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

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

Submission by Gold Bullion Holdings Limited

Dear Sirs

This submission is made to The Committee of European Securities Regulators ("CESR") by Gold Bullion Holdings Limited ("GBH"), in response to the 2nd Consultation Paper on CESR's Draft Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS.

GBH is a private company owned by several participants in the financial services and gold mining and processing sectors, including the World Gold Council and ETF Securities Limited. GBH is aware that those organisations have also made submissions to CESR, and GBH supports those submissions.

GBH's main submissions follow, however we have also included some additional information which is attached as an appendix. The appendix examines in more detail; the origination of the precious metals exclusion in the first UCITS Directive, evidence of existing eligible commodities exposure and how a gold price tracker may be a more efficient way for UCITS managers to diversify the UCITS and to manage its liquidity and portfolio holdings.

Background to Gold Bullion Securities

GBH is the holding company of Gold Bullion Securities Limited ("GBSL"). GBSL has issued debt securities ("Gold Bullion Securities") which are listed for trading on the London Stock Exchange and Euronext.

Gold Bullion Securities entitle the holder, upon redemption of the security, to receive payment of a sum of money (alternatively a holder can elect to be paid in gold under

certain conditions). However the amount of the payment is not fixed. Rather, the amount is determined by reference to the prevailing gold price, being the price determined by sales in the “London AM Fix”, which is the internationally-recognised pricing mechanism for gold prices.

Gold Bullion Securities are created in transactions between “Authorised Participants” (banks, who are Authorised Persons under UK regulations) and GBSL, and then traded on a secondary market – for which purpose they are listed for trading on the London Stock Exchange (LSE) and Euronext (respectively GBS: LSE and GBS: Euronext) (both regulated markets). Gold Bullion Securities are marketed by Société Générale under their Lyxor brand.

When an Authorised Participant creates new Gold Bullion Securities, the Authorised Participant pays the full value of the security as at the creation date. Hence the security holder can have no further liability, and his exposure cannot be greater than the amount paid. GBSL then buys and holds physical gold for the purposes of securing its future liability to security holders when the Gold Bullion Securities are redeemed. That gold is beneficially owned by GBSL, but is held subject to a charge in favour of (and is effectively under the control of) a trustee, who holds the charge, and its rights to control disposal of the gold, for the benefit of all security holders. In this way the liability which GBSL has to security holders on redemption of Gold Bullion Securities is fully secured.

Hence, Gold Bullion Securities are secured debt instruments, or debt securities, as described in the definition of “transferable securities” in the UCITS Directive. The only difference between Gold Bullion Securities and more traditional forms of debt securities is that the amount repayable on redemption is not set in dollars, but is set in ounces of gold (another form of currency). The security holder does not own an underlying commodity, rather he owns a debt instrument where the amount repayable on redemption can vary, and is determined by reference to an external, objective market price.

The market for Gold Bullion Securities is very liquid, and holders of these securities are easily able to sell their securities if necessary. Under the terms of the agreements between GBSL and the Authorised Participants, the Authorised Participants have committed to make a market in Gold Bullion Securities.

Gold Bullion Securities have attracted a great deal of interest from the investment community. Many investors and investment funds (including UCITS) have developed comprehensive strategies which involve exposure to commodity prices, and Gold Bullion Securities are a very convenient, cost-effective, and secure manner to provide desired portfolio diversification, through a highly liquid transferable security which is traded in well-regulated markets, with transparent pricing. However the question of UCITS eligibility has caused concern among UCITS. The FSA considers that Gold Bullion Securities are UCITS eligible, but other regulators have expressed uncertainty.

Consequently GBH requests that the question of GBS’ UCITS eligibility be clarified through this consultation process.

Primary Submission of GBH

This paper sets out a number of submissions of GBH, in relation to some of the questions raised by CESR in the 2nd Consultation Paper. All of these submissions are set out in **bold type**. However there is one primary submission, as follows:

The primary submission of GBH is that freely-transferable debt securities, which do not convey ownership of a physical commodity but whose redemption payment amount is dependent on prevailing commodity prices determined in a transparent manner, and which securities are themselves traded in a regulated market, should be eligible for investments by UCITS.

GBH would be happy to provide further details of Gold Bullion Securities, and to meet with CESR representatives to discuss these issues in detail, if requested.

The Purpose of the UCITS Directive

CESR has set out in some detail the purpose of the UCITS Directive, and the approach being taken by CESR to its task. GBH accepts and supports the views expressed by CESR.

In particular, given that UCITS are authorised to be sold to private retail and institutional investors alike, it is appropriate that the Directive requires UCITS to follow strict guidelines on investment spread, fund liquidity and disclosure to ensure that retail investors in UCITS are adequately protected.

For this reason, the Directive prohibited investments in physical assets: precious metals or property (other than where the property is used in the business of the UCITS). This prohibition has widely been interpreted to apply not just to precious metals but to any commodities.

However it very clear, and it is important to understand, that the prohibition in respect of precious metals was not intended to be a prohibition against exposure to precious metal prices. There is no doubt that UCITS can invest in companies which mine and produce precious metals, which clearly is an exposure to precious metal prices. Rather, the prohibition was for reasons of liquidity and disclosure. At the time of the Directive, in 1985, investments in precious metals were not uncommon, but there was not a liquid market and there were valid concerns about transparency of pricing. This was the reason for the prohibition.

Nevertheless some UCITS and even some regulators have expressed concern that pricing mechanisms which have a component of commodity pricing might contravene the precious metals prohibition.

GBH submits that securities which are freely transferable in a regulated market should be UCITS eligible unless there are valid reasons for concerns about liquidity or disclosure (including transparency of pricing mechanisms). The fact that a debt security is based on or includes a component of pricing which involves exposure to

commodity prices is irrelevant, as long as the security otherwise qualifies as a transferable security.

GBH requests that CESR make clear that the prohibition in relation to precious metals (or any commodities) relates only to the holding of physical commodities, not to debt securities which are priced by reference to commodity markets.

The Question of Liquidity

GBH agrees with the approach set out in the draft Level 2 advice in Box 1. The only concern we have is in relation to item4, which says: “Where the security embeds a derivative element, such derivative element must be taken into account, as required by Art. 21(3)”.

GBH understands and supports the intent of this provision. However GBH wishes it to be made clear that this provision has no application to fully-paid debt securities whose redemption price is wholly or partly determined by reference to commodity prices. Securities such as Gold Bullion Securities are not derivatives of the type described in that Article.

Other Eligible Transferable Securities

GBH agrees with the approach suggested in Box 2.

Closed End Funds as “Transferable Securities”

GBH agrees with the approach suggested in Box 3.

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

GBH agrees with the approach suggested in Box 10.

However GBH submits that debt securities priced by reference to prevailing commodity prices are not “financial derivative instruments” as described in the draft advice.

Embedded Derivatives

Subject to clarifying the following concern, GBH agrees with the approach suggested in Box 11.

The draft advice proposes that, 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.

GBH interprets this proposed approach as requiring that **all three** of the above conditions must be met before a transferable security can be considered to be an embedded derivative.

GBH submits that debt securities priced by reference to prevailing commodity prices are not embedded derivatives, because the second condition is clearly not met, i.e. it cannot be said that there is a separate component whose economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract. Rather the entire instrument has a single set of economic characteristics and risks. The 3rd condition is also not met; while the price of the underlying commodity is linked to the price of the security, the underlying commodity does not change the price or risk of (and hence has no impact on) the security in the way in which an embedded derivative would change the price and risk of the host contract.

Financial Derivative Instruments

A UCITS is an undertaking “the sole object of which is the collective investment in transferable securities and/or other liquid financial assets referred to in Art. 19(1)”. Financial derivative instruments are addressed in Art. 19(1)(g).

GBS submits that the clear intent of Article 19(1) is to permit the investment by UCITS in transferable securities (as defined by the Directive), and also in certain financial derivative instruments. Consequently if a security is a transferable security (as defined), then the question of whether it is a permitted type of financial derivative instrument does not arise.

CESR’s advice should clearly state that questions concerning what is an acceptable financial derivative instrument only arise if the instrument in question is not a transferable security (as addressed in Box 1 in the draft advice).

The following comments relate to what should constitute an acceptable financial derivative instrument which is not a transferable security.

GBH accepts that UCITS may not invest directly in gold. GBH also accepts the principle that derivatives should not be used to circumvent the principles of the Directive.

However it is important to bear in mind just what the relevant principle is. The purpose of the commodities restriction is not to prevent UCITS investing in situations which give exposure to commodity prices. If that was the intent, then UCITS would not be permitted to invest in companies which produce commodities, the value of which is largely determined by commodity prices.

Rather, the intent is to prevent investments in assets which are not liquid, or where the pricing or value of those assets is inadequately disclosed.

Consequently GBS submits that derivative instruments should not be excluded merely because they provide exposure to commodity prices.

GBH also wishes to make submissions on what constitutes a “financial derivative instrument” for the purpose of the Directive.

GBH submits that debt securities priced by reference to prevailing commodity prices are not “financial derivative instruments” as described in the draft advice.

Debt securities priced (i.e. where the amount of the debt is determined) by reference to prevailing commodity prices are still, purely and simply, debt securities. The commodity price exposure is the underlying and there is no change to that exposure (there is no embedded derivative).

In the case of Gold Bullion Securities, GBSL actually holds physical gold (acquired using the subscription price paid for the securities), as security to enable it to be able to meet its liability to security holders on redemption of the security. However that gold is merely security to ensure that GBSL has the money it needs to pay its security holders. Physical gold is a good form of security, because by definition it can be sold for an amount equal to the prevailing gold price, which equals the liability which GBSL has to security holders on redemption of their securities. That security could just as easily be obtained from other sources, such as a contract with a bank (which took the pricing risk).

GBH submits that where a security issuer merely holds its assets as a means to secure the liability it has to security holders on redemption of their securities, those assets should not be considered as assets underlying a derivative instrument.

Convertibility

Finally, GBH wishes to make some submissions in relation to debt securities which contain a convertibility option.

As set out above, GBH submits that debt securities priced by reference to prevailing commodity prices which meet the criteria set out in Box 1 of the draft advice (fully transferable, admitted for trading on a regulated market, adequate disclosure (e.g. through pricing from another regulated market or other independent pricing mechanism), etc.) are transferable securities as defined in the Directive, and therefore are eligible investments for UCITS without any further questions being necessary.

However it is possible that a security which meets all of those criteria, may also contain an option whereby the security holder (and not the issuer) has the option to take delivery of a specified quantity of the referenced commodity instead of payment of the debt.

GBH submits that a debt security which meets all of the requirements of a transferable security, and which also includes a right (but not an obligation) on the part of the security holder to elect to receive commodities (under certain conditions) instead of the payment due, is not excluded from UCITS eligibility because of that option.

If a UCITS elected to exercise that option, that would be a different matter – the UCITS would clearly have chosen to take an investment in an excluded asset. However the fact that the UCITS merely has the right to take commodities doesn't affect the nature of the security. This is no different than the position every UCITS is in at all times – it always has the legal right to sell any security and buy commodities if it chooses, but it would put itself in breach of the UCITS directive if it did so. The essential thing is that the UCITS has no *obligation, or obligation at the election of the issuer*, to take commodities instead of the payment due.

GBH is grateful for the opportunity to make these submissions, and would be happy to provide any further submissions or representations sought by the Committee.

A handwritten signature in black ink, appearing to be "Nik Bienkowski & Martin Byrnes".

Nik Bienkowski & Martin Byrnes
Chief Operating Officer & General Counsel
Gold Bullion Holdings Limited

Below is a summary of why GBH believes the precious metals exclusion originated and why it should not apply to securities which meet the criteria of transferable securities.

APPENDIX

A.1 The intention of the 1985 Directive was to preclude physical holdings

- Only precious metals and certificates representing them were specifically excluded
- The focus on precious metals specifically (and not commodities) may have been because at that time the only type of physical commodities that were commonly held for investment purposes were precious metals
- When the original directive was effected, many investors held precious metals (gold or silver bars or coins) as part of their portfolio, yet the directive wanted UCITS funds to hold only transferable securities and not physical assets such as gold
- The exclusion of precious metals was not based on any view that economic returns from commodities were not suitable for a UCITS (that is a matter for the manager and not the regulator), but rather to prevent funds from investing in something which was not a transferable security
- Some may have argued that the forms of precious metals investment in existence around 1985 may have been transferable securities and eligible securities under the 10% “other” category as stated in Article 19.2(a)

Evidence

Commodities investment in the early 1980s

To assess this exclusion in the directive, it is necessary to look at the environment surrounding the precious metals market in the 1980s. Commodities investment in the 1980s was typically only possible in precious metals, usually via physical gold accounts, gold coins or gold certificates. Kruggerand's were launched in 1967 and were legal tender under the South African Reserve Bank Act (No. 90 of 1989). It was common for investors, particularly European and high net wealth investors, to put 5% of their portfolio into gold. Precious metals certificates prior to 1985 came in the form of certificates or notes issued by Governments, gold certificate plans (example, Perth Mint Certificates) or commodity warehouse receipts, and these forms of certificates usually gave the right to request redemption in physical metal. None of these were transferable securities although some may have tried to argue that some of these forms were transferable securities.

Van Damme and the intention of Article 19.2(d)

We refer to the Van Damme Report regarding commentary on the provisions of the Council Directive 85/611/EEC of 20 December 1985 in Paragraph 93, Van Damme states:

“... it was learnt that the assets other than transferable securities held by some UCITS exceptionally included gold or certificates representing gold. Since this is incompatible with the definition of UCITS, the Directive includes a provision, superfluous thought it may appear, to the effect that a

UCITS may not acquire either precious metals or certificates representing them.”

Van Damme recognizes that this inclusion is superfluous as the holding of precious metals or certificates in 1985 was not a transferable security, and therefore not compatible with the definitions of UCITS.

A.2 UCITS are permitted to buy commodities exposure

- UCITS are permitted to take commodities exposure – they already do this via purchase of companies in the natural resources sector
- Gold companies are highly correlated to the gold price however a gold tracker (a security which tracks the gold price and is cash settled) provides more efficient exposure to the gold price

Evidence

Ordinary equities of listed companies are eligible securities and this includes resource companies with commodities price exposure such as: Newmont Mining (gold), Shell and Exxon (oil), Rio Tinto (diversified commodities). Gold companies, for example, have very narrow business operations and are usually focused on the exploration, mining and production of gold only. This is evidenced by the correlation of their return with the gold price (see Table 1 below). Since gold mining companies are eligible securities for UCITS, it must be that the original UCITS Directive did not intend to prevent all commodities exposure.

Table 1

Correlation with spot gold price

	Amex Gold Index	Newmont	Glamis Gold	Anglogold Ashanti	Placer Dome
10 years (weekly data)	0.731	0.630	0.566	0.609	0.641
10 years (monthly data)	0.755	0.642	0.674	0.582	0.683
5 years (weekly data)	0.712	0.653	0.595	0.597	0.582
5 years (monthly data)	0.738	0.672	0.643	0.587	0.604

source: Bloomberg. Calculations: Gold Bullion Holdings

A.3 Efficient portfolio management and diversification

- The spirit of the UCITS directive is to provide protection to investors while allowing them to efficiently diversify their portfolios
- By excluding exposure to commodities and precious metals, this reduces choice and therefore limits potential diversification
- Commodity trackers (a security which tracks a commodity price and is cash settled) allow more efficient portfolio management:

- o Commodity trackers are negatively correlated to the major asset classes and less correlated to equities and bonds than the securities of resource companies – this results in greater diversification benefit
- o Commodity trackers are less risky as they are not exposed to corporate malfeasance or corporate risks such as financial risk, operational risk, management risk and exploration risk
- o Commodity trackers may allow a UCITS fund whose objective it is to invest in the mining industry to manage its portfolio more efficiently

Evidence

Eligibility of asset classes

Article 1(2) states that the sole objective of UCITS funds is the “principle of risk spreading”. By excluding an entire asset class – commodities – the Directive would be forcing less choice upon UCITS funds, choice which is available to all non-UCITS investors. Since the Directive stipulates the sole objective of risk spreading, we believe that the precious metals and property exclusion in Article 19.2 relates only to the acquisition of physical assets (or possibly unlisted securities). As such, we believe the intention in 1985 was not to exclude an entire asset classes from the range of eligible securities. In addition, it would not have been possible in 1985 for anyone to determine that exposure to a particular asset class was not suitable for all UCITS even though based on the returns and available securities at the time, they may have assumed that the only eligible assets required for UCITS were equities, bonds and cash.

Technical Analysis

Based on some of the qualitative and quantitative criteria used by managers to determine the eligibility, suitability and allocation of any security to a UCITS, we believe that commodity trackers are very efficient and consistent with UCITS.

For the purposes of diversification, managers often look for assets which are not correlated with other assets, particularly equities and bonds. The table below shows the correlation of various oil equities with the S&P500 equity index.

The table shows that:

- commodity equities can have a high positive correlation with an equity index
- An oil tracker has low correlation to equities, showing that direct exposure can result in a more efficient portfolio
- In addition, a commodity tracker has near perfect correlation to the commodity

Table 2

Correlation with S&P500 Index

	Exxon	BP	Chevron	Amex Oil Index	Oil Tracker
10 years (weekly data)	0.502	0.365	0.397	0.479	-0.013
10 years (monthly data)	0.424	0.437	0.444	0.474	-0.048
5 years (weekly data)	0.602	0.591	0.522	0.566	-0.043
5 years (monthly data)	0.461	0.393	0.415	0.458	-0.087

source: Bloomberg. Calculations: Gold Bullion Holdings

Controllable risks

A manager seeks to diversify the UCITS in order to reduce risk. Commodity trackers expose the UCITS to only one risk, commodity price risk and this can be controlled by selling the security. Investing in resource companies exposes the UCITS to additional risks which sometimes cannot be controlled by the UCITS manager: financial risk (bankruptcy), operational risk (mine failures, environmental law suits), exploration risk (spending shareholder's money for no return), and management risk (bad decisions, fraud). As a result, a commodity tracker can reduce portfolio risk and specific investment risk.

Practical Application

To demonstrate the above, we describe an example of where a commodity tracker would be very consistent with the efficient management of a UCITS.

UCITS fund: mining/resources fund

Objective: to invest in the natural resources industry

Management of the fund:

- *Investment opportunities*: once the fund reaches a significant size, the number of investment opportunities are greatly reduced, particularly as most of the large, liquid securities would already be owned by the fund
- *Number of securities*: with significant available cash for investment, a large fund may have to invest in many smaller securities which increases risk, administration and costs and thus may result in inefficiencies
- *Bull and bear markets, or mis-priced securities*: resource companies are usually more leveraged to the underlying commodity than the actual commodity itself. Thus, the ability to buy/sell securities with greater or less exposure to the underlying commodity increases the manager's ability to efficiently manage the portfolio and may enhance returns
- *Liquidity*: managers usually keep a portion of the fund's assets in cash to take advantage of investment opportunities and also to manage redemptions (so that the manager can comply with Article 37 of the UCITS Directive). It may not be optimal for the manager to keep cash available as this results in increased tracking error from the benchmark. If the manager is able to securitise the cash by investing in a commodity tracker, then tracking error is reduced.