Fondbolagens Förening

2005-11-21

Committee of European Securities Regulators

11-13 Avenue de Friedland

75008 PARIS FRANCE

Comments on the second consultation on CESR's Draft Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS

SIFA, the Swedish investment Fund Association[1] has been given the opportunity to comment on the above-mentioned CESR consultation and would like to submit the following comments.

General Comments

SIFA would like to express its appreciation for the work done so far by CESR regarding definitions on eligible assets.

As members of the European Fund and Asset Management Association (EFAMA) we support the position paper submitted by EFAMA and concur with the views expressed therein. We therefore limit our comments to a few issues raised by our members as of particular interest to the Swedish fund industry.

[1] SIFA represents the Swedish fund industry through our 31 member companies, which together represents around 95 percent of the fund assets under management in Sweden. For more information please visit www.fondbolagen.se.

THE SWEDISH INVESTMENT FUND ASSOCIATION, STUREPLAN 6, 114 35 STOCKHOLM, SWEDEN
PHONE: +46 8-506 988 00, FAX: +46 8-662 53 39, E-MAIL: FBF@FONDBOLAGEN.SE
WWW.FONDBOLAGEN.SE

Specific comments

Comments on questions 1 and 2
SIFA believes that the requirements in Box 1 and 2 that a security must be freely negotiable on the capital markets need to be clarified. What is especially important to make clear is how a right of first refusal can be said to affect the negotiability of a security. Divergent interpretation of the above mentioned in the Member States could severely affect the competition between UCITS set up in different Member States.

The right of first refusal in a shareholder's agreement and the articles of association can be construed in different ways. Sometimes the conditions set up mean that the shares can only be sold to another existing shareholder. In other cases the conditions set up mean that the other existing shareholders have to be offered to buy the shares from the shareholder that wants to sell off shares. If none of the other existing shareholders have, within a stipulated time frame, declared themselves willing to buy the shares, the shares can be sold outside the group of existing shareholders.

A total prohibition for a UCITS to make investments in shares issued by companies where the shareholder's agreements or the companies' articles of association set up conditions regarding the right of first refusal would make it very difficult to make investments in unlisted companies or companies in a pre-IPO phase.

It should at least be possible for the UCITS to make investments in shares issued by companies where the shareholder's agreements or the company's´ articles of association set up conditions that the shares must first be offered to existing shareholders but can then be sold to someone else (as described above). At least this should be allowed for investments set up in section 19 (2)(a) of the Directive.

Regardless of the above, the UCITS should at any time be able to comply with Art. 37 of the Directive.

For further comments see EFAMA's comments.

Comments on box 3

SIFA strongly supports the new approach concerning closed ended funds as transferable securities. We would however appreciate some clarification about point 3 of box 3:

"UCITS may not make investments in closed end funds for the purpose of circumventing the investment limits provided for UCITS by the directive".

SIFA fears that this wording can lead to divergent interpretations by the different supervisory authorities. Especially if the sentence is interpreted as implying that a look-through method is required, which is not the case for transferable securities defined in box 1 and 2. Further the advice does not include a definition of a closed ended fund and SIFA worries that the combination of a look-through requirement and a wide interpretation of what a close end fund is, could lead to a situation where for example Holding Companies like *Investor* or *Industrivärden* who together represent app. 4 per cent of SIXPX[2] would be excluded as a transferable security as defined in box 1.

Comments on box 11

SIFA would like to repeat its criticism regarding the definition of embedded derivatives from the last position paper. SIFA believes it is important that it be clarified in the advice that, for the purpose of deciding whether a certain financial instrument embedding a derivative is eligible for a UCITS, it is the nature of the host contract that is decisive, and that the UCITS is not deemed to be *investing* in the embedded derivative. Otherwise SIFA fears that the definition proposed by CESR can have a negative impact on the Swedish market, as "non-sophisticated" UCITS would no longer be able to invest in traditionally important financial instruments such as con-

[2] SIXPX present the average performance on the Stockholm stock market adjusted for the restriction preventing investment funds (UCITS) from investing more than 10 percent of their assets in shares in one and the same company.

vertible bonds. SIFA strongly supports EFAMA's proposal for the following definition:

A transferable security or a money market instrument can be said to include an embedded derivative when:

a) It embeds a derivative instrument materialized by a contract with a third party and
b) It replicates all the characteristics of the derivative products or the underlying risk, that is:
    i. It allows the full transfer of the underlying risk;
    ii. Does not modify the inherent risk using methods such as mutualisation, credit enhancement, active management of the underlying.

If CESR decides to press ahead with the definition in the proposal it is imperative that transitional rules are included.

Boxes 13 and 14

SIFA would like to raise the question of the eligibility of investing in futures on individual commodities for future reference, especially in the light of the possibility to invest in commodity indices. We are aware that commodity futures are not mentioned in art. 19 (1)(g) but we feel that CESR for the sake of consistency at least should indicate their opinion on this matter in the technical advice.

There are a number of reflections that could be made in regard to individual commodity futures in UCITS:

1) From a wealth creation perspective it is not in the interest of the unit-holders to exclude commodity futures. Commodity futures have historically shown a positive performance over time.

2) SIFA believes that there is a logical flaw in allowing futures on commodity indices as eligible instruments and at the same time exclude individual commodity futures. A parallel can be drawn to only allowing UCITS to invest in indices of

volatile equities, e.g. commodity producing-, bio technology- and information technology stocks etc, but not in the individual stocks. SIFA challenges the assumption that individual commodity futures contain more risk than e.g. the above-mentioned stocks or e.g. unlisted securities. SIFA believes it is unreasonable to allow investments in plain vanilla calls and puts, while not accepting investments in individual commodity futures. Both the normal volatility risks and the exceptional event risks tend to be higher in options on equities than they are in commodity futures. Beside the risk of fluctuating prices, there is the risk of mispricing etc. Clearly, unlisted securities (without a market determined price) are far more risky in that regard than a market listed commodity future. From a price quality perspective, there are many individual stocks that have a lesser liquidity (and thus a lower price quality) than commodity futures.

3) From a macro-economic perspective, it would be beneficial to achieve a better balance between supply and demand for commodity futures. SIFA believes that the combined group of sellers of commodity futures historically has been significantly larger than the group of buyers. Opening up single commodity futures to UCITS would help to achieve a better balance.

4) Consumers investing in UCITS do not primarily seek alpha on a standalone basis, but rather alpha in relation to the risk assumed. Diversification is best achieved by combining uncorrelated or negatively correlated assets with each other. Giving the fund manager the ability to include single commodity futures in the portfolio, rather than just futures on commodity indices, would facilitate construction of more efficient portfolios than by just being able to use commodity index futures. In some instances, some specific commodities do a good job in reducing the overall portfolio risk, in other situations; another subgroup of commodities does a better job. By just allowing futures on commodity indices, the fund managers' toolbox to efficiently manage risk decreases.

Above, we have tried to briefly describe the theoretical as well as practical benefits associated with commodities futures (alpha opportunities as well as increased risk-spreading) for the unit-holders. SIFA believes the “political” discussion on commodity futures mirrors the discussion in regard to derivatives in earlier years. SIFA would like CESR to expand its discussion on commodity futures in its technical advice to the Commission and if possible urge the Commission to do some further work in the area.

We hope our comments will be of assistance to CESR and we are naturally at your disposal should you have any questions regarding our comments.

SWEDISH INVESTMENT FUND ASSOCIATION

Pia Nilsson
Managing Director

Joakim Uvegård
Legal Counsel