CESR'S ADVICE ON CLARIFICATION OF DEFINITIONS CONCERNING ELIGIBLE ASSETS FOR INVESTMENT OF UCITS

A RESPONSE BY FIDELITY INVESTMENTS

The importance of clarity

We are grateful for the opportunity to comment on CESR's draft advice. It is of strategic and everyday importance to us that there is certainty regarding which assets may or may not be held by a UCITS. While we appreciate that in the dynamic and inventive world of financial services it is not possible to legislate in advance for new instruments or the way existing instruments may develop, it is important that we have as much clarity as possible regarding the eligibility of UCITS investments.

Too much detail

However, we do not regard detail and clarity as one and the same. In fact we believe that as a whole the advice is too detailed and has therefore created a lack of clarity. As well as on occasions sacrificing clarity we believe that the level of detail has created two other problems.

Stretching beyond the mandate

Firstly, there are sections where the CESR draft advice has strayed beyond the questions of eligibility and into the conduct of the fund. Examples of this include the discussion of liquidity in Box 1, the qualitative conditions surrounding the use of credit default swaps in Box 16, and the imposition of accounting rules in Box 4. As these address issues other than the eligibility of assets they seem to fall outside the Commission's request and mandate. This not only calls into question the extra-curricular aspects of the advice, but also potentially undermines those parts of the advice which are within the mandate but with which these other items are bundled.

Unintended consequences

Secondly, the attention to detail has resulted in a number of we believe unintended consequences. The prime example of this is the requirement in Box 4 to apply a particular accounting methodology to money market instruments. The problem being that the proposed methodology runs counter to accepted market practice and would have the effect of excluding the majority of money market funds available today. We assume this was not the advice's intention.

Transition

The result of the advice is to potentially exclude certain assets and indeed classes of assets which are in use by UCITS today, yet the paper is silent on what might be done to ensure a transition in a way that conforms to the advice but also respects the interests of investors. We would urge CESR to address this issue quickly.

A Clarification of Art.1(8) (Definition of Transferable Securities)

1. Treatment of structured financial instruments

Q1 *Do you agree with the approach to the treatment of transferable securities and structured financial instruments outlined in this draft advice?*

No, it goes beyond CESR's mandate and is also inappropriate in places

Q2 *What would be the practical effort in your view if such an approach were adopted?*

Many legitimate investments would be excluded and the management of eligibility become much more complex than today. We also suspect that given the letter of unnecessary detail this approach is unlikely to result in a smoother process for registration and mutual recognition.

Commentary

Paragraph 28 spells out, that while liquidity is important, the admission of a security to trading is not a guarantee of liquidity. Whether or not instruments legally constructed as a share or a bond, even if admitted to a regulated market, have sufficient liquidity is not, therefore, *prima facie* evidence of a lack of eligibility. Similarly, the fact that such instruments may not be listed and that this may affect the amount of information available and ability to value such instruments, is not *prima facie* grounds for exclusion. We would also note that liquidity in single instrument can come and go. It would make it impossible to manage if there was a strict standard at the instrument level base don some measure of liquidity and such instruments would be moving in and out of eligibility on an almost daily basis. The UCITS is required to consider liquidity at the fund level which is where it is best managed.

We share the implied unease of the consultation that certain types of structured financial instruments can create a means of subverting the UCITS investment restrictions and introduce unforeseen risks to a UCITS' portfolio. However, a number of the issues raised by CESR in paragraph 33 fall within the investment judgement of the UCITS investment manager and are not, as such, matters which should be crystallized within a legislative framework. Indeed, we do not regard them as matters on which CESR has been asked to provide advice by the Commission.

There is clearly a balancing act to be performed. We feel that in some significant part the Draft Level 2 Advice achieves this. We have no comment to make on paragraphs 1 and 3 of the Advice other than to say that we believe them to be broadly correct and proportionate. Paragraph 2 crystallises the balancing act we referred to and does not work well as drafted. We have a few comments on paragraph 2.

- In the sub-paragraph headed 'liquidity' we believe that nothing germane is added after the initial sentence ending "Art. 37 of the Directive." The level of detail contained in these sentences appears unnecessary.

- On the question of "Valuation" the advice should make clear that should there be short term problems with valuing an instrument (e.g. a stock is suspended and the price quoted is simply a last traded price) that this will not compromise the eligibility of the stock. In other words, the criteria to be assessed should be evaluated under normal market conditions.

- The requirement that a UCITS assess continuously the risk of the security goes beyond the question of eligibility both in common sense and fact. This would mean that a failure by a UCITS to carry out a particular oversight process could mean that a security becomes ineligible for that UCITS , when it is held by all other funds in that sector. This is not a logical outcome.

- Overall, we feel paragraph 2 matters are all for consideration by the UCITS and its investment manager. Once an investment objective has been incorporated within the UCITS' offering documents and approved by its Home Member State regulator, then the stricture that the fund comply with its investment objective is sufficient leverage for regulatory action by the competent regulator. This is not Level 2 territory.

2. Closed end funds as "transferable securities"

Q3 *Does the reference to "unacceptable risks" in the context of cross-holdings require further elaboration, and if so, how should it be elaborated?*

We believe the "look-through" requirements of the advice to be discriminatory and unnecessary

Q4 *Do you consider that in order to be considered as an eligible asset for a UCITS, a listed closed end fund should be subject to appropriate investor protection safeguards? If so, do you consider the proposed safeguards sufficient and clear enough?*

We believe that this entire approach is misinformed. If we are happy to take a share as acceptable as it is subject to the listing rules, similarly a listed fund

Q5 *Further to the requirements in Box 2b), CESR is considering to clarify the investor protection safeguards with the following options:*

- *the UCITS should verify that the listed closed end fund is subject to appropriate restrictions on leverage…and that it is subject to appropriate controls and regulation in its home jurisdiction; or that*

- *the UCITS should consider the extent to which the closed end fund can leverage…..…*

See our response to Q5

Q6 *Should/should not UCITS be required to invest only in such listed closed end funds, that invest in transferable securities, that would themselves be eligible under the UCITS Directive?*

Such an approach is to require non-UCITS funds to behave as UCITS funds, and to discriminate against mainstream offerings, such as the UK investment trusts which are today acceptable.

Commentary

The issue here is whether the proposed advice has the effect of restricting a UCITS from making legitimate investments. We agree entirely with CESR that there is a danger that the transferable security route could lead to a fund of hedge funds receiving a UCITS authorisation, but the response to this concern must be focused and proportionate.

The decision as to whether a particular enterprise takes the form of a limited company structure or a closed end fund structure can be driven by the simplest and most straightforward of motives – the tax efficiency of the structure most commonly. For example, the UK is currently consulting on the issue of Real Estate Investment Trusts (REITs). If the conversion charge is sensible then our expectation is that many listed property companies will convert to REITs, in whole or in large past. If CESR's advice were to have the effect of disqualifying such investment this seems arbitrary and unnecessary given that investment in property companies today is perfectly acceptable.

Regardless of whether it is appropriate (or within CESR's power to comment) on the question of the underlying assets represented by a transferable security, a distinction should be made between those end investments whose nature can still flow through the structure of a closed end fund which is a transferable security, and those end investments whose nature is significantly modified by such a structure.

For example, in our view the primary incompatibility of real property with UCITS is its lack of liquidity. However, investment in real property via a property company or some form of closed end fund listed on a regulated market removes that incompatibility. In other words the structure adopted removes the risk that would otherwise be "unacceptable" in a UCITS' context. We see no reason why there should be a distinction, say, between a listed property company and a listed REIT for this purpose. They are all but identical in terms of risk profile.

In looking at funds which engage in cross-holdings, are highly geared, and which carry out uncovered shares sales, the analysis is different. Whether structured as a transferable security or as a simple closed and fund there remains the possibility of cataclysmic loss. However, that loss cannot be more than the amount invested and to be frank it is almost as easy to lose all your money on a simple equity as through some allegedly exotic structured instrument.

We feel therefore that the Draft Level 2 Advice in Box 2 is essentially misguided in trying to look under the skin of the instrument being purchased – should we not buy Consolidated Goldfield shares because it underlying assets are those which a UCITS could not own directly? This is clearly nonsense: we are buying a share, not the underlying assets of the company.

If CESR is to persist in this inappropriate level of look through then the advice should be further clarified by inclusion of the type of differentiation outlined above between those instruments where end risks flow through and those where the end risks are significantly modified.

In response to Question 6, if the Advice takes the form of looking at the end investment then it risks discriminating against legitimate structures which may actually have the effect of addressing the risk with which CESR is concerned.

3. Other eligible transferable securities

Q7 *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 that the suggested approach in Box 3 as appropriate?*

We think the reference back to Box 1 creates a problem as this appears to eliminate the category of unapproved transferable security

Commentary

In paragraph of the advice in Box 3 the references to Box 1 (in paragraph 2) eliminates the concept of an eligible transferable security that is not approved. Provided that an instrument meets the tests for being a transferable security it should have an appropriate place within the universe of UCITS eligible assets. We support IMA's suggested redraft of Box 3.

B Clarification of Art. 1(9)(Definition of Money Market Instruments)

1. General rules for investment eligibility

2. Art.19(1)9h)

Q8 *Do you agree with this approach, and especially the proposal that one of the conditions for the eligibility of asset booked securities and synthetic asset-backed securities under Article 19(1) is that they be dearly on a regulated market under the provisions of Art. 19(1)(a) to (d)? If not, please give practical examples of the potential impacts.*

We believe that this section represents far too great a level of detail for the mandate, and for our needs as a firm. We also are particularly concerned that the advice in Box 4 not only goes beyond the proper concepts of eligibility but would also result in the exclusion of most liquidity and money market funds from UCITS given they employ a straight-line amortization basis of valuation.

Commentary

We have some comments on the Draft Level 2 Advice in Boxes 4 to 8, and it is as follows:

- In Box 4 the factors to be taken into account should be assessed in terms of normal market conditions, If, for example, a pricing service were to experience technical difficulties to the extent that the second criteria (accurate and reliable valuation) was not fulfilled, this should not change the essential character or eligibility of the instruments concerned.

- The requirement in Box 4, paragraph 1, second bullet is that of a particular method of accounting for MMIs which is: a) not appropriate in a consultation on eligibility; and b) not the recognised practice for the vast majority of liquidity and money market funds. Such funds, as recognised by auditors and rating agencies, use the straight-line amortization method, only reverting to a mark to market valuation when there is an appreciable difference – this is usually set at 50bps. If CESR retains this advice the impact of the money market fund industry will be immense, and it rules out the option for a stable or fixed NAV cash fund within UCITS.

- The third bullet of that paragraph requires that MMIs have a low interest risk to qualify. This is inappropriate. Much emerging market debt is relatively high risk, yet is demonstrably suitable for the right sort of UCITS fund and where proper disclosure has been made. This seems an unnecessarily nannyish approach, rather like saying that shares are permitted but only if there is a limited risk of capital loss.

- We support the IMA redrafting of Box 4

- We believe the Draft Level 2 Advice in paragraph 1 of Box 5 adds nothing to Box 4 and feel it should be deleted.

- The remaining two paragraphs of Box 5 go beyond what is necessary or appropriate for a definition of eligibility and should be deleted.

- We sympathise with CESR's task in interpreting the definitions in Art. 19(1)(h) given the inadequacy of the original text. However, we do not see market practice accurately reflected in paragraph three of Box 6. Firstly, information memoranda or similar are usually issued for a programme, not an individual debt issue; secondly the reference to "independent authority" in the third bullet point would exclude European Commercial Paper where such memoranda are signed off by auditors and not authorities as such. We support IMA's suggestion of the use of the term "independent entity".

- The presumption in respect of EEA and G10 countries' establishments in Box 7 is helpful. However, we are also very conscious that the resulting list omits several major economies and markets (for example, Australia) and would suggest that the presumption could legitimately and usefully be extended to IOSCO or OECD countries. This also has the benefit of consistency with Boxes 7 and 12 in approach.

3. Other eligible money market instruments

No comments

C. Clarification of scope of Art.1(8)(Definition of Transferable Securities) and "techniques and instruments" referred to Ast.21

We support CESR's stated intention set out in paragraph 70 to set out broad criteria and principles rather than provide an "exhaustive list" that, frankly, is likely to prove anything but. However, we would question the usefulness of continuing to place emphasis on a phrase such as "efficient portfolio management" (EPM).

Firstly, to require that a UCITS use EPM is just the same as requiring that it not use inefficient portfolio management. This seems an unnecessary admonition where a UCITS is required to act in the best interests of its shareholders, as it is. Secondly, EPM has a uniquely defined legacy from UCITS1 where it was employed for a very specific purpose in respect of derivatives. We feel that paragraphs 2 and 3 of the Draft Level 2 Advice in Box 10 could usefully be combined as "Techniques and instruments must be used in the best interests of shareholders".

Generally we believe that CESR's advice is too prescriptive. There is an obligation on UCITS to have appropriate risk measures and processes in place and therefore there is no need to include phrases such as "acceptably low level of risk" in the advice. We, in the same vein, regard paragraph 6 as unnecessary.

D. Embedded derivatives

In Box 11 CESR's Draft Level 2 Advice appears to diverge from the intention set out in paragraph 70, notably in paragraph 3 of the Advice by being to list-driven and detailed.

We believe paragraph 3 to be unnecessary. Similarly paragraph 4 of the advice attempts to be very specific, but in creating two qualitive bases for exceptions achieves quite the opposite.

We feel paragraph 4 could be lost and the general principle remain better intact.

Similarly Box 6 seems to do little other than requirements set out in the Directive, so we would question whether they need to be included in the CESR level 2 advice.

E. Other collective investment undertakings

Unfortunately Box 12 is another example of detail being offered in lieu of clarity. There are several factors listed here which do not address the question set by the Commission and appear extraneous at best, unnecessarily limiting at worst.

Paragraph 1, first bullet point - We do not regard Memoranda of Understanding as a factor logically to be taken into account in assessing the equivalence of supervision. We note that IOSCO has only very recently re-launched an initiative to sign up its members to an enforcement MoU, a process which it (rather optimistically) allows 5 years to complete. Many MoUs are unsigned because of relatively minor issues and it seems perverse to penalize UCITS shareholders for regulators' inability to complete complex and bureaucratic processes. In our view membership of IOSCO should be more than sufficient to provide the background comfort required.

Paragraph 1, third bullet point - The requirement for an independent trustee/custodian is super-equivalent to UCITS' own requirements, which allow for related parties to act as trustee/custodian. It also ignores the fact that some jurisdictions manage to run collective investment schemes regimes with no requirement for a depositary, notably Australia and the US. We note that the recent IOSCO paper on fund governance discusses the concept of single independent entity, a concept which not only is inclusive of the UCITS approach, but also the approach adopted in those jurisdictions noted above. Accordingly we see this suggested factor as unnecessary – it is not useful as an indicator of equivalence.

Paragraph 1, seventh bullet point – There is no obligation for even a UCITS to have a management company (several jurisdictions within the EU recognise self-managed UCITS), so this requirement falls at the first hurdle. Also, we are not aware of any EU regulator that actually approves the rules of a scheme or its choice of depositary should it have one. All UCITS funds would fail this criteria as written.

F. Financial derivative instruments

1. Financial derivative instruments: general considerations

We feel that CESR has made its Draft Level 2 Advice in Box 13 unnecessarily complicated.

Our view is that financial derivatives can only ever derive one or more (but rarely all) characteristics of an underlying eligible asset. Even a single stock future only derives certain characteristics of the underlying transferable security: it usually imperfectly replicates any significant income stream and conveys none of the governance aspects of ownership of the underlying such as a right to vote at an AGM.

It is therefore more consistent with reality, as well as simpler in definitional terms, to define a financial derivative instrument for UCITS as a derivative which derives one or more characteristics of an eligible asset or combination of eligible assets.

2. The eligibility of derivative instruments on financial indices

Q9 In addition to the criteria developed in the draft CESR advice, CESR is considering the following options:

- *Only financial indices based on eligible assets should be considered as eligible underlyings,; or that*

- *The wording of Ast.19(1)(g) does not require UCITS to apply a look through approach when concluding derivatives on financial indices….*

In the context of the above, and as far as derivates on commodity financial indices are concerned, it is considered, whether:

- *Derivatives on financial indices on financial instruments based on commodities would be considered as eligible; or whether*

- *Derivatives on financial indices on commodities would be considered as eligible.*

No comments

3. OTC Derivatives

We support CESR's Draft Level 2 Advice in Box 15 with one notable exception.

The advice in paragraph 3 is not addressing eligibility – it is extending the scope of the risk management process requirements and as such outside CESR's mandate. In particular we see no basis for the imposition of a new and potentially very costly reporting obligation, in this paper specifically, or more generally without a full cost benefit analysis being undertaken.

4. Credit Derivatives

Q10 *What is your assessment of the risk of asymmetry of information in relation to the use of credit derivatives by UCITS? Which kind of measures should UCITS adopt in order to limit the risk of asymmetry of information? Please explain the arguments for your view.*

We do not see asymmetry of information as relevant to a discussion on the eligibility of a particular asset type. In truth the asymmetry of information gradient exists across all asset classes at different slopes and in different directions.

Q11 *Do you consider that the problem of a potential asymmetry of information between issues and buyers of credit derivatives can be dealt with by limiting the nature of the issuers on which the credit risk may lie to [certain issuers]?*

See response to Q10.

Commentary

It should first of all be noted that the use of credit derivatives is already an established practice for many funds under UCITS1. It should also be noted that the risk of asymmetry of information exists across the range of eligible assets for UCITS, and there appears to be no cogent argument for singling out credit derivatives in this way.

We have no problem with the Draft Level 2 Advice in Box 16 except to note that while some of the criteria relate to the characteristics of the instrument in question, the asymmetry issue is essentially one relating to the competence and capacity of the UCITS or its investment manager. We do not believe that such a criteria is within the scope either of CESR's powers under UCITS III comitology, nor within scope of the Commission's mandate. It should, accordingly, be withdrawn.

We see no value in CESR restricting the use of credit derivatives with respect to the issuer provided the other relevant conditions are met.

G. Index replicating UCITS

1. UCITS replicating the composition of a certain index

Q12 *Do you consider that the CESR advice should require UCITS to provide an estimate of the quality of the index replication? Please give practical examples of the possible impacts of using estimates in this regard.*

We believe the Directive text to be self-explanatory and CESR's advice to be contrary to that interpretation.

Q13 *If your answer to the previous question is yes, which of the following two estimates would you consider appropriate, or would you consider both or another estimate necessary?*

See our answer to Q12. Option B is the only one that is a logical fit with the question.

Q14 *Should CESR suggest maximum theresholds as far as the estimates described above are concerned?*

See our answer to Q12.

Commentary

CESR appears to have answered a different question to that posed by the Commission. The term "replicating the composition of a certain index" in Art.22a(1) is a strict test, and rightly so, as a fund satisfying this test is allowed a very high concentration of risk. We feel it is sensible for CESR to provide advice on this point and for that advice to be particular in character.

For us the key word is "composition". The CESR debate and advice seems to be more focused on replicating the performance rather than, as the Directive directs, the composition of an index. Of the alternative estimates in Q13 only one is based on composition (Option B) and only this is therefore a permissible basis under the Directive.

We do not see the logic of a describing composition as including the replication of composition. Where the 20%/35% freedoms may arise is a key matter for investor protection. As index derivatives do not require a look-through a UCITS may use them without concerning itself with single stock/group limits. Therefore the only situation in which the 20%/35% freedoms should be needed are where the UCITS is committed to the replication of the composition of the index.

We believe Box 17 should read:

> "A UCITS is deemed to replicate the composition of a certain index if it has the aim and practice of replicating the composition of that index."

2. Index characteristics

We have no comments on the Draft Level 2 Advice in Box 18.