DUBLIN FUNDS INDUSTRY ASSOCIATION

Dublin Funds Industry Association

Response to CESR's advice on clarification of definitions concerning eligible assets for investments of UCITS

2nd Consultation Paper

INTRODUCTION

The Dublin Funds Industry Association (DFIA) is the representative body of the international investment fund community, representing the custodian banks, administrators, managers, transfer agents and professional advisory firms involved in the international fund services industry in Ireland. Given that as at end of August 2005 there were 3,726 Irish domiciled funds, including sub-funds, with a Net Asset Value of €521 billion, (2,103 Irish domiciled UCITS funds, including sub-funds with a Net Asset Value of €416 billion), all developments in the European investment funds arena are of particular interest and relevance to the Irish industry. As such we appreciate the opportunity to respond to CESR's draft advice on clarification of definitions concerning eligible assets for investment of UCITS, 2nd Consultation paper and for ease have structured our response to address the issues as they are raised in the Consultation paper of October 2005.

In general, we welcome the additional clarification afforded by the consultation paper in relation to the definition of eligible assets for UCITS funds. Our primary concern in connection with this process is the extent to which the process remains consistent with the following two key principles: -

- The purpose of the UCITS III Product Directive was to expand the list of eligible assets and should not prevent an existing UCITS maintaining investments, and continuing to invest, in assets which were considered to be eligible assets under the 1985 Directive; and

- The imposition of additional rules, which will compel a UCITS or any other party such as, for example, the depository to conduct a more onerous evaluation of the eligibility of assets, should be imposed only after a suitable cost benefit analysis has been undertaken.

In particular, we would see, in relation to these two principles, that the more detailed guidance afforded by the consultation paper in relation to, for example, transferable securities will compel UCITS and investment managers and the depositories of UCITS to consider the introduction of additional evaluation criteria in order to determine whether a particular transferable security will constitute an eligible asset. It is not clear how this process will be undertaken. In the context of these additional procedures and systems, we would suggest that it would be more appropriate that any of these more detailed requirements should form part of level 3 guidance rather than level 2 advice as

there should be flexibility to allow different UCITS and investment managers to adopt different systems to satisfy themselves that investments satisfy the criteria applicable to investments for UCITS funds.

We also have concerns in relation to the transitional arrangements for introduction of the clarification of definitions of eligible assets. As indicated above, we believe that this process will be counterproductive if it results in a situation whereby existing UCITS funds authorised under the 1985 Directive will be required to quickly divest themselves of certain assets which had been considered acceptable and eligible assets for UCITS funds under the 1985 Directive. The UCITS may also be obliged to amend their documentation to reflect the new requirements which will have regulatory, cost and time consequences for the UCITS and their investors. CESR has indicated that, with regard to these transition arrangements, it will welcome assessments from market participants of the number of such UCITS and investors involved. Unfortunately, the nature of this process is such that it is only the actual application of new detailed evaluation criteria which will help to identify the number of UCITS and number of investors involved. Furthermore, we note that the consultation paper states that any "possible transitional arrangements can only be of a very limited nature". After two years of experiencing considerable difficulties adapting to the transitional arrangements imposed on funds authorised under the 1985 Directive, we would suggest that the imposition of an aggressive timetable for compliance with further new requirements will act as a set-back to the UCITS industry generally and that, accordingly, CESR should maintain an open position in relation to the nature and timeframe of the transitional arrangements.

Draft Level 2 advice/ Level 3 guidelines

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.

    - 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).

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 should 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.

Questions:

Q1. Do you agree with the approach as suggested 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.

Response

We would reiterate the general comment made in our response on the first consultation paper to the effect that the proposed approach is overly prescriptive and goes further than was considered necessary when defining the term **transferable securities** for the purpose of the Directive.

The fourth bullet point in paragraph 1 of the Level 2 advice requires that there must be regular, accurate and comprehensive information available to the

market on the security or, where relevant, on the portfolio of the security. We would submit that the previous requirement which was that the UCITS should assess the extent to which the issuer regularly makes information available to the market would be more appropriate. It is not clear what is meant by each of the terms **regular**, **accurate** and **comprehensive** and this could create additional uncertainty.

We are concerned about the fifth bullet point under paragraph 1 of the Level 2 advice namely that the security must be freely negotiable on the capital markets. This would appear to be an attempt to define the term **transferable** which was not considered necessary in the original UCITS Directive or in the amendments thereto. It is difficult to see what the terms **freely negotiable** and **capital markets** are intended to mean in this context and we would submit that their inclusion could cause confusion and additional interpretative issues for the industry.

We do not agree that the risk of a transferable security is required to be captured in the risk management process of the UCITS as stated in paragraph 3. We believe that it is clear from the Directive that the risk management process contemplated by article 21 is only intended to monitor and measure the risk of the derivative positions in the portfolio and not the risks of every security in the portfolio. In this regard, we note paragraph 11 of the preamble to the Product Directive which states that in order to ensure constant awareness of the risk and commitments arising from derivative transactions and to check compliance with investment limits, these risks and commitments will have to be measured and monitored on an ongoing basis.

We would submit generally in relation to liquidity that a UCITS should, in considering the liquidity of potential investments, be able to take into account the investment time frame contemplated by its investment objective i.e. whether the UCITS seeks to achieve its objective in a short, medium or long time frame. This will be relevant to the investors' behaviour.

Paragraph 5 in the Level 3 guidelines states that the presumption that a traded transferable security is liquid does not apply if the UCITS knows or ought reasonably to know that any particular security is not liquid. We submit that the introduction of the objective test would be unfair to investment managers and is likely to create interpretative challenges for UCITS, their investment managers and their custodian/trustees. It is also not clear how a UCITS should treat a security in its portfolio if circumstances change following purchase of the security such that it becomes illiquid. We would agree that the presumption should not apply if the manager knows that a security is not liquid at the time of purchase.

In relation to paragraph 6, and the examples of matters which a UCITS may need to consider in assessing liquidity risk, we would reiterate our comment on the previous consultation that significant burdens could be imposed on investment managers by this guideline because from a liability standpoint they may consider it necessary to maintain records to demonstrate the due diligence which they had undertaken in view of this provision. There is already a requirement that the investment managers of UCITS be subject to appropriate regulation. The effect of this provision could be to indirectly impose obligations on investment managers as to the manner in which they conduct

their business. The Investment Services Directive, for example, does not seek to highlight matters which an investment manager authorised thereunder should take into account when making investment decisions and we do not think it is necessary or appropriate for CESR to effectively seek to do this through this process.

Draft Level 2 advice/Level 3 guidelines

BOX 2

LEVEL 2

1. For an investment in a transferable security to be eligible under Art. 19(2)(a), it must be a transferable security that does not comply with one or more of the conditions respectively described in Art. 19(1)(a) to (d). It must however fall within the definition of "transferable security" in Article 1(8). In particular:

   - the security must not exposure 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 a valuation of the security available on a periodic basis which is derived from information from the issuer of the security or from competent investment research;
   - there must be regular and accurate 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 state investment objective of the UCITS. These objective 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).

LEVEL 3

5. For transferable securities falling within this Box liquidity can not automatically be presumed. The UCITS will therefore need to assess the liquidity of such securities where this is necessary to meet the requirements of Art. 37. the assessment should be done in the same way as in Box 1. if the security is assessed as insufficiently liquid to meet foreseeable redemption requests, the security must only be bought or held if there are sufficiently liquid securities in the portfolio so as to be able to meet the requirements of Art. 37.

6. The security's risks and their contribution to the overall risk profile of the portfolio must be

assessed on an ongoing basis.

Questions:

Q2. 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 marked, based on your experience.

Response

We would reiterate the points made in relation to box 1 in relation to bullet points 4 and 5 under paragraph 1.

We would reiterate in relation to paragraph 3 the point made in relation to the risk management process in the context of paragraph 3 of box 1.

We would note in relation to paragraph 5 that, as there is in any event a 10% limit in relation to transferable securities falling within this box, the liquidity of such securities should not be of such importance as it is for transferable securities falling within box 1.

Draft Level 2 advice/Level guidelines

BOX 3

LEVEL 2

1. "Transferable security" includes a closed 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 in contractual form are eligible where their corporate governance mechanisms are equivalent to those applied to companies generally.

Questions:

Q3.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 funds structured in contractual form compared to those structured as companies?

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

Response

We do not agree with the approach suggested in paragraph 2 of box 3 for the reasons set out in our response to the previous consultation. In addition, if a closed ended fund complies with the requirements of box 1 or box 2, it should not be subject to an additional level of scrutiny. There is no equivalent requirement in relation to the investor protection safeguards offered by any other permissible transferable security or money market instrument which falls within box 1 or box 2.

We would submit in relation to paragraph 3 that the paragraph should be amended to focus on the intention of the UCITS to use a closed ended fund for this purpose. The UCITS may not be aware, having invested, of the composition of the portfolio of investments held by a closed ended fund. It could in theory be possible if the portfolio was looked through to allege that the UCITS investment limits had been circumvented. This would not be something within the control of the UCITS and would clearly not reflect a deliberate intention on its part to circumvent the investment limits.

Based on our experience, the listing requirements for funds structured in contractual and corporate form are not materially different and only differ where appropriate to reflect the form of legal vehicle involved.

We would submit in relation to contractually based funds that it may be difficult for them to meet the definition of transferable securities contained in the Directive but that, if they do, for the reason set out above, it should not be necessary to subject their corporate governance mechanisms to additional scrutiny.

BOX 4

LEVEL 2

The definition of Money Market Instruments can be clarified as follows:

- with respect to the criterion "liquid": instruments which can be sold at a limited cost in an adequately short timeframe taking into account the requirement of Art. 37 of the UCITS Directive that the UCITS should repurchase or redeem its units at the request of any unit holder.

- with respect to the criterion "value which can be accurately determined at any time": instruments for which accurate and reliable valuation systems are available and enable the UCITS to calculate a net asset value in accordance with the value at which MMIs held in the portfolio could be exchanged, between knowledgeable, willing parties in an arm's length transaction. This enables the UCITS to fulfil the requirement set by Art. 1(2) of the UCITS Directive requiring that units be repurchased or redeemed at the request of unit holders. These systems can be based on market data or on valuation models and include systems based on amortised cost methodology.

- with respect to the criterion "normally dealt in on the money market": as a general rule, this will include instruments which have a maturity at issuance of less than 12 months or a residual maturity of up to and including one year as a general rule, or regular yield adjustments in line

with money market conditions at least every 12 months. UCITS should conduct an in depth analysis of the risk profile of instruments which do not comply with these maturity criteria to check that they have the risk profile of money market instruments.

LEVEL 3

When assessing the liquidity of a MMI, the following cumulative factors have to be taken into account:

- at the instrument level:
  - frequency of trades and quotes for the instrument in question;
  - number of dealers willing to purchase and sell the instrument, willingness of the dealers to make a market in the instrument in question, nature of market place trades (times needed to sell the instrument, method for soliciting offers and mechanics of transfer);
  - size or issuance/program;
  - possibility to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), at limited cost, in terms of low fees and bid/offer prices and with very short settlement delay;
- at the fund level, the following relevant factors should be considered in order to ensure that any individual MMI would not affect the liquidity of the UCITS at the fund level:
  - unit holder structure and concentration of unit holders of the UCITS;
  - purpose of funding of unit holders;
  - quality of information on the fund's cash flow patterns;
  - prospectuses' guidelines on limiting withdrawals

These elements must ensure that UCITS will have sufficient planning in the structuring of the portfolio and in foreseeing cash flows in order to match anticipated cash flows with the selling of appropriately liquid instruments in the portfolio to meet those demands.

BOX 4

LEVEL 3

With respect to the criterion "value which can be accurately determined at any time": if the UCITS considers that an amortization method can be used to assess the value of a MMI, it must ensure that this will not result in a material discrepancy between the value of the MMI and the value calculated according to the amortization method. The following UCITS/MMI will usually comply with the later principles:

- MMI with a residual maturity of less than 3 months with no specific sensitivity to market parameters, including credit risk or
- UCITS investing solely in high-quality instruments with as a general rule a maturity or residual maturity of at most one year or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days.

These principles along with adequate procedures defined by the UCITS should avoid the situation where discrepancies between the value of the MMI as defined at level 2 and the value calculated according to the amortization method would become material. These procedures might include updating the credit spread of the issuer if necessary.

Treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances will usually comply with the criterions "normally dealt in on the money market".

Questions:

Q4. 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/or at the 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.).

Response

We would submit that the use of the terms **knowledgeable** and **willing** in the second bullet point in level 2 is unnecessary as it may require an additional level of analysis to be added to the valuation process. Probable realisation value has, since the original UCITS Directive was enacted, been a valuation criterion with which the market was happy and does not we believe require any further clarification. The degree of knowledge which a person may have and their willingness to enter into a transaction could of course affect the price they are willing to pay and we think it should be sufficient for this paragraph to simply refer to an arm's length transaction.

In relation to the third bullet point under level 2, we would submit that it is not appropriate to focus on the characteristics of the instrument but rather to focus on the relevant market. As was noted in our submission on the first consultation paper, the money markets are constantly evolving and any criterion suggested in this context should focus on where and by whom the instrument is traded rather than on the characteristics of the instrument.

In relation to the level 3 guidelines on liquidity, we note that it is stated that the factors set out therein have to be taken into account. We believe that these factors should only be included as examples of matters which might be taken into account. We would reiterate the comments made in our previous submission to the effect that the investment manager of a UCITS in constructing its portfolio will have to bear in mind the liquidity of the entire portfolio in view of the obligations of the UCITS under articles 37 and, once satisfied that an MMI meets the definition of the term contained in the Directive, should not be further constrained by CESR in its selection of MMIs for investment. As with any other traded investment, it will only be when the UCITS goes to sell the instrument that it will be able to ascertain whether or not at that time it can be sold in a short period. We would also point out that a number of the factors included are by their nature subject to change such as the unitholder structure in the UCITS. It is not clear whether CESR intends for a UCITS to be required to monitor the liquidity of each MMI at the time of purchase only or throughout the period during which it is held. We envisage that it would add significantly to the compliance monitoring costs of a UCITS if the liquidity of an MMI would have to be considered against each of these

factors throughout the term during which that instrument is held.

In relation to the use of the amortisation method of valuing MMIs, we would note that this is a key tool for the European money market fund industry and in particular those of its participants who are members of IMMFA. We understand that the majority of such funds are domiciled in Ireland and authorised as UCITS. It is customary for such funds to also obtain a rating such as AAA from one or two of the recognised rating agencies. This type of fund has been very successful at increasing assets under management even though the European money market fund industry is still extremely small when compared to its equivalent in the United States.

We would submit that the portion of the UCITS market represented by such funds and their providers would potentially be severely prejudiced by any CESR recommendations which would restrict their ability to continue to operate as they do presently. We would point out in this regard that Irish UCITS money market funds may currently utilise the amortised cost method to value securities with a residual maturity of fifteen months or less. In order to enable an Irish UCITS to identify and address any discrepancies between the value of the MMI as calculated using the amortised cost method and the value calculated by reference to market prices, such funds are required to carry out a weekly review of any discrepancies and there is an acceleration process firstly to daily reviews, and thereafter to the board of directors of the UCITS/management company, if any discrepancy exceeds certain threshold limits. In addition, the Irish rules provide that the amortised cost valuation method may be applied to floating rate instruments, inter alia, where they have a residual maturity of up to five years in the case of high credit quality instruments where procedures are adopted to ensure that the valuation produced does not vary significantly from its true market value.

We would also note that the Irish rules currently provide that a UCITS which is not a money market scheme may provide for valuation by an amortised cost method in respect of securities with a residual maturity not exceeding six months. We would submit that the Irish requirements which have been accepted by the money market funds authorised in Ireland represent an appropriate level of regulatory requirement in this regard and that CESR should not recommend more onerous requirements.

We agree with the guideline that treasury and local authority bills, certificates of deposit, commercial paper and banker's acceptances will usually comply with the criterion **normally dealt with on the money market**.

Draft Level 2 advice/Level 3 guidelines

BOX 5

LEVEL 2

1. When assessing whether a given MMI is eligible under Art. 19(1)(a) to (d) of the UCITS Directive, consideration must be given to the overall coherence of the provisions set by the Directive. The fact of the admission to trading on a regulated market of a MMI provides a presumption that the conditions of "liquidity" and "accurate valuation" are complied with. These criteria are not automatically fulfilled and in the event that a UCITS believes that this presumption should not be relied upon, the MMI should be subject to an appropriate assessment.

LEVEL 3

2. Given the clarification of the above definition of MMI, CESR's view is that there is no scope for gaining exposure to precious metals through the investment in such instruments.

3. Regarding the specific issue of the prohibition of uncovered sales, CESR is of the opinion that Art. 42 implies that short selling of MMIs by a UCITS is not authorised.

<u>Questions:</u>

Q5. Do you agree with the approach as suggests in Box 5?
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.

Response

In relation to paragraph 1, we would submit that the suitability of any MMI for investment by UCITS is a matter to be determined by the investment manager of the UCITS taking into account all factors available to it. We would submit that the key decision in this regard should be the one made at the time when the decision to invest is made and that there should not be an ongoing requirement to monitor the continuing suitability of the MMI.

In relation to paragraph 2, we would reiterate our previous comment that the prohibition under the Directive is on investment in precious metals or certificates representing them. We would submit that there should not be a prohibition on investment in transferable securities or MMIs which by virtue of the activities of the relevant issuer, or the terms of the relevant securities, give exposure to precious metals or to their performance.

In relation to paragraph 3, we would reiterate our previous comment which was to note that Article 42 does not prohibit anything other than uncovered sales of money market instruments. We would submit that to avoid confusion, it would be preferable to maintain use of this terminology.

<u>Draft Level 2 advice/Level 3 guidelines</u>

BOX 6

LEVEL 2

1. The factors above in Box 4 concerning MMIs apply also to MMIs that are not dealt in on a regulated market.

2. The criterion requiring that the issue or the issuer of MMIs not admitted to or dealt in on a regulated market "is itself regulated for the purpose of protecting investors and savings" as referred to under Article 19(1)(h) means money market instruments which fulfil the following criteria:

   - availability in information on both the issue or issuance program and the legal and financial situation of the issuer prior to the issue of the MMI;

   - regular up-dating of this information (i.e. on an annual basis or whenever a significant

event occurs);

- control of this information by an independent body specializing in the verification of legal or financial documentation and composed by persons meeting various standards of integrity and not subject to instructions from the organization they belong and from the issuers;

- a minimum amount of each issuance of EUR 150,000 or the equivalent in other currencies;

- free transferability and electronic settlement in book-entry form;

- availability of reliable statistics regarding the issue or issuance programs.

LEVEL 3

3. It remains the responsibility of the UCITS to ensure whether a MMI that is not dealt in on a regulated market is an eligible asset.

Questions:

Q 6. 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.

Response

We would submit in relation to paragraph 2 that these factors should only constitute guidelines rather than attempting to define this particular sub-category of MMI.

We would also submit that the requirement that there be control of information by an independent body is vague and open to multiple interpretations and as such will not be welcomed by UCITS, their investment managers and/or custodians/trustees.

Draft Level 2 advice

BOX 7

LEVEL 2

The criterion "issued by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law" as referred to in Article 19(1)(h) third indent means an issuer which is subject to prudential rules and
- which is located in the European Economic Area or
- which is located in G10 countries (including USA, Canada, Japan and Switzerland) or
- which has at least an investment grade rating or

- for which it can be demonstrated based on an in-depth risk-assessment of the issuer that the prudential rules are at least as stringent as those laid down by Community law.

Questions:

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

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.

Response We have no objection to CESR's views outlined above. However it would be helpful if CESR could indicate, as Level 3 guidance, what specific criteria should be taken into account in carrying out an in depth analysis of a non EEA, non G10 or non investment grade issuer.

Draft Level 2 advice

BOX 8

LEVEL 2

1.Entities that fall under the fourth indent of Art. 19(1)(h) are a specific category of asset backed commercial papers that are built on a two-tier structure and that are secured by banking credit enhancement. Regarding entities that fall under the fourth indent of Art. 19(1)(h), the banking liquidity line has to be secured by a financial institution which itself complies with the third indent of Art. 19(1)(h). Credit institutions providing this protection must have a rating that is at least equal to that of the program in question.

2. Unless they comply with the provisions of the fourth indent of Art. 19(1)(h) as clarified in paragraph 1 of this Box (this implies, for instance, that they would be built on a two-tier structure), asset backed securities and synthetic asset backed securities do not fall in the category defined by that indent.

3. Asset backed securities and synthetic asset backed securities may be eligible under other provisions of the UCITS Directive. This may be the case, for instance, if they are dealt in on a regulated market.

Questions:

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

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

Response We have no objection to the approach suggested in Box 8.

Draft Level 2 advice

BOX 9

LEVEL 2

Other money market instruments are those instruments that comply with the definition of a MMI as set by Art. 1(9) of the UCITS Directive, i.e. are normally dealt in on the money market and fulfil the requirements of liquidity and accurate valuation, and which have been clarified above, but do not, however, fall in the categories defined by Art. 19(1)(a) to (d) or (h).

Questions:

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

Response Subject to our comments regarding the clarification by CESR in Box 4 of the general conditions specified in Art 1 (9) of the UCITS Directive, we have no objection to the approach suggested in Box 9.

Draft Level 2 advice

BOX 10

LEVEL 2

1. "Techniques and instruments relating to transferable securities and money market instruments" mean techniques and instruments that are used in a way which:

   - ensures compliance with the requirements of an adequate risk-management process, in line with the general provisions of the Directive, as well as with the detailed risk spreading rules specified by Art. 22 of the Directive;
   - is for the purpose of efficient portfolio management;
   - respects the provisions of the Directive regarding prohibited transactions.

2. "Efficient portfolio management" means investment decisions involving transactions which:

   - are economically appropriate. This implies that they are realized in a cost-effective way;

   - are entered into for one or more of the following specific aims:
     - the reduction of risk;
     - the reduction of cost; or
     - the generation of additional capital or income for the UCITS with an appropriate level of risk, taking into account the risk profile of the UCITS as described in the fund's prospectus and the general provisions of the UCITS Directive, including Art. 19 (eligible assets), Art. 21 (risk-management process of the UCITS) and Art. 22 (investment limits).

LEVEL 3

3. Based on the above-mentioned criteria, techniques and instruments relating to transferable securities and money market instruments include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending and securities borrowing. The requirement to comply with the provisions of Art. 21 imply in particular that if UCITS are authorized to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operations must be taken into account to calculate the global exposure of the UCITS.

4. Regarding the coherence between Art. 19 and Art. 21(2), CESR notes that currently only financial derivative instruments are subject to both articles. Therefore, in accordance with the wording of Art. 21(2), financial derivative instruments used under Art. 21(2) must comply simultaneously with the provisions of Art. 19. However, financial derivative instruments used

under provisions of Art. 19 are not automatically subject to the "efficient portfolio management" requirement of Art. 21(2).

5. Art. 28 of the Directive defining the obligations concerning the information to be supplied to unit holders by UCITS implies that techniques and instruments relating to transferable securities and money market instruments can not result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its applicable sales documents.

<u>Questions:</u>

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

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.

Response

It is submitted that there is no express requirement in Art 21(1) or elsewhere in the UCITS Directive for a risk management process for the use of techniques and instruments (other than financial derivative instruments) to be put in place. Consequently CESR should clarify and justify what is meant by the phrase "the general requirements on UCITS" in paragraph 94 of the Consultation Paper, based on which CESR asserts that the requirement of a risk management process for the use of techniques and instruments stems and not from the provisions of Art 21(1) of the UCITS Directive.

It is also submitted that the Recommendation on the use of derivatives by UCITS does not expressly provide for a risk management process for the use of techniques and instruments (other than financial derivative instruments) to be put in place. Indeed the risk management methodologies provided for in the Recommendation such as those relating to global exposure and counterparty exposure refer exclusively to financial derivative instruments.

Draft Level 2 advice

BOX 11

LEVEL 2

1. For the purpose of applying Art. 1(8) and 1(9) in conjunction with Article 21(3) 3rd subparagraph, a transferable security or a money market instrument embeds a derivative where it contains a component

   - by virtue of which some or all of the cash flows that otherwise would be required by the transferable security or money market instrument which function as host contract can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative;

   - whose economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract; and

- which has a significant impact on the risk profile and pricing of the transferable security or money market instrument in question.

2. For the purpose of applying Art. 1(8) and 1(9) in conjunction with Article 21(3), a transferable security or money market instrument shall not be deemed to embed a derivative where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such as component shall be deemed to be a separate financial instrument.

3. Given the three criteria developed above in paragraph 1, collateralized debt obligations (CDOs) or asset backed securities using derivatives, with or without an active management, will generally not qualify as SFIs embedding derivatives, except if:

- they are leveraged, i.e. the maximum potential loss resulting from the use of credit derivatives (after compensation with hedging agreements if any) must not exceed the value of assets held by the CDO; or

- they are not sufficiently diversified.

4. As an exception to the preceding paragraph, a tailor-made hybrid instrument, such as a single tranche CDO structured to meet the specific needs of a UCITS, should be considered as embedding a derivative from the Directive point of view. Such a product offers an alternative to the use of an OTC derivative, for the same purpose of achieving a diversified exposure with a pre-set credit risk level to a portfolio of entities. Its treatment should therefore be similar to that of an OTC derivative instrument, if the consistency of the Directive provisions is to be ensured.

LEVEL 3

5. In order to clarify the scope of the above definition, CESR considers appropriate to provide an illustrative and non-exhaustive list of structured financial instruments (SFIs) which could be assumed by a UCITS to embed a derivative:

- credit linked notes;
- SFIs whose performance is linked to the performance of a bond index;
- SFIs whose performance is linked to the performance of a basket of shares with or without active management;
- SFIs with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management;
- convertible bonds; and
- exchangeable bonds.

6. UCITS using SFIs embedding derivatives must respect the principles of the Directive. These include:

- Embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108/EC);

- In compliance with the third indent of Art. 21(3) of the Directive, "*when a transferable security or money market instrument embeds a derivative, the latter must be taken into account when complying with the requirements of (Art. 21)*". As a consequence, the UCITS must:

- employ "a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio" (Art. 21(1));

- have a global exposure relating to derivative instruments that does not exceed the total net value of its portfolio (Art. 21(3));

- comply with all the investment limits set by Art. 22 and Art. 22a: "A UCITS may invest ... in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits set laid down in Article 22" (Art. 21(3)). More specifically:

  - UCITS using SFIs embedding derivatives should refer to the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments by UCITS in order to comply with the risk spreading rules required by Art. 22 of the Directive, as this Recommendation sets out how the underlying assets of financial derivative instruments should be taken into account when assessing compliance with the risk limits set by the above-mentioned article; and

  - Embedded derivatives will generally not be taken into account when calculating counterparty limits, except if these products enable the issuer of the hybrid instrument to pass the counterparty risk of underlying derivatives to the UCITS.

- Coherence must be ensured with the requirements set for financial derivative instruments, as developed below in this draft advice.

- Requirement to check compliance with the above mentioned principles will depend on the characteristics of the embedded derivative and on its impact on the risk profile and pricing of the hybrid instrument. If this impact is not significant, controls can be tailored accordingly.

Questions:

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

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.

Response It is submitted that in accordance with CESR's views set out in paragraph 96 of the Consultation Paper, paragraph 2 of the Level 2 advice in Box 11 be amended by inserting the words "or has a different counterparty from that transferable security or money market instrument" at the end of the first sentence.

In relation to paragraph 3 of the Level 2 advice, it is submitted that

(i) greater clarity is required as to how the criterion of leverage qualifies CDOs and asset backed securities as SFIs embedding derivatives – Certainly CESR's commentary regarding Box 11 suggests that there should be a transfer of counterparty risk to the investor in order for an instrument to constitute a transferable security embedding a derivative; and

(ii) greater clarification is required as to what constitutes "sufficiently diversified" in the context of CDOs and asset backed securities using derivatives.

Draft Level 2 advice

BOX 12

LEVEL 3

1. In CESR's view, the following matters can be used to assess whether a collective investment undertaking is subject to supervision "equivalent to that laid down in Community law", as provided in Art. 19(1)(e), first indent. These factors are indicators of equivalence, which can be used to guide a decision on equivalence:

   - Memoranda of Understanding (bilateral or multilateral), membership of an international organization of regulators, or other co-operative arrangements (such as an exchange of letters) to ensure satisfactory cooperation between the authorities;

   - the management company of the target collective investment undertaking, its rules and choice of depositary have been approved by its regulator; and

   - authorisation of the collective investment undertaking in an OECD country.

2. In CESR's view, the following matters can be considered in deciding whether the level of protection of unit holders is "equivalent to that provided for unit holders in a UCITS", as referred to in Art. 19(1)(e), second indent. These factors are indicators of equivalence, which can be used to guide a decision on equivalence:

   - rules guaranteeing the autonomy of the management of the collective investment undertaking, and management in the exclusive interest of the unit holders;

   - the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision;

   - availability of pricing information and reporting requirements;

   - redemption facilities and frequency;

   - restrictions in relation to dealings by related parties;

   - the extent of asset segregation; and

   - the local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the collective investment undertaking.

Questions:

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

Response

In relation to paragraph 1 of the Level 3 guidelines, it is submitted that Memoranda of Understanding and membership of an international organization of regulators should not be considered an indicator of equivalence, given that it is exclusively referred to as an additional requirement to equivalence in the first indent of Art. 19 (1) (e) of the UCITS Directive. However, in relation to this additional requirement, it is not transparent to industry participants what memoranda of understanding or other co-operative arrangements are in place by UCITS competent authorities. Furthermore, given different co-operative arrangements may apply to each UCITS competent authority, it is possible that what constitutes supervision "equivalent to that laid down in Community law" in one member state may not constitute supervision "equivalent to that laid down in Community law" in another member state.

It is submitted CESR should clarify that, subject to the factors expressly referred to in the first and second bullet points of Art 19(e) of the UCITS Directive, not all of the factors referred to in paragraphs 1 and 2 of the Level 3 guidelines which can be used to guide a decision on equivalence are necessary but any one or a combination of them which reasonably satisfy the UCITS competent authority that the "other collective investment undertaking" is subject to supervision "equivalent to that laid down in Community law" or that the "level of protection for unitholders in the other collective investment undertakings is equivalent to that provided for unit-holders in a UCITS" (which ever is applicable) should suffice.

BOX 13

LEVEL 2

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g), financial derivative instruments mean derivatives whose underlying consist of assets which are eligible for UCITS. In particular, eligible assets in this context include:

   - assets listed in Art. 19(1);
   - financial indices;
   - interest rates;
   - foreign exchange rates or currencies;
   - a combination of these; and
   - financial instruments having one or several characteristics of eligible assets (e.g. dividends).

2. Eligible assets exclude:

   - non-financial indices; and
   - commodities.

3. Regarding investments giving an exposure to commodities, reference is made to point 2 of this draft advice concerning financial derivative instruments ("The eligibility of

derivative instruments on financial indices”).

LEVEL 3

4. Operations in derivatives may never be used to circumvent the principles and rules set out in the Directive, as stated in Recital 13 of the Directive 2001/108/EC. As a consequence, underlyings of derivatives must be eligible assets.

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

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.

Response We have no objection to this approach. However, in paragraph 1 of the level 2 advice, it may be more appropriate, in the second sentence, to refer to “eligible underlyings” rather than “eligible assets”. It would not be accurate to state that “financial indices” or “interest rates” or “foreign exchange rates” are “assets” in their own right as it is only the instrument that is related to any of the foregoing that constitutes an “asset”.

BOX 14

LEVEL 2

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g) first indent, financial derivative instruments on a financial index mean those financial derivative instruments which are based on a financial index which:

- Comply with the criteria set by Art. 22a(1) of the Directive, that is that they:

  - be sufficiently diversified;

  - represent an adequate benchmark for the market to which it refers; and

  - be published in an appropriate manner.

- Comply with the diversification rules (including ratios) set by Art. 22a of the Directive

- Comply with the following criteria regarding index management process, transparency and contract design:

Index management process:

(i) Index composition: the index must measure the performance of a representative group of underlyings in a way that is meaningful and useful (i.e. the index must be representative of the market to which it refers). The constituents must be appropriately diversified to ensure that performance is not unduly influenced

by the performance of one or two components. These underlyings should be sufficiently liquid, to enable users replicate the full index if necessary. The rules under which constituents can be removed or included must be clearly outlined.

(ii) Index weighting and methodologies for calculating index levels: Index providers use different methodologies to calculate index levels. With regard to stock indices these are usually capitalization-weighted (including modified capitalisation-weighted indices where the weighting of any single component is limited). Price-weighted or equal dollar weighted methodologies are also utilized.

(iii) Index calculation and dissemination process: an efficient index will have robust procedures to collect prices (including procedures to price components where a market price is not available) and to calculate and subsequently publish the index value. Price sources are determined by the index provider.

(iv) Index rebalancing: index providers must revise or "rebalance" their indices periodically to ensure that they continue to reflect the markets to which they refer. The criteria and procedures for index rebalancing are set out in the index provider's rules and protocols. This information should be available on as wide and timely a basis as possible.

Transparency

Index providers are to provide on a as wide and timely a basis as possible material information for market users in respect of such matters as index calculation and rebalancing methodologies, changes in the composition of the index, the timing and implementation of any index changes and information relating to any operational difficulties in providing timely or accurate index information.

Contract design of stock index derivative products

(v) The method of calculation: whether the index is calculated in an appropriate way including the weight given to component stocks so that the price movements of a few particular components do not exert undue influence on the movement of the index.

(vi) The number of component stocks: whether the index is composed of a sufficient number of stocks of non-affiliated issuers so that the price movements of a few particular components do not exert undue influence on the movement of the index.

(vii) The liquidity of component stocks: while there may be great differences in the liquidity of component stocks, whether each component stock has sufficient liquidity so that the trading of such stock does not exert undue influence on the movement of the index.

(viii) The dispersion of component stocks within a business sector or across sectors:whether the component stocks are broadly based so that the price movement of stock belonging to a certain business sector does not exert undue

influence on the movement of the index.

(ix) The replacement of component stocks: whether there is a non-arbitrary and well publicized procedure for reconsideration of the appropriateness of continuing to include index component stocks, either on a regular basis, or as occasion demands.

(x) The selection of component stocks in full consideration of the items i) to iv) above.

2. Given the complexities of hedge fund indices and the fact that they are still developing, CESR cannot recommend, at this stage, allowing hedge fund indices to be considered as financial indices. However, CESR is monitoring the issue and is willing to reconsider its position in 12 months, after gaining sufficient experience.

3. Indices based on financial derivatives on commodities may be eligible provided they comply with the above criteria.

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

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.

Response

We have no objection to the approach specified in paragraph 1 of the level 2 advice. However, we would query whether this is appropriate for level 2 advice and whether it should, more properly, constitute level 3 guidance.

We do not agree with the approach suggested in paragraph 2 of the level 2 advice. We believe that, if the relevant hedge fund index meets the criteria set out in the preceding paragraph, it should constitute an acceptable index. In particular, we believe that this will create difficulties of interpretation and distort the market in relation to authorisation of UCITS funds in view of the fact that certain UCITS funds may have already been authorised in a number of jurisdictions on the basis that they will invest in financial derivative instruments based on a financial index which is a hedge fund index. This would create difficult transitional issues. It would be unreasonable to suggest that these funds should not continue to operate in this manner. Equally, it would be unfair to competitors to prohibit entry to the market on the same terms. In particular, the level 2 advice suggests that CESR will reconsider its position after it gains sufficient experience. However, it is submitted that CESR should apply the general rules which it has set out in paragraph 1 of the level 2 advice until such time as it seeks to refine those rules in any particular respect for hedge fund indices. However, this should not act as a barrier to investment in financial derivative instruments based on such indices in the interim.

We have no objection to paragraph 3 of the level 2 advice.

BOX 15

LEVEL 2

Fair value

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g) third indent (OTC derivatives), the criterion "fair value" means the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Process for accurate and independent assessment and reliable and verifiable valuation on a daily basis

2. For the purpose of applying Art. 21(1) in conjunction with Art. 19(1)(g) third indent, the criteria " process for accurate and independent assessment of the value of OTC derivatives" means:

- regarding the accurate assessment of the value of the OTC derivative: a process which enables the UCITS throughout the life of the derivative to value the investment concerned with reasonable accuracy at its fair value on a reliable basis reflecting an up-to-date market value

- regarding the independent assessment of the value of the OTC derivative: a process which has been agreed between the UCITS and the depositary and which complies with the requirement that the UCITS does not rely solely on market quotations. If no reliable up-to date market value is available, fair value should be based on the pricing model which has been agreed between the UCITS and the depositary. When doing so, reference should be made to an accepted methodology

- organization and means allowing for a risk analysis realized by an entity independent from commercial or operational units and from the counterparty or, if these conditions cannot be fulfilled, by an independent third party. In the latter case, the UCITS remains responsible for the correct valuation of the OTC derivatives. Lastly, this organization of the UCITS implies that risk limits are to be defined.

3. For the purpose of applying Art. 21(1) in conjunction with Art. 19(1)(g) third indent, the criteria "*reliable and verifiable valuation on a daily basis*" means :

- a valuation of the contracts by the UCITS on a daily basis which is conducted in a way that can be controlled and which guarantees that the valuation corresponds to the fair value (as defined above) of the OTC derivative. This can be achieved :

- Either by requiring that the valuation provided by the counterparty be checked against that performed by an independent third party at an adequate frequency. The UCITS remains responsible for the correct valuation of OTC derivatives and must, inter alia, check that the independent third party can adequately value the types of OTC derivatives it wishes to conclude.

- Or by requiring that the valuation be performed by an independent third unit within the UCITS. Independent in this context means a unit:

- Which is independent from the department in charge of managing

the UCITS.

- Which has the adequate means (both human and technical) to perform this valuation. This implies that the UCITS use its own valuation systems, which can however be provided by an independent third party. This excludes the use of valuation models provided by a party related to the UCITS (such as a dealing room with which OTC derivatives are concluded) which have not been reviewed by the UCITS. This also excludes the use of data (such as volatility or correlations) which have not been qualified by the UCITS.

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

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.

Response We have no objection to the approach as suggested in box 15.

BOX 16

LEVEL 2

1. A credit derivative is a financial instrument allowing the transfer of the credit risk of an underlying asset or assets, independently from the other risks associated with the asset (exchange rate risk, index risk, interest rate risk).

2. A credit derivative is an eligible asset for a UCITS provided that the following conditions are met:

   a) The credit derivative complies with the conditions of eligibility of derivative instruments;

   2. The end of the transaction can only result in the delivery or in the transfer of assets eligible for UCITS, including cash.

3. For the purpose of applying Art. 21(1) in conjunction with Art. 19(1)(g), the criterion of a "risk-management process which enables the management or the investment company to monitor and measure at any time the risk of positions and their contribution to the overall risk-profile of the portfolio" means a process which in respect to credit derivatives, in addition to the requirements that exist for all OTC derivatives, takes into account the risks of asymmetry of information, in particular with related parties acknowledging private information on firms referenced by credit derivatives.

4. It is recalled that credit derivatives are OTC derivatives and must therefore comply with the provisions of this advice regarding OTC derivatives (Box 15).

LEVEL 3

5. This means for a UCITS a need

a) to take into account the risk of asymmetry of information when concluding credit derivatives with counterparties which may have access to non-public information, especially with firms referenced by credit derivative instruments; and

b) to undertake this assessment with the highest care when this counterparty is a related party of the UCITS.

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

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.

Response

In general, we agree with the approach as suggested in box 16. We welcome the clarification that it is sufficient for a UCITS to take into account the risks of asymmetry of information rather than imposing a standard which might require them to “limit” such risks, in view of the difficulty of ensuring the latter. However, we would question whether this proposal is realistic. It is likely to be difficult for a UCITS to obtain sufficient useful information in order to allow it to complete any such assessment. We would, also, question the text of sub-paragraph b of paragraph 5 of the level 3 advice. This requires a UCITS to undertake the relevant assessment “with the highest care” when the counterparty is a related party of the UCITS. This is an impossible standard to measure. It would be more appropriate to apply the normal standard of care applied to an investment manager which is to take reasonable care and to rely on existing rules regarding related party transactions. Otherwise, it is impossible for any UCITS to judge the standard by which it will be held accountable.

BOX 17

LEVEL 2

1. A UCITS is deemed to replicate the composition of a certain index if its only aim is to replicate the composition of the underlying assets of the index. This aim can be achieved through the use of derivatives, or any other techniques and instruments as referred to in Art. 21(2) of the Directive.

LEVEL 3

2. CESR notes that a standardized method of calculation for the assessment of the quality of replication by the UCITS would enhance competition between index funds and improve the quality of products accessible to retail investors. It therefore calls for the professional associations to achieve such a standardization, taking into account the regulations already in force in some Member States in that area.

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

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.

Response We agree with the approach suggested in box 17. However, the inclusion of Guidance has been requested in respect of the appropriateness of using exchange traded funds (“ETF’s”) for index replication. Article 22a permits an index replicating fund to invest up to 20% in any single issuer, and up to 35% in a single issuer in exceptional market conditions. These limits are relevant if the UCITS scheme is investing in the securities directly to replicate the index. It has been argued that it should be possible to utilise ETFs, which are substantially invested in the securities comprising the relevant index, for the purposes of achieving the aim of index replication. The Directive refers to a scheme whose investment policy has the "aim" of replicating the composition of an index. Neither the Directive nor the Consultation Paper prescribes how a fund shall achieve the aim of index replication and although Article 22a assists replication by direct investment, it does not require it as the only means. The Consultation Paper already highlights that the use of derivative instruments and/or techniques and instruments leads to an improvement in the quality of index replication by minimising the tracking error in a cost-effective way and should therefore be permitted. This confirms that the aim of index replication might be achieved through means other than a direct investment in all of the assets comprised in the index in proportion to their relevant weighting, particularly where the use of other instruments would lead to an enhanced level of replication in a cost-effective manner.

As previously stated, no guidance is provided as to how a fund shall achieve the aim of index replication but plainly, if a technique can be utilised which will (a) reduce the cost to the investors in the fund and (b) lead to an improvement in the quality of index replication by minimising the tracking error, it seems to us that such techniques should be permitted as part of the index replication strategy. It is submitted that the use of ETFs, as part of an index replication strategy, would meet all of the requirements set out in Article 22a of the Directive.

BOX 18

LEVEL 2

A specified index can be eligible for replication by a UCITS if it meets the three conditions set by Art. 22a(1) of the Directive. These conditions should be interpreted as follows:

- An index is sufficiently diversified if it respects the risk diversification rules set by Art. 22a. In addition, UCITS should provide an appropriate information for the subscribers in the simplified prospectus, if the limit for investment in shares and/or debt securities issued by the same body is raised above 20% and to a maximum of 35% for a single issuer, in compliance with Art. 22a(2), in order to justify exceptional market conditions;

- The methodology of the index provider will as a rule ensure that the index represents an adequate benchmark for the market to which it refers. This methodology should generally not result in the exclusion of a major issuer of the market to which it refers;

- An index is published in an appropriate manner if:

- it is accessible to the public; and

- the index provider is independent from the index replicating UCITS in question. This does not preclude them from forming a part of the same economic group with the existence of adequate Chinese walls.

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

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.

Response

In general, we agree with the approach as suggested in box 18. However, we would object to the requirement, of the first indent, that a UCITS should provide appropriate information for subscribers in its simplified prospectus if the limit for investment in shares and/or debt securities issued by the same bodies is raised above 20% and to a maximum of 35% for a single issuer. It should be sufficient for a UCITS to rely on the general investment restrictions set out in the prospectus. In particular, there is a requirement that the index must be published in an appropriate manner. One assumes that the purpose of this requirement is to ensure that subscribers will, at all times, have adequate up to date information in relation to the composition of the index and the concentration of positions in the relevant index. As market conditions may change over time this may mean that a particular UCITS may need to avail of this provision at certain times and not at other times. Accordingly, to introduce a specific provision in the simplified prospectus would possibly mislead investors by creating the impression either that this level of concentration does or does not arise whereas the actual market position may be more fluid. Accordingly, we would submit that this requirement is not necessary.