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FRANCE

CESR CONSULTATION ON THE CLARIFICATION OF DEFINITIONS CONCERNING ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

Deutsche Bank is a global financial institution and a leading participant in the UCITS market both in terms of distribution and acting as arranger, promoter or manager.

In the last 3 years Deutsche Bank has set up more than 50 structured funds via its Luxembourg fund platforms representing close to €8 billion under management. These figures exclude any activities undertaken by DWS, the active asset management division of Deutsche Bank. All of these structured funds have been passported into one or more countries in the EU or have been publicly distributed in countries such as Hong Kong and Singapore.

We welcome the opportunity to submit our comments in this consultation exercise and trust that they are shared by a significant part of the industry.

COMITOLOGY

We would like to make first a general remark in relation to the regulation of UCITS and competition between UCITS and other instruments available to investors.

Deutsche Bank is a specialist in developing and distributing structured products. It is among the top 3 players worldwide in this business. Such products are financial instruments generally linked to one or more underlying asset classes (equities, indices, interest rates, credit in any kind of form, commodities, mutual or hedge funds, FX and hybrid combinations). Such links can be in a pure linear way or can take the form of simple or rather sophisticated formula driven payouts. The products can be leveraged, principal protected or not.

These products are very popular as they respond to the growing demand of investors to invest in more tailor-made products, products with a certain level of principal protection, and products that offer a well defined pay-off mechanism vs products with a discretionary component.

It is crucial to bear in mind the fact that a UCITS fund is only one among many other financial products in which investors may invest to gain the type of exposure we described above.

Ultimately the same financial exposure can be sold to investors using a broad range of instruments, including structured notes, certificates, shares, special purpose vehicles and life insurance policies.

In our view, a UCITS fund offers the advantage of diversification, segregation and intervention of a fiduciary manager (to the extent this adds value for algorithmic products) as well as supervision by the regulators.

A restrictive view on the use of modern financial techniques, could well lead to the further disintermediation of the UCITS fund industry in the offering of structured, i.e. innovative and more tailor-made investment products.

This process is already taking place in different European countries. As an example, we would like to mention Germany where the retail certificate business represented by year end 2004 almost € 83 billion in volume as compared to zero in 1997. This figure represents a 41% increase compared to 2003. With most newly issued products being capital protected notes, this business is clearly in competition with UCITS funds. The entire retail UCITS fund industry, on the contrary, has practically seen zero growth in Germany in 2004. The growth of the certificate business compared to fund business is also driven by convenience (ability of investors to trade daily), cost, time to market and a general absence of complex investment restrictions.

If the fund industry wants to maintain a position in a market where investors' appetite for financial instruments has shifted from a merely linear exposure to bonds and equities into alpha generating and/or principal protected strategies of defined payoffs, the fund industry should be offered the broadest means within the legal framework to compete for the retail investor's assets. In general terms we believe an extensive use of a "look through" approach by way of interpretation would not be in the best interests of the industry or its regulators.

It is understood that different regulators have different views on the interpretation and degree of liberty offered under UCITS III. This is a logical and expected outcome of the European model. However, it is important that any such differences arise out of legitimate concerns of investor protection rather than the protection of a local fund industry, which would be contrary to the spirit of UCITS and indeed European financial integration.

Finally, certain differences among fund managers themselves cannot be altogether ignored. UCITS III requires asset managers to shift from rather static to modern financial risk tools in assessing exposure to and potential behaviour of new financial instruments in which they invest. The complexity of the risk modelling and the profound understanding of this financial behaviour is traditionally not the strongest skill set of an important part of the traditional active asset managers. Given the growth in structured fund products, these managers could express a conservative view that is merely inspired by market share protection of their delta one long fund position in the shorter and longer term.

Having made these general points, we would like to comment on certain particular aspects where you have required feedback from interested parties.

TRANSFERABLE SECURITIES

Transferable Securities “embedding a derivative element”

CESR has been asked to clarify what factors are to be taken into account to determine if certain instruments are transferable securities “embedding a derivative element” and are subject to Art 21.(3).

DB’s view

We believe the same interpretative criteria applied to the term “transferable securities” should be used in connection with the meaning of “embedded derivatives” referred to in the last sentence of Art. 21(2). This is a matter left by the Directive to Member States and there should not be restrictions introduced at CESR level by way of interpretation. The use of derivatives and the particular risks associated with them are dealt with in terms of the Directive’s approach to and recommendations on risk management. This is further emphasised when the Directive itself sets the “bottom line” of their use in the second paragraph of Art. 21(2): the test has to be consistency with investment objectives as expressed in the fund’s rules, instruments of incorporation or prospectus.

We agree with the point made by CESR on the information supplied to unit holders. Clear investment objectives and full disclosure of risk levels remain the cornerstone of our activity. Provisions to this effect are to be found elsewhere in the Directive and are already applicable.

Financial Derivative Instruments: Eligibility of Derivative Instruments on Financial Indices.

CESR has been asked to advise on factors to be used to determine under what conditions a derivative financial instrument, especially a credit derivative instrument, falls within the definition of financial instruments of Art. 19(1) (g).

The view that only assets generally eligible for investments by UCITS should qualify as constituents of financial indices cannot be derived from the provisions of the Directive. Art. 19 (1) (g) mentions financial indices as one of the feasible underlyings of derivatives; there is no indication that this type of underlying should have a different standing from the other underlyings, which would be the consequence of the opposite opinion (in so far as the financial index would have to qualify as one of the other eligible assets at the same time). Furthermore, the use of the term “*financial index*” indicates that that index has to be financial in nature. That can be said of a large variety of elements that can be underlying the index, including inflation and economic statistics and commodity and other prices.

In addition, we see no room for the application of the requirements set up by Art. 22a (1) of the Directive to the notion of financial indices in general. Art. 22a (1) clearly follows the purpose of raising the general investment limits for shares and debt securities for index tracking funds; all that can be derived from it is that the special investment limits set up by that provision cannot be applied to funds not pursuing an investment-tracking strategy. Again, the term “*financial index*” rather points to an interpretation according to which the index merely has to be financial in nature, which can also be said of indices which do not represent a benchmark for the relevant market. CESR’s proposed text would also prohibit investments into indices tracking tailor made baskets, even though a direct investment into the underlying assets would be permitted.

Moreover restricting the discussion as to whether it is required or not to look through financial indices is an approach we think is unduly narrow. There are many other factors that come into play and which are not addressed at all in the CESR Consultation Paper. Below are two examples of products which have been recently approved by EU regulators under UCITS III along with a short description of the reasons why which these two products have been accepted:

Example 1

The first product consists in the acquisition of a portfolio of government bonds and entering into an OTC total return swap agreement in order to gain an exposure to a financial index comprising several financial indices (sub-indices) including S&P Hedge Fund indices and sovereign debt indices (under a licence from S&P). This product has been approved on the basis of the following non-exhaustive list:

- *risk profile dimension*: the product provides a capital protection mechanism in the sense that if the underlying index of the swap goes below 75% of its initial level, the maximum aggregate weight for hedge fund indices must be reduced to 70% (and to 40% if the index goes below 50% of its initial level). Moreover the annualised volatility of hedge fund indices over the last 10 years proved to be significantly lower than the annualised volatility of equity indices and bond indices (knowing however that past performance is not a guarantee of future performance);
- *Liquidity dimension*: the product allows redemptions of shares on a weekly basis. It is worth noting that the liquidity of the constituents of the index is totally irrelevant for the fund and its shareholders. The liquidity of the product is indeed vested with the swap counterparty who has the contractual obligation to make regular cash payments to the fund in case of positive performance of the index. In other words the liquidity risk is transferred to the swap counterparty. The fund is exposed to an OTC counterparty risk but this risk is properly dealt with in the Directive (Art.19(1)g and 22(1));
- *cost dimension*: the combination of OTC derivatives (i.e., total return swaps) and financial hedge fund indices is a cost effective way to provide investors with an economic exposure to hedge funds. S&P Hedge Fund Indices (for instance) are actively traded financial indices. Moreover, the existence of exchange-traded funds tracking the performance of these financial hedge fund indices enables the swap counterparty to hedge its exposure.

Example 2

The second product consists in the acquisition of a portfolio of government bonds and entering into a total return swap agreement in order to gain exposure to a financial index comprising of four commodities (metals). This product has been approved on the basis of the following non-exhaustive list:

- *risk profile dimension*: the product is principal protected with a bank guarantee at the maturity date (i.e., investors have the guarantee to recover their initial investment at the maturity date). The first dividend payment (at the end of the first year) is also guaranteed. Moreover, the maturity of the product is 4 years (i.e., a short investment horizon). Notwithstanding the fact that the index only comprises 4 constituents, the index is sufficiently diversified and representative because metal constituents available are very limited in number;

- *liquidity dimension*: same comments as for the first product above;
- *cost dimension*: the combination of OTC derivatives (i.e., total return swaps) and financial commodity indices is a cost effective way to provide investors with an economic exposure to commodities. Commodity indices can be used by a broad range of financial products (e.g., certificates, life-insurance products, notes) so that economies of scale are achieved for the benefit of investors.

These two examples highlight the advantages for investors of structured products using financial indices. They also highlight the fact that every structured product needs to be approved by the competent regulator on a case by case basis and by making a global assessment of all its features within a three dimensional framework (i.e., cost dimension, risk dimension and liquidity dimension). A narrow approach and excessively detailed and restrictive regulation would prevent innovative products meeting the needs of institutional and retail investors and would hurt the attractiveness and competitiveness of the European fund industry, especially in the field of structured products.

INDEX REPLICATING UCITS

Mandate

CESR has been asked to advise on the criteria used to determine when a UCITS can be said to be “replicating the composition of a certain index” under Art 22(a)(1).

DB's view

Given that the Directive specifically allows the use of derivatives, we are of the view that UCITS must be allowed to replicate either the composition or the performance of an index.

With regard to the question of whether a UCITS fund should be under an obligation to provide an estimate of the quality of the index replication we believe that both proposals are acceptable.

Index Characteristics: “sufficiently diversified”, “adequate benchmark” “published in an appropriate manner”

Mandate

CESR has been asked to assess the factors and conditions relating to the above characteristics of an index under Art 22(a)(1).

DB's view

We disagree with CESR's extension of risk dispersion rules set by Art. 22(a) to financial indices. In order for a financial index to be deemed “sufficiently diversified”, it should be sufficient that the financial index in question adequately represent the reference market, even if this financial index comprises only a few index constituents (please refer to the second example above).