

Comments on CESR's 2nd Consultation Paper on Clarification of Definitions concerning Eligible Assets for Investments of UCITS

General Comments

Countries such as Austria who let cease UCITS I to be effective in December 2004 and therefore did not take advantage of the full transitional period till 13th February 2007 for UCITS I, fell into a black hole since the products CESR currently is discussing were possible under UCITS I in Austria. Austria trusted that UCITS III is a liberalisation and that investment strategies and products which were eligible under UCITS I, would be eligible under UCITS III. As a matter of fact, Austrian investors did have to bear huge costs and a complete standstill in innovation happened due to the fact that products under UCITS I and under UCITS III were and are not possible to being launched due to the current delay in establishing a common interpretation and a level playing field.

The UCITS framework for investment funds should be a facilitator and not a gilded cage. European fund managers will need to be put in the driving seat if they are to compete successfully against new products and against tougher European and global competition. The UCITS framework can not afford in the current low yield environment to lose on competition from other similar savings products subject to less restrictive investor protection provisions.

When CESR delivers its analysis to the Commission, this period will have lasted two full years. **There are no two legal interpretations for the word financial index. CESR's mandate is a legal clarification of the interpretation of the directive it shall never be targeted at practical and/or investment issues at the sphere of the fund manager. For the purpose of a common level playing field we demand from CESR that either**

- **Financial indices (incl. hedge fund indices) are eligible for all states or**
- **that the local regulator is able to decide according to his experience or**
- **a clear statement that financial indices (incl. hedge fund indices) are not legal.**

We welcome the fact that CESR identified commodity indices as well as hedge fund indices to be eligible assets but we object the 12 month reconsideration period. **As a matter of fact most or all of CESR's concerns can be fixed through an appropriate risk disclosure statement in the fund's prospectus.** We also welcome the fact that no look through approach is attempted for transferable securities such as closed end funds and also for SFI's which would therefore be a consistent interpretation of the directive.

The first and the second Consultation Paper of CESR concerns important legal questions dealing with the legal frame work of UCITS funds. The questions raised have a strong economic impact since it directly influences the investment policy of UCITS funds. We would like to emphasize that CESR should make precise statements that give a clear guideline for the fund industry within Europe. Only in this case the main purpose of the UCITS directive is met so that the fund industry within Europe has the same or at least nearly the same legal framework with regards to investment instruments and policy.

Detailed Comments

Ad BOX 1 "Definition of Transferable Securities"

We agree that through listing a security it becomes transferable and therefore a listed security is a "transferable security" and an eligible asset for a UCITS. We also agree that the fact of admission to trading on a regulated market of a transferable security provides a presumption of liquidity and a UCITS is able to rely on that presumption. We also think that applying equity market characteristics such as liquidity, trading volume, information etc. to bond markets is an impossible task and can not be done. Accepted Market Practices also differ substantially between these two markets. All the before said was true for UCITS I and is therefore also true for UCITS III. If a structured financial product (SFI), closed end fund or asset backed security (ABS) takes the form of a transferable security it is therefore an eligible asset. **We are emphatic on the opinion that a certificate linked to a hedge fund index structured as a transferable security is an eligible asset.**

With regard to SFI's that include an embedded derivative, CESR's advice refers to Article 21 (3) of the directive (Sec 30 of the explanatory text as well as Sec 4 of BOX 1). The scope of application of Art 21 with regard to embedded derivatives should be defined in a precise way. In our understanding Art 21 (3) of the directive does not have an impact on the eligibility of the underlying of the embedded derivative. The SFI as transferable security qualifies under the UCITS directive as such. The reference to Art 21 (3) means that the risk of the embedded derivative has to be taken into account as well as the general principles of risk diversification are to be applied. We propose the following wording for BOX 1:

BOX 1

LEVEL 2

1. "Transferable security" means, in the context of Art. 19(1)(a) to (d), that the transferable security must fall within the definition of "transferable security" in Art. 1(8) of the Directive. In particular:

- the security must not expose the UCITS to loss beyond the amount paid for it or where it is a partly paid security, to be paid for it;
- the liquidity of the security must not compromise the UCITS' ability to comply with Art. 37 of the Directive;
- there must be accurate, reliable and regular prices, either being market prices or prices made available by valuation systems independent from issuers;
- there must be regular, accurate and comprehensive information available to the market on the security or, where relevant, on the portfolio of the security; and
- the security must be freely negotiable on the capital markets.

2. 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.

3. The risk of the security must be adequately captured in the risk management process of the UCITS.

4. Where the security embeds a derivative element, such derivative element must be taken into account, as required by Art. 21(3). **This reference does not limit the investment scope with regard to SFIs. A UCITS fund may invest into SFI irrespective of the underlying. With regard to the risk measurement as well as diversification principles an embedded derivative is to be taken into account.**

BOX 1

LEVEL 3

Liquidity

5. There is a presumption, but not a guarantee, that transferable securities admitted to trading on a regulated market as defined in Art. 19(1) are liquid. The presumption does not apply if the UCITS knows or ought reasonably to know that any particular security is not liquid.

6. If the UCITS knows or ought reasonably to know that any particular security is not liquid (so that the presumption of liquidity does not apply) the UCITS must assess its liquidity risk. The liquidity risk is a factor that the UCITS must consider when investing in any financial instrument in order to be compliant with the portfolio liquidity requirement to the extent required by Art. 37. In taking this prudent approach, the following are examples of the matters a UCITS may need to consider:

- the volume and turnover in the transferable security;
- if price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy; also evaluation of the opportunity and timeframe to buy or sell;
- where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of available prices;
- 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 **may** be considered.

7. The security's risks and their contribution to the overall risk profile of the portfolio must be assessed on an ongoing basis.

Ad BOX 3 "Closed end funds as "transferable securities"

We agree that closed end funds structured as transferable securities are eligible assets for UCITS. We believe that „appropriate investor protection safeguards" are met by meeting the standards for listing a security. We also think it is not possible for a UCITS to circumvent the investment limits provided for UCITS by the UCITS Directive since in the unlikely case that a closed end fund is not diversified at all, i.e 100% of the closed end fund's portfolio consists of one security the UCITS will end up with the minimum UCITS diversification with the respective 10% and 5% limits which means that the UCITS is sufficiently diversified.

If closed end funds as transferable securities are eligible assets for UCITS the same must be true for open end funds structured as a transferable security. We do not recognize a difference here.

Example: A listed investment company with variable capital (open end fund)

LEVEL 2

BOX 3

1. "Transferable security" includes a closed end fund **and an open end fund** which complies with the requirements of Box 1 or Box 2.
2. The asset management activity carried on by or on behalf of the closed end fund must be subject to appropriate investor protection safeguards.
3. UCITS may not make investments in closed end funds for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive.
4. Closed end funds and **open end funds** in contractual form are eligible where their corporate governance mechanisms are equivalent to those applied to companies generally.

Ad BOX 11 "Embedded Derivatives"

If SFI's are transferable securities they become eligible assets for UCITS. "Embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108/EC)" can only mean that the exposure to the underlying of the financial derivative instrument achieved via the embedded derivative has to be included into the calculation of the concentration limits laid down in Article 22 and the global exposure relating to derivative instruments shall not exceed the total net value of the UCITS portfolio on the basis of the commitment approach for non-sophisticated UCITS and according to a VAR/ stress test approach for sophisticated UCITS (Article 21(3)). **The conclusion is that only the host contract is being tested for eligibility but not the underlying of the embedded derivative. The underlying of the derivative is tested for concentration limits and global derivative exposure limits.**

Example: Certificate linked to the price of oil

Ad BOX 14 “The eligibility of derivative instruments on financial indices”

We object the introduction of the IOSCO criteria as a level 2 advice since the IOSCO criteria shall be addressed to the Index Provider and not to the UCITS. The UCITS has no control on the index construction and therefore we think the IOSCO criteria is useful as a level 3 advice only.

We welcome CESR's clarification that indices based on financial derivatives on commodities are eligible. We do not understand why indices based on cash commodities shall not be eligible? The difference is only relevant for the hedging counterparty.

CESR argues that due to diversification needs and due to the greater demand, indices based on financial derivatives on commodities are eligible. This is simply not the fact. Even though CESR asked in the first consultation paper about the eligibility of commodity indices only, about 70% of the respondents favoured hedge fund indices.

CESR argues that it needs more time to understand specific issues of hedge fund indices such as survivor bias, selection bias, non-consistency of the sector of hedge funds, backfilling bias and inclusion of not investable hedge funds.

If the objections raised by CESR were true than no counter party would be willing to write a derivative on this index.

ALL THE BEFORE MENTIONED DOES THEREFORE NOT EXIST IN INVESTABLE HEDGE FUND INDICES.

As a matter of fact we are of the opinion that hedge fund indices do also comply with the IOSCO criteria more than commodity indices do. Most stock and bond market indices use market capitalization weights but there is no market capitalization for commodity futures. The CRB index employs equal weights. In contrast, the GSCI uses "production" weights. The DJ AIG index is rebalanced every year using a combination of production weights and liquidity considerations. More diversification benefits for a portfolio will be achieved with hedge fund indices since e.g. the GSCI has more than 65% exposure to energy alone.

Weightings as of May 2004

Co m m o d i t y	CRB	GSCI	DJAIG
Aluminum	-	0.029	0.071
Cocoa	0.059	0.003	0.020
Coffee	0.059	0.006	0.028
Copper	0.059	0.023	0.067
Corn	0.059	0.031	0.051
Cotton	0.059	0.011	0.018
Crude Oil	0.059	0.284	0.167
Brent Crude Oil	-	0.131	-
Feeder Cattle	-	0.008	-
Gas Oil	-	0.045	-
Gold	0.059	0.019	0.053
Heating Oil	0.059	0.081	0.047
Lead	-	0.003	-
Hogs	0.059	0.021	0.051
Live Cattle	0.059	0.036	0.067
Natural Gas	0.059	0.095	0.099
Nickel	-	0.008	0.019
Orange Juice	0.059	-	-
Platinum	0.059	0.000	-
Silver	0.059	0.002	0.022
Soybeans	0.059	0.019	0.051
Soybean Oil	-	0.000	0.017
Sugar	0.059	0.014	0.038
Unleaded Gas	-	0.085	0.054
Wheat	0.059	0.029	0.038
Red Wheat	-	0.013	0.000
Zinc	-	0.005	0.023
Total	1.000	1.000	1.000

The Austrian industry also objects transitional arrangements for UCITS funds which have been authorised as such by a Member State but which cease to be a UCITS as a result of the clarification of eligible assets in regards to hedge fund indices. These products enter the local market with the EU passport as retail products. The transitional period will mean for these funds to conduct business as usual amplified by the fact that CESR is reconsidering in 12 months. This would mean a three year delay period for Austria and vice versa a three year competitive advantage for other member states.

CESR's mandate is a legal clarification of the interpretation of the directive it shall never be targeted at practical and/or investment issues at the sphere of the fund manager. For the purpose of a common level playing field we demand from CESR that if hedge fund indices are legal that either

- **Financial indices (incl. hedge fund indices) are eligible for all states or**
- **that the local regulator is able to decide according to his experience or**
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There are no two legal interpretations for the word financial index. A situation were one "financial index" is eligible but the other is not, as well as a situation were it is eligible in one member state but not in another member state is far away form the common European market.

We need to apply the directive in a consistent manner. CESR should clarify the eligibility and interpretation of the directive. If commodity indices are financial indices so must hedge fund indices be. All other interpretation would be inconsistent. The decision if certain criteria such as IOCSO are met shall be the responsibility of the market practitioners.

Remarks by Chairman Alan Greenspan To the International Monetary Conference, June 6, 2005: "I trust such an episode would not induce us to lose sight of the very important contributions hedge funds and new financial products have made to financial stability by increasing market liquidity and spreading financial risk, and thereby enhancing economic flexibility and resilience."

Alternative Investment Association Austria (VAI)

Martin Greil

General Secretary

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