



26 November 2004

Committee of European Securities Regulators
11-13 avenue de Friedland
75800 Paris
FRANCE

Formal mandate to CESR: Call for evidence – Eligible Assets.

Dear Sir

Schroders is a global provider of investment services with over €140 billion under management and offices in 30 countries. With regard to the UCITS Directive we have fund ranges in two EU jurisdictions. In Luxembourg we currently have four UCITS qualifying SICAVs totalling approximately €17.5 billion funds under management and of these, our flagship product; the Schroder International Selection Fund, is registered in 13 EEA jurisdictions and 22 countries world-wide. In the United Kingdom we have a range of UCITS qualifying unit trusts totalling approximately €14 billion funds under management which is sold to both UK retail and institutional clients

Given our business, we are very interested in any initiative relating to the UCITS Directive and have the following views as to what CESR should consider in its advice to the European Commission in relation to the clarification of definitions concerning eligible assets for investment of UCITS schemes.

Clarification of Article 1(8) (Definition of transferable securities)

3.1.1 Treatment of 'structured financial instruments' & 3.1.3 Other eligible transferable securities

We suggest that when considering the definition of transferable security CESR should look at both the issue of 'transferability' as well as what is a 'security' from first principles.

'Transferable' should be interpreted as ensuring that the title to the instrument can be freely transferred. That is to say that if the instrument cannot be transferred, or only be transferred with the consent of a third party, then it is not 'transferable' and cannot be invested in at all. The listing of such an instrument on a regulated exchange makes the legal transfer easier but is not of direct relevance to the definition. So we do not think there is a direct link between the definition of 'transferable security' with the underlying liquidity of the instrument.

The need for a UCITS to invest in liquid transferable securities (to meet the requirement of the UCITS to be able to be valued accurately and dealt regularly) is addressed by the mechanism provided for in Article 19. If the transferable security is traded on an eligible market it is deemed to be adequately liquid and so it and other such transferable securities may be invested in without limitation. Where transferable securities are not traded on such a market they can only consist of up to 10% of the UCITS under Article 19(2), thereby restricting UCITS investment in potentially illiquid transferable securities.

In determining what a 'security' is, the definition contained in the Directive provides that this includes 'bonds and other forms of securitised debt ('debt securities')'. The primary consideration of this part of the definition should be to accept the general market understanding of what is meant by 'securitised debt' and it is irrelevant for the purposes of the definition (but not for other parts of the Directive) as to whether the underlying structure of such securitised debt includes asset classes that are not eligible for a UCITS to invest in directly. We point out that should there have been a need to 'look through' the structure in the definition, the Directive would have provided such wording equivalent to that found in Article 21 (3) within the definition.

3.1.2 Closed end funds as 'transferable securities'

We strongly support the proposition that shares in closed ended funds should fall within the definition of transferable security and so be an eligible investment to the extent that they comply with all the relevant conditions foreseen in the Directive. We suggest CESR takes into consideration the informal commentary accompanying the original Directive (the 'Vandamme commentary') which makes it clear that such an interpretation should prevail¹. Any alternative interpretation would surely have been signposted in the amending Directives and the absence of any specific Article or Recital when the amending Directive was published provides weight to this view.

Clarification of Article 1(9) (Definition of money market instruments)

3.2.1 General rules for investment eligibility

We suggest to CESR that the prime definition of money market instrument is Article 1(9). The factors that are relevant are that the instrument is normally dealt on a money market, is liquid and can have its value accurately determined. It would seem reasonable to assume that Article 19 (1)(a) to (d) listed money market instruments are therefore a sub set of the Article 1(9) definition.

We would point out to CESR that in determining its advice it should focus on the history of Article 19 and the fact that several jurisdictions define some money market instruments as transferable securities (i.e. falling within 'debt securities'). By doing so this interpretation resulted in the original UCITS Directive Article 19(2)(b) being an empty shell. However, this should not necessarily be a concern given the additional investment flexibility the new Directive now provides by explicitly including money market instruments in the Directive, and the Commission would have been aware of these issues given the Article 20 notification requirements accompanying the original Directive.

We suggest CESR's advice could usefully focus on the subset of money market instruments not dealt in on a regulated market. That is on the definition of 'money markets' where these are not regulated markets and specifically the degree of valuation accuracy and liquidity necessary to meet the definition.

Clarification of the scope of Article 1(8) (Definition of Transferable Securities) and "techniques and instruments" referred to in Article 21.

In framing its advice we suggest CESR considers the prime motive behind Article 21(3) when reference is made to 'When a transferable security or money market instrument embeds a derivative'. We point out that the very fact that the wording of the Article is as it is means that such instruments **must** be treated as transferable securities or money market instruments – otherwise why make such a reference?

We would suggest to CESR that the prime motive behind Article 21(3) is to stop a UCITS structuring derivatives into a transferable security (that are not based on an index) so as to avoid the 'look through' requirement of Article 21 (3) 3rd paragraph, first sentence. The Directive is not looking to prohibit derivatives being structured in such a way, merely trying to ensure consistency of treatment when compared to a derivative not structured in such a way.

If CESR agree with this principle motive, then we suggest in its advice to the Commission it would be useful to provide examples of how such transferable securities are treated. For specific examples we suggest:

- a) a transferable security that embeds a derivative based on a commodity would not be an acceptable investment as the commodity does not meet the eligible assets of a UCITS scheme given Article 19(2)(d);

¹ See paragraph 107(d) of the Vandamme commentary which states: 'The restrictions in (a) and (b) above do not apply to investment in the units of collective investment undertakings of the closed-ended type.....This is entirely justified since the units of the undertakings of the closed-ended type (which normally have a stock exchange listing) are similar to any other transferable security, and from the standpoint of the Directive's rules on investment, they have to follow the general rules applicable to transferable securities'.

- b) a transferable security that embeds a financial derivative which gives an exposure to one share only resulting in the subsequent economic exposure of 50% to that one share would not be acceptable since the exposure does not respect the 10% spread limit of Article 22(2)); and
- c) a transferable security that embeds a derivative based on a financial index would be acceptable given Article 19(1)(g) and Article 21(3) 3rd paragraph.

Other collective undertakings

We suggest to CESR that a general factor to take into consideration is that if a collective investment scheme is available to be sold to the public in a territory subject to regulatory oversight then it is highly likely it offers adequate investor protection anyway, given that regulators throughout the world are looking to protect the public. However, we recognise that the Directive wording looks to ensure 'equivalent' rather than 'adequate' supervision and investor protection.

We would suggest that in its advice CESR looks to a solution that results in the use of IOSCO principles relating to collective investment schemes as the basis on which equivalence is tested. It is appreciated that at present not all territories have yet to be audited to confirm their compliance with these principles. In the interim where one Member State has accepted a particular jurisdiction as offering equivalent investor protection, we suggest that analysis is provided to all CESR members to ensure a common list is produced and maintained.

Derivative Financial Instruments

Our previous comment on the definition of transferable security, and its relationship with Article 21 is relevant here. In addition we suggest that irrespective of CESR's view on the use of credit derivatives as investments in their own right under Article 19(1)(g), that CESR confirm that credit derivatives are a useful tool to manage risk (credit and duration), in relation to bond portfolios and therefore their use as a technique and instrument falling under Article 21(2) is not in doubt.

"Index replicating UCITS"

We suggest to CESR that in its advice to the Commission on 'replicating the composition of an index', it consider the impact of the derogation from Article 22 that Article 21(3) provides. Since the Article 21(3) derogation would allow the spread rules to be disregarded when an index derivative is used to replicate the performance of an index, we suggest the Article 22a(1) derogation which allows a partial relaxation of the spread rules will be rarely used in practise.

Yours faithfully



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