

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

About the Alternative Investment Association Austria (VAI)

The Alternative Investment Association Austria (VAI) is representing national and international alternative investment houses totalling more than €66bn Assets under Management with more than €5.5bn exposure to the Austrian Alternative Investment market. Members of the association are institutions under the authority of FMA or their national financial market authority.

The goal of the Alternative Investment Association Austria (VAI) is to enable members to offer products that comply with the Directive which is applied in a flexible manner so as product innovation is not inhibited and at the same time all investments are consistent with the investor protection principles.

Austria has a vibrant alternative investment community with history going back to 1989/90 and investors are well educated about the merits of absolute return products independent of benchmarks. Therefore we welcome the opportunity to respond to the effort of CESR and the commission to establish a unified regime for the operation and promotion of regulated open ended collective investment undertakings throughout the European Union.

General Comments

We agree to the utmost importance to ensure that UCITS do follow strict guidelines on investment diversification, fund liquidity and disclosure to ensure that retail investors in UCITS are adequately protected. At the same time we also must point out that discrimination of certain investment instruments and techniques is not a good way to ensure this goal.

We are of the opinion that investor's demand is producing product supply. Investors demanded and are already invested in structured products, closed end funds and hedge fund indices alike. Consider a market like Germany, where retail investors are investing heavily in certificates with sophisticated embedded derivatives on various underlyings like commodities, equities, etc. Over-regulation increases the cost to the investors but does not necessarily deliver greater investor protection. The Clarification of Definitions concerning Eligible Assets is a great opportunity to increase the level of protection, i.e. guiding investors into regulated structures versus unregulated alternative structures (eg. Certificates) and at the same time reduce cost to the investor through a common interpretation.

Detailed Comments

Ad BOX 1 “Treatment of structured financial instruments”

The Alternative Investment Association Austria (VAI) considers Liquidity, Valuation, Information, Transferability to be good indicators which shall be considered by the manager of the UCITS for defining whether or not a security or a structured financial instrument may be considered as a "transferable security". We would like to caution defining liquidity with volume and turnover or times and sales of an instrument alone since many fixed income products are liquid through the obligation of the issuer to provide liquidity to the market, or in the case of OTC derivatives, counterparties do provide liquidity but the contract itself is not traded on a tick by tick basis.

We also agree that it is the responsibility of the manager of the UCITS not to compromise the overall liquidity of the portfolio. We wish to point out that liquidity of a portfolio is also granted through diversification.

Ad BOX 2 “Closed end funds as transferable securities”

A UCITS is allowed to invest in shares of a company listed on a regulated stock exchange. This listed company, e.g. an “Investment-Bank”, uses leverage, has commodity exposure, engages in short selling activities and has illiquid assets on its books. No Look-Through Approach is applied. Investor protection safeguards are well covered through legal mandatory information requirements and through pricing of the security through participation of the public in a recognized public market.

The Alternative Investment Association Austria (VAI) is of the opinion that in the case of a "closed-end fund," legally known as a "closed-end investment company", structured as a transferable security and listed on a regulated stock exchange, all of the before mentioned applies accordingly, i.e. no Look-Through is applicable and investor protection safeguards are well covered through legal mandatory information requirements and through pricing of the security through participation of the public in a recognized public market.

Examples:

- Altin AG, ISIN CH0014424524
- Creinvest AG, ISIN CH0004422975
- Castle Private Equity AG, ISIN CH0005978165
- Meinl European Land, ISIN AT AT0000660659

We do not think that CESR's reference to "unacceptable risks" in the context of cross-holdings requires further elaboration since a "fund" is diversified but even if the unlikely event occurs that a listed closed end fund is not diversified at all, a UCITS would end up with a maximum of 10% or respectively 5% allocation to the holdings of the listed closed end fund itself.

Ad BOX 11 "Embedded derivatives"

The Alternative Investment Association Austria (VAI) is of the opinion that transferable securities that offer the holder of the security the identical economic characteristics and risks as the embedded underlying shall NOT be considered as embedded derivatives. If a UCITS e.g. buys a Note or a structured financial instrument (SFI) linked to a basket of stocks with 100% performance participation and NO capital guarantee and NO leverage, the exposures and risks of the underlying are identical as if the UCITS would have bought the basket of stocks directly. Therefore SFI's linked to an index or a basket of securities do not embed a derivative if the before mentioned applies and shall be considered in the 100% cash bucket of a UCITS versus the 100% derivative bucket of the UCITS. There might be e.g a tax reason why a UCITS fund buys a certificate versus the underlying in pure form.

Examples:

- Open End Index Certificate ISIN AT0000340146, Underlying: DJ Euro Stoxx 50, no capital guarantee, 100% participation, no leverage
- Open End Index Certificate ISIN AT0000340161, Underlying: ATX, no capital guarantee, 100% participation, no leverage
- Open End Index Certificate ISIN AT0000615315, Underlying: Basket of Steel Producers, no capital guarantee, 100% participation, no leverage
- Open End Index Certificate ISIN AT0000481189, Underlying: Basket of Energy Stocks, no capital guarantee, 100% participation, no leverage

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

According to Recital 13 of the Directive 2001/108/EC, operations in derivatives may never be used to circumvent the principles and rules set out in the Directive. We completely disagree that a derivative linked to a financial index is a circumvention of the directive because:

Article 19.1 (g) of the Directive (which allows a UCITS to invest in financial derivative instruments under specified conditions) can be read as being separate from the conditions in Article 19.1(e) (which relates to funds in which the scheme may make direct investment).

Article 19.1 (g) allows UCITS funds to invest in OTC derivatives if the underlying consists of instruments such as financial indices, interest rates, foreign exchange rates or currencies, in which the UCITS may invest according to its investment objectives as stated in the UCITS' fund rules or instruments of incorporation.

Various member states already have approved hedge fund index and commodity index linked UCITS products and hereby implemented the view that Article 22a of the Directive can not be used to explain the term "financial indices" as described in Article 19.1 (g) since it is referring to "stock or debt securities indices". If we compare the term "financial indices" to the term "stock or debt securities indices" it shall be noted that the term "stock or debt securities indices" of Article 22a is more specific and therefore narrower than the term financial indices as described in Article 19.1 (g).

The Alternative Investment Association Austria (VAI) is of the opinion that Hedge Fund Indices and Commodity Indices are with no doubt financial indices according to Article 19.1 (g) and these indices do comply with the concentration limits set by Article 22a or are even more diversified. Since the Look-Through approach is not applicable for indices, derivatives and SFI's linked to financial indices shall be considered eligible assets.

We are of the opinion that commodity indices which are comprised of derivatives on commodities can be regarded identical to Commodity Indices comprised of commodities directly and therefore derivatives and SFI's linked to these indices shall be considered eligible assets.

Today's existing investable Hedge Fund Indices are a benchmark for the universe they track, are sufficiently diversified and are published appropriately. Survivorship bias does not exist in these indices since performance can not be adjusted backward. Hedge fund indices are a straight forward statistically proven benchmark for absolute return alternative investment funds as well as is the Dow Jones Index for equities with only 30 constituents.

Examples:

- MSCI Hedge Invest Index, 121 constituents
- MSCI Hedge Invest Systematic Trading Index, 22 constituents
- MSCI Hedge Invest Discretionary Trading Index, 11 constituents
- MSCI Hedge Invest Long Bias Index, 11 constituents
- MSCI Hedge Invest Variable Bias Index, 10 constituents

- MSCI Hedge Invest Equity Non-Directional Index, 15 constituents
- MSCI Hedge Invest Convertible and Equity Arbitrage Index, 13 constituents
- MSCI Hedge Invest Event-Driven and Merger Arbitrage Index, 12 constituents
- MSCI Hedge Invest Fixed Income Index, 10 constituents
- S&P Hedge Fund Index, 41 constituents
- S&P Arbitrage Index, 15 constituents
- S&P Event-Driven Index, 13 constituents
- S&P Directional/Tactical Index, 13 constituents
- S&P Managed Futures Index, 15 constituents
- S&P Equity Long/Short Index, 22 constituents
- S&P Equity Long/Short US Index, 11 constituents
- S&P Equity Long/Short Global Ex-US Index, 11 constituents
- CSFB/Tremont Investable Hedge Fund Index, 60 constituents
- CSFB/Tremont Convertible Arbitrage, 11 constituents
- CSFB/Tremont Emerging Markets, 10 constituents
- CSFB/Tremont Equity Market Neutral, 10 constituents
- CSFB/Tremont Event Driven, 10 constituents
- CSFB/Tremont Fixed Income Arbitrage, 10 constituents
- CSFB/Tremont Global Macro, min. 10 constituents
- CSFB/Tremont Long/Short Equity, 25 constituents
- CSFB/Tremont Managed Futures, 10 constituents
- CSFB/Tremont Multi-Strategy, 10 constituents
- Goldman Sachs Commodity Index, 24 constituents
- Reuters CRB Index, 17 constituents
- Dow Jones AIG Commodity Index, 19 constituents

As a final argument we would like to point out that member states such as Austria and Germany do have national investment vehicles that are fund of hedge fund structures which are authorised to be distributed to retail investors. Since (retail) investor protection can be guaranteed in these national fund of hedge fund vehicles, we therefore think that investor protection is guaranteed *pari passu* for UCITS investing in financial indices such as hedge fund indices.

Alternative Investment Association Austria (VAI)

Martin Greil

General Secretary

Vienna, June 2005