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S O L I C I T O R S

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CESR'S ADVICE ON CLARIFICATION OF DEFINTIONS CONCERNING ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS – CONSULTATION PAPER

Dillon Eustace is pleased to have the opportunity to participate in CESR's consultative process and to comment on the consultation paper issued by CESR, March 2005.

Before commenting on some specific aspects of the consultation paper we have taken the opportunity to express some thoughts on the potential for UCITS III and our hopes for the development of the collective investment industry under the Directive.

The forum represented by CESR gives a unique opportunity to create an investment product that serves investors well over the coming years. To take a restrictive view for reasons other than appropriate investor protection is to undermine the UCITS initiative. If the European Union does not develop as strong environment for investment products, other centres, outside Europe will develop a centres of excellence. As advisers, we know that nothing is more frustrating for promoters and investment managers then when very valid investment strategies are not permissible because of highly prescriptive rules and limits. In many cases, this cannot be helped because of the nature of the UCITS product, but there are also many occasions where the rationale is hard to justify or understand.

It occurs to us that different views have been expressed in relation to CESR's mandate. On more than one occasion, the view has been expressed that CESR's mandate is limited "to clarification of the definitions in order to ensure uniform application of this Directive throughout the community". Whether or not CESR's advice goes beyond its remit, we would urge that nothing is proposed which would limit further the opportunities presented by the Directive itself. The Directive is designed for retail investors and contains all the protections that one would associate with a retail regime. It serves no purpose to read restrictions into the Directive which are not already there.

For example, when considering whether extra criteria should be imposed in relation to that proportion of the assets which can be invested in non eligible assets, it should be borne in mind that a restriction of 10% is imposed for that very reason. Equally, the Directive itself contains detailed protections relating to risk concentrations and therefore it should not be necessary to impose detailed and extra restrictions and criteria in relation to underlyings, for example, to closed-ended funds. Instead, within the broad requirements for diversification as provided for in the Directive, investment managers which are themselves subject to regulation, should be allowed to do the job for which they are paid.

There is a good case to be made that UCITS I was overly restrictive and as a consequence its potential was constrained. By the same token, the experience in terms of investor protection was good and consequently we would strongly argue that the new Directive should not be interpreted so as to prevent any investments or strategy which was permissible under UCITS I. Some of CESR's advice, particularly in relation to criteria which might be imposed for investment in certain asset classes and their underlyings could lead to uncertainty when it comes to making investments.

Turning to the specific aspects of the consultation paper we would comment as follows:-

Clarification of Article 1(8) (Definition of Transferable Securities)

Do we agree with the approach to the treatment of transferable securities and structured financial instruments outlined in the draft advice?

No, we do not agree with the approach taken. The Commission requested consideration of the factors to be used in determining if financial instruments whose underlying involves products of varying degrees of liquidity meet the requirements for recognition as a "transferable" security within the meaning of the UCITS Directive. Structured financial instruments must, to be permissible investments for a UCITS, fall within one of the permitted categories of investment, one only of which is "transferable securities". In formulating its draft advice CESR purports to introduce new requirements with respect to "transferable" securities.

In determining whether or not a structured financial instrument is a "transferable security", in our view, consideration should firstly be given to whether the relevant asset is a "security" and secondly whether it is a "transferable" security. However the draft advice focuses on matters which are more appropriate for consideration in the investment management process of a UCITS rather than in determining considerations of transferability (which we understand to mean whether the relevant assets are securities which are under their terms of issue transferable/can be transferred).

In determining whether an asset is a "security" we submit that Article 1.8 provides sufficient guidance although we believe the word "other" before "negotiable securities" should be omitted from the third indent as it implies that shares and bonds as referred to in the first two indents are negotiable whereas this may not in fact be the case. In determining whether a security is "transferable" we submit investors in securities would typically have regard to restrictions imposed under the constitutional documents of an issuer in and/or by the law of the country of incorporation of the issuer, rather than "liquidity". In determining transferability, whether or not a security is listed and familiarity with the rules of the relevant exchange will be important as typically a stock exchange will require that a security proposed to be listed is freely transferable thereby relieving the UCITS of investigating the constitutional documents and local law pertaining to the issuer.

We submit liquidity is a relevant consideration in determining the ease with which securities can be bought and sold and therefore a matter to be considered within the relevant investment management process, having regard to the obligation of the UCITS to redeem units on request, rather than in the context of the legal meaning of transferability.

Specifically with respect to liquidity, CESR's view that the liquidity of individual securities should be considered and individual securities must not compromise overall liquidity exceeds the Directive's requirement at Article 37 that UCITS must redeem units at the request of unitholders. The Directive at Article 37.2 permits the temporary suspension of repurchase of units in exceptional circumstances, implicitly acknowledging that there may be circumstances in which the UCITS may not have liquidity. We also point out that (a) the mandate from the Commission recognises that assets underlying financial instruments may have "varying degrees of liquidity" (ie some assets may be more liquid than others); and (b) Article 19.4 of the Directive permits UCITS to hold "ancillary liquid assets" thereby recognizing that all assets held by a UCITS need not necessarily be liquid.

We would also strongly caution about attaching extra criteria and prescription to transferable securities which fall under Article 19(2).

Considering the practical effect, we believe this approach, if taken, would cause confusion as UCITS may interpret the advice as meaning that only structured financial instruments which are (i) "transferable securities" and (ii) comply with the advice given, may be acquired, whereas in fact a permissible structured financial instrument could be either a transferable security or any of the permissible categories of "liquid financial asset" referred to in Article 19(1) of the Directive. The approach taken merges the questions of "transferable securities" with investment management processes.

Closed Ended Funds as "Transferable Securities"

Considering whether the reference to "unacceptable risks" in the context of cross-holdings require further elaboration, generally we believe the approach taken in the draft advice is prescriptive and limiting. In determining whether closed ended funds should be invested in, a UCITS must consider whether the relevant share/unit constitutes a "transferable security" or other permitted UCITS investment under Article 19(1). In determining whether an asset is a transferable security, regard should be had to the criteria outlined in our response to question 1 above.

On the assumption that a closed ended fund in any particular circumstances constitutes a "transferable security", adequate risk spreading/reduction requirements are already specified by the Directive e.g. maximum single issuer exposure requirements and restriction of investment in unlisted securities. In particular if a security issued by a closed ended fund is listed on a recognised exchange, the issuer will have undergone a rigorous listing approval process which will have considered such matters as risk spreading and investor protection. In many cases risk spreading and investor protection in listed closed ended funds will be greater in a closed ended fund than in a directly held investment. Whether or not an investment is appropriate will be determined by a UCITS having regard to the investment objective and policies of the UCITS as disclosed in the Prospectus for the scheme. We believe (i) regard should be had to the objectives and policies of underlying schemes for consistency with the UCITS scheme and to the approach taken by the underlying scheme with respect to risk spreading (ii) and appropriate risk disclosure should be made in the UCITS prospectus but that further detailed assessment of the underlying fund should not be required.

In light of our comments above, in summary, we do not believe reference should be made to "unacceptable risks" which is an imprecise term nor should an attempt be made to further elaborate the meaning of "unacceptable risks".

In considering whether in order to be considered as an eligible asset for a UCITS, a listed closed end fund should be subject to appropriate investor protection safeguards, please see our comments above with respect to the approval process for listed funds which we believe afford adequate investor protection safeguards.

In the context of Q5, please see our comments above with respect to risk diversification. On the assumption that the underlying fund diversifies risk (which will typically be a requirement for listed funds) we do not believe further detailed assessment of the underlying scheme is needed.

In the context of Q6, we believe the key issues with respect to underlying listed funds is risk diversification (not necessarily as specified for UCITS but as permitted by the relevant exchange on which the fund is listed) and investor protection criteria (as adopted by the relevant exchange). It should be possible for a UCITS to rely on the safeguards employed by listing exchanges, which, when coupled with a prudent investment management process and adequate and clear disclosure to investors, in our view, provides sufficient investor protection without further "look through" analysis.

We believe investment in closed ended schemes should not be limited (nor is it by the Directive) to listed closed ended schemes. Investment in unlisted closed ended schemes will of course be subject to the restrictions specified in the Directive for unlisted investments.

We agree that investments made under Article 19.2(a) of the Directive will be investments which do not comply with the requirements specified by Article 19.1. However we do not accept that unlisted closed ended schemes are unlikely to constitute "transferable securities" and refer you to our analysis of how a "transferable security" should be assessed (at our response to question 1 above) and our last paragraph at our response to question 6 above.

In general, we do not support the application of the draft advice in Box 1 to investments under Article 19.2(a). These investments are limited to 10% of NAV and under UCITS I were not subject to such criteria.

Clarification of Article 1(9) (Definition of Money Market Instruments)

We would suggest that the advice in each of the boxes dealing with these instruments is too prescriptive. The advice should be modified to give broad guidance in relation to eligibility. However, it should be left to the Manager to determine that a given security falls within the definition of an MMI in the Directive.

Aspects of the advice under this heading contemplate looking through the instruments to the underlying exposures. Both under this heading and other headings, there is no requirement in the Directive to look through the instrument and we strongly support the view that such an approach is dropped.

We would support the proposition that money market instruments which are dealt in on a regulated market should be considered as liquid and having a value that can be accurately determined.

With regard to box 7 we note the presumption in relation to the Economic Area and G10 countries. We would caution against a counter presumption such that instruments in establishments outside this area become problematic.

In relation to box 8, we believe that it should be a matter for the Manager to decide whether asset backed securities or synthetics constitute MMIs.

Clarification of Scope of Article 1(8) (Definition of Transferable Securities) and "Techniques and Instruments referred to in Article 21

We support the proposed advice under this heading but argue that it is for the Manager to determine whether adequate measures are adopted. There is no requirement specified in the Directive in relation to the level of risk arriving from techniques and instruments and maximum flexibility should be afforded managers so as to manage the portfolio in the best interests of investors. References in box 10 should not be used by competent authorities to pass judgment on managers, for example, as to what constitutes "acceptably low levels of risk".

Embedded Derivatives

We would recommend that Article 21(3) should not apply to circumstances where a derivative is not embedded in a transferable security or money market instrument but instead is being used to hedge risk. Therefore, it is important that the definition cannot be interpreted as applying to hedging situations. We further submit that in relation to paragraph 3 of box 11 that it is for the Manager to decide what constitutes an embedded derivative. By giving examples, will this not prompt competent authorities to second guess investment managers?

Other Collective Investment Undertakings

Box 12 lists factors which can be used as a guide. There is a danger that any deviation from these factors will prove difficult.

Financial Derivative Instruments

The Mandate from the Commission on this topic is for advice on the factors to be used to determine whether and under what conditions any given situation a derivative financial instrument especially a credit derivative instrument falls within the scope of the definition under Article 19(1)(g). In short, CESR's mandate is to determine under what conditions FDI can be considered as eligible assets for UCITS. We would suggest that in making this determination, primary considerations should be:-

- Permitted FDI should not facilitate or permit the circumvention of the principles and rules set out in the Directive.

- Are the risks of a nature and extent consistent with the principles of the Directive.

- Would the opportunity to invest in such investments be attractive to investors and in principle be in investors interests and thus desirable.

If the relevant Financial Derivative Instruments meet these criteria, CESR and its interpretation should be sympathetic to the aims and goals of promoters of a financial product who provide choice and opportunity for investors. To take a narrow and unimaginative interpretation is to sell the concept of a single financial market short.

The primary question must be, assuming that the answers to the three questions mentioned above are in the affirmative, whether the risks associated with FDI in financial indices are the same or of a similar nature to those associated with direct investment in non-eligible assets. If the risks are different and of a nature consistent with the principles of the Directive then investment in such instruments should be permitted.

In the consultation paper in paragraph 90 it is pointed out that members views differ on whether financial indices based on non-eligible assets should be considered as eligible underlyings. The Directive does not distinguish between eligible and non-eligible assets in this context but instead talks about financial indices which is an asset class in its own right. An index on commodities is not the same thing as a commodity. The nature of the exposure is different. To allow investment in financial indices based on a basket of hedge funds or commodities will not result in a circumvention of the principles and rules set out in the Directive.

The criticism of many initiatives in the creation of a single market and it is particularly the case with respect to UCITS I is their narrow scope and limited potential. Therefore, provided investors are not exposed to unacceptable risk or risk which is inconsistent with the Directive as a whole the Directive should be interpreted so as to facilitate the interests of investors.

We would strongly support the view that there is no requirement to look through to the constituents of the index itself.

In relation to commodities we would support the view that the financial indices on commodities should be permissible. The requirement for a derivative to be based on a financial index on financial instruments based on commodities adds a further step with no obvious extra protection.

With respect to creditor derivatives we would suggest that the considerations referred to earlier should be applied when contemplating the permissible extent of investment in credit derivatives. We feel that the draft level 2 advice on this point is reasonable.

It might be relevant and at the risk of being impertinent, to suggest that regulators have an image problem too and if they are perceived always as being conservative and obstructive, they will lose the goodwill of the product designers and the market. There may well be a concern of pushing the envelope too far but where there is potential to use imaginative interpretation without unreasonable consequent risks, this should weigh heavily on the minds of the industry. It should be borne in mind that the overall objective of the industry as a whole including regulators is to make available suitable products in an orderly and regulated manner. The aim of the Directive is to expand the number of suitable products and therefore it is incumbent on the industry not to interpret the Directive in the most restrictive manner,

particularly if the only purpose or result is the protection of home markets to the frustration of quality product producers. It does not serve the consumer well and serves to limit choice.

Index Replicating UCITS

A number of interested parties have advised against prescribing an estimate of the quality of the index replication. We would support this view. The danger generally of imposing such conditions will be to make the UCITS III product particularly cumbersome and unworkable. The Directive provides a minimum framework for investor protection, but it is for the investment managers to invest on behalf of investors.

Equally, we do not support maximum thresholds. Such prescriptive conditions make such funds difficult to operate and, for example, do not take account of specific or extreme market conditions.

We would be happy to discuss any of the points raised in this submission and to be involved in any initiative following on from the consultative process.

Yours faithfully,

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David Dillon
on behalf of Dillon Eustace