



21 November 2005

Committee of European Securities Regulators
11-13 Avenue de Friedland
75008 Paris
France

Dear Sirs

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

As the representative body for depositaries of UK-based authorised collective investment schemes, DATA are grateful for the opportunity to comment on “CESR's advice on clarification of definitions concerning eligible assets for investments of UCITS”.

The Depositary and Trustee Association (DATA) represents all depositaries and trustees of UK-based authorised unit trusts and open-ended investment companies (OEICs). At the end of September 2005, the members of DATA were responsible for safeguarding £324.4 billion of funds under management.

DATA welcomes CESR's attempt to resolve a number of differences in implementation of the UCITS Directive across the EU jurisdictions. DATA believes that standardising the interpretation of the Directive will remove a number of difficulties arising when our clients attempt to passport their funds into other EU jurisdictions. That said, DATA does have a number of issues regarding CESR's advice.

CESR's Advice – Level 2 or 3

There has been a great deal of discussion as to whether CESR's advice should be level 2 (measures implementing Directives and adopted by the Commission after advice from CESR and the European Securities Regulators) or level 3 (co-operation amongst regulators). We note that CESR have now split their advice between level

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2, which is high level principles, and level 3, which provides details of complying with level 2. There is a concern amongst a proportion of DATA membership that with level 3 co-operation there is a significant risk that some jurisdictions may take a more restrictive or liberalised approach to implementation of guidelines. This could lead to the continuance of the current position of regulatory arbitrage between Member States and retain the difficulties in the notification process. DATA recommends that CESR monitor the implementation process of this advice to ensure a reasonable level of symmetry between Member States.

Consultation process

DATA welcomed the extension of the deadline for CESR to provide advice to the Commission, but is disappointed that the industry and its representatives have had only one month to consider the revised advice. This short consultation period could give rise to unidentified, unintended consequences. DATA has identified a number of, what we believe to be, unintended consequences, which are documented in the enclosed paper. As an example, the redefinition of “embedded derivative” would appear to include close-end funds that invest in derivatives.

Ineligible UCITS

DATA members remain concerned that CESR's advice will disallow investment in certain assets which have to date been eligible since the implementation of the 1985 Directive.

Where a UCITS' objective and policy is, for example, to invest in hedge fund indices, this fund in totality would no longer comply with the UCITS Directive. We note that it is CESR's opinion that such funds were never UCITS compliant, but this raises concerns whether the fund has a UCITS passport. Will investors who invested in the fund via the passport be able to continue to retain their investment or will the host regulator deem the investment to be illegal? Specifically with regard to funds that invest in hedge fund indices, will these funds lose their UCITS status but potentially regain it again at some point in the future?

DATA recommends that CESR give full consideration to all the legal and ethical implications of a UCITS, in compliance with CESR's advice, no longer being able to retain UCITS status.

Transitional provisions

CESR's advice, as currently drafted, may require radical changes to managers' and depositaries' processes and procedures for determining the eligibility of assets. In a number of cases the implementation of this advice will also require the reallocation of assets to comply with the new requirements, which will potentially incur significant costs that will be charged to the fund and thus, ultimately borne by the investor.

DATA recommends that to reduce the significant disruption and, hopefully, to reduce the costs of reallocation, CESR provide a transitional period, at the end of which all UCITS must comply with the new requirements.

If you wish to discuss any of the points raised in our response please do not hesitate to contact me.

Yours faithfully

Ros Clark
Technical Adviser

Enc: DATA's detailed response

CESR Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS – 2nd Consultation

DATA's detailed comments

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

1. Treatment of “structured financial instrument”

Answers to CESR's specific questions

Do you agree with the approach in Box 1?

Please, give your view on the possible impacts of the proposed approach to your activity/more broadly to the UCITS market, based on your experience.

DATA welcomes the modifications CESR have made to the advice on the definition of “transferable security”, especially the clarification that the UCITS must have sufficient liquidity to meet redemptions rather than there being a prescriptive obligation for all securities in the fund to be liquid.

2. Other eligible transferable securities

Answers to CESR's specific questions

Do you agree with the approach as suggested in Box 2?

Please give your view on the possible impacts of the proposed approach to your activity/more broadly to the UCITS market, based on your experience.

DATA believes that the level 2 advice in box 2 will prevent investment in unlisted securities or securities sold through a private placement. As investment in these transferable securities is restricted to 10% of the value of the fund we consider specific parts of this advice are unnecessarily restrictive.

The requirement for there to be “regular and accurate information available to the **MARKET**” is overly restrictive. Unlisted securities do not necessarily make such information available to the market but will be available to the investor. **DATA agrees that to be eligible the information about the security should be available but instead of these being required to be disclosed to the market as a whole it should be available to the manager or UCITS.**

DATA is concerned that the requirement for the “security to be freely negotiable on the capital markets” could potentially be unnecessarily prescriptive. This

term, which arises from MiFID, has yet to be clearly defined and DATA wishes to prevent the possibility that investment in unlisted securities would be prohibited or that the UCITS definition of “capital market” will vary from that in MiFID. **DATA therefore recommends that to prevent unnecessary prescription and to retain clarity the advice should be amended to state simply that the “security must be freely negotiable”.**

3. Closed end funds as “transferable securities”

Answers to CESR’s specific questions

Do you agree with the approach as suggested in Box 3? What is your view of the options presented concerning the specification of the “appropriate investor protection safeguards”?

Is the suggested treatment of contractually based funds appropriate, i.e. is it enough to apply same requirements to closed end funds of the contractual type as to the corporate type of funds, or should CESR explore different criteria for closed end funds of the contractual type? Do listing requirements differ sensibly between fund structured in contractual form compared to those structured as companies?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA remains of the belief that a close-end fund is a transferable security and provided it meets the criteria in Box 1 or 2 is an eligible investment. DATA welcomes the presumption in Box 3 that a closed-end fund falls within the definition of “transferable security”.

DATA is of the view that provided the close-end fund is listed this provides an appropriate standard for investment purposes. The close-end fund, as for any other listed securities, will need to comply with the listing requirements. In fact in a number of jurisdictions, including the UK, close-end funds have additional listing requirements above and beyond those requirements for public limited companies. **DATA does not consider that there should be any further additional requirement for the close end fund to have further investor protection above and beyond the listing requirements.**

DATA is content that close-end funds in contractual form will be eligible but consider it inappropriate for them to comply with the requirement of having corporate governance mechanisms “equivalent to those applied to companies generally” due to the structure of these instruments. **If CESR are intent that there should be additional safeguards for such instruments then the requirement should be for the management company to be regulated.**

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

1. General rules for investment eligibility

Answers to CESR's specific questions

Do you agree with the approach as suggested in Box 4?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

Given the very low level of interest rates (especially in the eurozone), what are the thresholds currently used by the industry to qualify a discrepancy as being material?

Are these thresholds defined at the instrument and/of fund level?

Does the industry use escalation procedures to prevent any discrepancy to become material? Please give details of these escalation procedures (discrepancy threshold, steps taken etc.).

DATA on the whole welcomes CESR's modifications to the advice on defining eligible money market instruments (MMI) but considers that appropriate amendments will need to be made to the text to prevent unnecessary prescription.

In the third bullet point of the advice, the criterion, "normally dealt in on the money market", includes instruments which have:

- a maturity of issuance of less than 12 months;
- a residual maturity of up to 12 months; or
- regular yield adjustments in line with money market conditions at least every 12 months.

We note that these requirements will prevent UCITS from investing in a number of MMI issued in the USA as these will often have a maturity of issuance of 397 days (13 months). The US Investment Act 1940 provides this flexibility in order to prevent inadvertent breaches arising due to any slight delay in settlement of the instrument. **DATA recommends that CESR's advice is amended to allow for this flexibility in UCITS to ensure that US MMI are eligible for investment.**

DATA believes that the factors that should be taken into account when determining the liquidity of an MMI should not be cumulative. The main criterion for determining liquidity should be the "possibility to repurchase, redeem or sell the MMI in a short period at limited cost". The other criteria are secondary considerations, and any failure to meet those requirements would not necessarily mean that the MMI is not liquid. For example, the size of issuance of the MMI may be relatively small, but the instrument may still be redeemed in a short period at limited cost. **DATA recommends that CESR's advice states that the main criterion for determining liquidity should be the possibility of redeeming in a short period at limited cost, with the remaining criteria being secondary considerations that the manager**

may wish to take into account.

DATA is concerned that there is an obligation upon the UCITS to “foresee cash flows in order to match anticipated cash flows with the selling of appropriate liquid instruments.” Where a money market fund is predominately an institutional fund, the manager may well have information regarding likely inflows and outflows. However, where the fund investor basis is predominately retail consumers, the manager will be unable to foresee such cash flows. Surely, the reason for the underlying MMI to be liquid is that the manager can meet unforeseen inflows and outflows and thus comply with Article 37. **DATA recommends that the final paragraph of CESR’s Level 3 advice on page 21 is deleted.**

DATA welcomes modifications to CESR’s advice to allow for valuation of money market funds to include amortisation. This has ensured that a large sector of money market funds, specifically stable NAV funds, can retain their UCITS status. This advice does, however, still prohibit a significant number of money market funds, as the flexibility to amortise is restricted to those funds which have a weighted average maturity of 60 days. **DATA recommends amortisation should be provided for funds that have a weighted average maturity of 90 days so that these funds can retain their UCITS status.**

Do you agree with the approach as suggested in Box 5?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly the UCITS market, based on your experience

DATA does not have any specific comments on Box 5 of CESR’s Advice.

2. Article 19(1)(h)

Answers to CESR’s specific questions

Q6 *Do you agree with the approach as suggested in Box 6?*

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA has concerns regarding CESR’s advice in Box 6. As this advice has been based on the STEP project, which is specifically designed to standardise dealing practices in Europe, especially for European Commercial Paper, it would appear to exclude investment in a number of instruments including certificates of deposit issued by local authorities.

We note that CESR’s advice has also gone beyond that of the STEP project by

requiring an “independent body” to control information regarding the issue or issuance program. STEP are considering that the information should be controlled by an “independent authority” or “independent entity” (e.g. auditor). At CESR’s open hearing, held on 7 November, there was comment from the panel that “independent body” would not just include an auditor but would instead be a committee of independent persons. **DATA considers that this is too prescriptive and recommends CESR require that any information is controlled by an “independent authority or entity”.**

Q7 Do you agree with the approach as suggested in Box 7?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA does not have any specific comments on Box 7 of CESR’s Advice.

Q8 Do you agree with the approach as suggested in Box 8?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA does not have any specific comments on Box 8 of CESR’s Advice.

3. Other eligible money market instruments

Q9 Do you agree with the approach suggested in Box 9?

DATA does not have any specific comments on Box 9 of CESR’s Advice.

C. Clarification of scope of Art.1(8) (Definition of Transferable Securities) and “techniques and instruments” referred to in Art. 21

Q10 Do you agree with the approach as suggested in Box 10?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA is generally content with the CESR’s advice in Box 10. However, there is a concern regarding the requirement for **ALL** “techniques and instruments” to comply with Article 22 of the Directive, specifically the risk spreading rules.

Article 21 requires only “techniques and instruments” that are derivatives to comply with the risk spreading rules, and any extension of that requirement is in fact re-defining level 1 text rather than clarifying the definition of “techniques and instruments”. In a number of circumstances it would not be feasible for the manager to comply with this requirement. For example, when stock-lending, would the manager require multiple counterparties in order to comply with the risk spreading requirements? **DATA recommends that, as required by the directive, the risk spreading rules should apply only to derivatives that fall within the definition of “techniques and instruments”.**

D. Embedded derivatives

Q11 Do you agree with the approach as suggested in Box 11?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA considers that CESR's advice on the clarification of the definition of embedded derivatives is too far reaching. The advice, as currently drafted, could potentially include close-end funds that themselves invest in derivatives. DATA would strongly argue that such a security is not an embedded derivative as it does not have the characteristics of such an instrument. **To prevent inclusion of close-end funds that themselves invest in derivatives DATA recommends that an additional bullet is point 1 of the level 2 advice stating that “the instrument should have an optional content”.**

E. Other collective investment undertakings

Q12 Do you agree with the approach as suggested in Box 12?

DATA remains concerned that CESR's clarification on the definition of “other collective investment undertakings” excludes investment in funds domiciled in the USA and Australia. Investment in funds domiciled in these jurisdictions would be prohibited because their fund governance structure does not require an independent trustee or custodian. We appreciate that there is a general obligation for “other collective investment undertakings” to have a level of protection of its unit holders “equivalent to that provided for unit holders in a UCITS”, but “equivalent” does not necessarily mean that the protection must be the same, rather that a similar level of protection is provided. IOSCO's review of CIS Governance concluded that whilst there are a number of different CIS Governance models, investors are provided with protection. In fact in Article 14 (5) of the UCITS Directive itself there is the provision to dispense with having to appoint a depositary in certain circumstances. **DATA recommends that CESR amend their advice to allow for investment in other collective investment undertakings where governance structures do not provide for an independent trustee/custodian, but which have equivalent protections e.g. independent directors.**

F. Financial derivative instruments

1. Financial derivative instruments: general considerations

Q13 Do you agree with the approach as suggested in Box 13?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA does not have any specific comments on Box 13 of CESR's Advice.

2. The eligibility of derivative instruments on financial indices

Q14 Do you agree with the approach as suggested in Box 14?

DATA is concerned about the level of detail of CESR's advice regarding the eligibility of derivative instruments on financial indices. We are specifically concerned that CESR are applying IOSCO's conclusions on the best practice recommendations for index providers to UCITS managers. The eligibility of financial indices should be determined by its diversity, publication and its representation of an adequate benchmark and not by prescriptive requirements about how the index provider selects or replaces stocks. **DATA recommends that everything after "comply with the diversification rules set by Article 22a of the Directive" in point 1 is deleted.**

We note that in point 2 of the advice, CESR rules out hedge fund indices being eligible, certainly for the next 12 months. In DATA's opinion if an index complies with the requirements on Box 14 then it is eligible. DATA notes that CESR has concerns regarding Hedge Fund indices, but preventing investment in them for a period of 12 months appears untenable. CESR's main concerns appear to be with regards to "uninvestable hedge fund indices" and these same issues would not arise for "investable hedge fund indices". There are a number of UCITS that already invest in hedge fund indices, and they would no longer be UCITS compliant, but might again become UCITS compliant at some point in the future. **DATA considers that managers and the investors of these funds should be provided with certainty.**

CESR in their advice notes that derivatives on commodities may be eligible provided they comply with the requirements in Box 14. However, there is no mention of property. **DATA recommends that CESR state in their advice that derivatives on property may be eligible provided they comply with the requirements in Box 14.**

3. OTC derivatives

Q15 Do you agree with the approach as suggested in Box 15?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA is generally content with CESR's advice on the valuation of OTC derivatives. Under the first bullet of point 3 there is a requirement that the valuation should be conducted in such a way that it "guarantees that the valuation corresponds to the fair value". **DATA considers that to provide a "guarantee" is too onerous and UCITS managers should, instead, have to take into account the fair value. DATA recommends that CESR make appropriate amendments to their advice.**

4. Credit derivatives

Q16 Do you agree with the approach as suggested in Box 16?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA does not have any specific comments on Box 16 of CESR's Advice.

G. Index replicating UCITS

1. UCITS replicating the composition of a certain index

Q17 Do you agree with the approach as suggested in Box 17?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA does not have any specific comments on Box 17 of CESR's Advice.

2. Index characteristics

Q18 Do you agree with the approach as suggested in Box 18?

Please give your views on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

DATA does not have any specific comments on Box 18 of CESR's Advice.