidity. With managed CDOs and other more sophisticated credit structures the fundamental issues for investment managers should be diversification of credit portfolios, default events etc.

Question 17 Do you agree with the approach as suggested in Box 17?

Given the market has moved to index derivatives in many cases the concept of replicating the underlying asset is now almost defunct. Most index funds can be replicated by a simple total return swap, which is much cheaper and more efficient than buying the underlying stocks. Liquidity in index derivatives is significant.

Question 18 Do you agree with the approach as suggested in Box 18?

The requirement that no single component should represent more than 35% would generally be acceptable to ensure diversification. There should however be a few exceptions, for example bund futures indices and single sector indices in various asset classes. We therefore suggest there is no specific percentage mentioned but that the rules set out in Box 13 apply instead, such that the responsibility is on the investment manager to ensure that the index complies with the diversification and market benchmark requirements.