

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

I. INTRODUCTION

The CNMV Advisory Committee welcomes the publication of the Working Paper presented by the CESR in connection with the Clarification of Definitions concerning Eligible Assets for Investments of UCITS, which will undoubtedly contribute to more uniform and coordinated application of the Directive.

The CNMV is also grateful for the open hearing held by the CESR on 9 May, which introduced transparency into this process and will benefit both supervisors and the supervised.

II. GENERAL COMMENTS

The CNMV Advisory Committee agrees with the CESR in that the interpretation and implementation of the Directive are very important for the construction of the internal financial market; in this connection, it considers that certain matters addressed in the Consultation Paper need to be clarified. In general, the following issues need to be emphasised:

- A. Financial instruments have undergone considerable innovation in recent years in order to improve efficiency in financing, investment and asset management.
- B. When analysing the eligibility of specific instruments, it may be very useful (though not necessary) to consider the Directive's goals, particularly the following two:
 - 1) Standardise regulatory conditions in the various countries in order to facilitate cross-border sales of UCITS.
 - 2) Ensure more effective and uniform protection for unit-holders and shareholders.
- C. Regulations on UCITS portfolios (e.g. diversification and liquidity) should not be considered in isolation from the individual assets since investor protection can also be ensured in ways other than simple regulation of products. In this connection, the amendments to the Directive (via UCITS III) attach greater importance to investor protection through disclosure and other requirements imposed on the management company (e.g. establishment of risk management procedures).
- D. Risk aversion on the part of many retail investors in recent years has led to a supply of UCITS that guarantee the invested principal or an absolute yield.

Many of the products analysed in the Consultation Paper have come to represent a sizeable proportion of these UCITS' portfolios in the course of this process of innovation.

- E. It is essential that management companies maintain sufficient capacity to offer these products, since they do not act in isolation (quite the contrary). UCITS face fierce competition from rival financial products which are subject to much less regulation and are less transparent and less supervised than UCITS. Consequently, it is important to maintain a balance so as to ensure that unnecessarily detailed or restrictive regulations do not make UCITS less competitive.

III. SPECIFIC COMMENTS

A. Structured financial instruments

Structured instruments should be considered to meet the formal requirements for eligibility if they are transferable securities that are listed or traded.

Article 1(8) refers specifically to "*bonds and other forms of securitised debt*". Consequently, there should be no reason to consider that structured financial instruments do not fall under the definition of transferable securities. For this reason, the underlyings should not be subject to the same requirements as the transferable securities themselves.

What matters is that the management company should ensure that the use of underlyings embedded in an eligible asset does not affect that asset's characteristics nor clash with the UCITS' investment policy, the risk it assumes or the general principles of the UCITS Directive.

Therefore, a detailed look-through process would be required in connection with the investment restrictions and the limitations on concentration in a single issuer. However, it does not appear justifiable to establish a general prohibition on underlyings that would be considered eligible if invested in directly. For example, a UCITS may invest in equities or fixed-income assets of issuers that invest in assets that are not directly eligible (e.g. listed real estate companies that invest in property).

The market in asset-backed securities is expanding rapidly in Europe. For greater transferability, most of these products are marketed through synthetic structures. Consequently, Asset Backed Securities (ABS), Collateralised Debt Obligations (CDO), Collateralised Debt Securities (CDS), Credit Linked Notes (CLN) and Mortgage Backed Securities (MBS) should be treated as ordinary private fixed-income assets without the need for a division or review of the underlying derivatives, provided that it can be shown that these instruments do not pose any risks over and above those posed by standard fixed-income assets.

As stated in section 28 of the Consultation Paper, given the differences in the liquidity of assets, even in those which are listed or traded, the management company should bear the responsibility for ensuring sufficient overall liquidity so as to comply with the obligations of Art. 37.

B. Listed closed-ended funds as transferable securities:

Listed UCITS are considered to meet the basic requirements for transferable securities under Art. 1(8) of the Directive, and they should be considered as such. Moreover, with the sole exception of Art. 2(1) of the Directive, no other provision provides any other specific treatment.

Once again, investment in assets of this type must conform to the UCITS' stated investment objectives, its risk level, the general diversification rules, the liquidity requirements to enable redemptions, etc.

C. Money market instruments:

The same principles as for transferable securities should be applied to money market instruments (MMIs). If the MMIs are traded on regulated markets, they should be considered as being sufficiently liquid and offering certainty in value. If they are not traded, they may also be eligible provided that the issuer is capable of meeting its obligations. In this respect, the requirements established in Art. 19(1)(h) of the Directive may be applicable.

Regarding underlying instruments embedded in those MMIs, we reiterate our general comments on transferable securities.

It would appear that the main issue, from the CESR's standpoint, is the assumption that Art. 1(2) requires that assets in which UCITS invest be liquid, considering that a security should be classified as liquid if it is listed or traded in on a regulated market and can be freely transferred. In practice, there are varying degrees of liquidity, in terms of the number of counterparties, trading volume, etc. However, this should not be used to make a distinction between eligible and ineligible assets.

In this connection, the degree of liquidity of the assets should be taken into account by UCITS in order to guarantee redemption.

Therefore, what matters is the liquidity of the UCITS itself, not of the individual instruments or components comprising its portfolio.

D. Techniques and instruments referred to in Article 21(3.3):

The goal of efficient portfolio management should be defined in broad terms, including techniques and instruments that contribute to attaining the UCITS' investment objectives, always taking account of the level of risk, general redemption requirements, etc.

The CESR mandate refers to the second indent of Art. 21(3) (transferable securities that embed derivatives), so the general comments above on structured financial products should be taken into account.

In this connection, this rule clarifies that if a UCITS invests in a transferable security that embeds derivatives, the management company must ensure that this investment conforms to the investment objectives of the UCITS (efficient portfolio management).

Moreover, the Directive does not prohibit the use of structured financial instruments; rather, it tries to ensure consistency of the requirements when compared to an unstructured derivative.

E. Other collective investment undertakings:

Regarding the level of investor protection, it might be advisable to establish a list of relevant criteria for attaining this objective. A criterion of reciprocity could be considered when defining the eligibility of UCITS from other jurisdictions.

F. Financial derivative instruments:

In connection with financial derivative instruments traded in on a regulated market, the comments above in connection with the definition of transferable security and its connection with Art. 21 are relevant here.

In connection with over-the-counter (OTC) derivatives, the criterion for deciding whether or not they are eligible is set out clearly in Art. 19(1)(g). Specifically, indent three of Art. 19(1)(g) defines the requirements for an instrument to be considered liquid, which must be analysed on a case-by-case basis in any event.

Additionally, credit derivatives are a tool for managing fixed-income portfolio risk and their use as instruments and techniques as referred to in Art. 21(2) of the Directive should not be questioned.

G. Index replicating UCITS:

As to whether the composition of an index is "sufficiently diversified", the Directive already elaborates on this issue, specifying the restrictions on specific investments that must apply to index replicating UCITS.

Any index that is published in general media, whether electronic or paper, should be considered to be "published in an appropriate manner".