

The Law Society's Company Law Committee

The Committee of European Securities Regulators

**Consultation Paper on CESR's Advice on Clarification of Definitions
concerning Eligible Assets for Investments of UCITS**

Response

June 2005

General

1. The Law Society's Company Law Committee welcomes the Consultation Paper on CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS of March 2005 (the "Consultation Paper").
2. The Committee agrees with CESR's comment in paragraph 2 of the Consultation Paper, that 'the even implementation and interpretation of EU legislation is a crucial dimension of the building up of the internal market in financial services'. We note that the European Commission has identified the need to clarify certain definitions of eligible assets of the UCITS Directive as a short term priority and that DG Internal Market intends to make use of the delegated powers conferred on the Commission to clarify some of the definitions and we support this approach.
3. We note that the draft technical advice contained in the Consultation Paper is advice to DG Internal Market to enable it to publish its own clarification of certain definitions and so the advice falls within Level 2 of the Lamfalussy approach, and not as CESR's advice to regulators falling within Level 3 of the Lamfalussy approach. This is particularly relevant where we see the proposed advice in the Consultation Paper as effectively amending the UCITS Directive rather than interpreting its provisions. However, we do note that there are a number of points made in the Consultation Paper which, of their nature, are more akin to general guidance and therefore, we would submit more appropriate to advice to Regulators under Level 3.
4. No recommendation is made in the Consultation Paper as to the effect of the clarification of definitions on existing funds. Given that these funds exist and have solicited money from the public on the basis of investment in particular ways, we suggest that it is essential that such funds receive grandfathering for the lifetime of the respective funds and we invite CESR to make this point in its response to the Commission.

5. In addition to responding to the specific questions raised in the Consultation Paper, this Response comments on Boxes where no questions are raised.

Consultation Paper

Box 1 Treatment of “structured financial instruments”

We have no comments on the detail of the draft Level 2 advice in Box 1. We do however repeat the point we make in paragraph 3 above regarding the character of the advice being given. There sometimes seems to be a dichotomy in the Consultation Paper between wording in the Boxes which might be advice to regulators and wording in the Boxes which is intended to enable DG Internal Market to clarify definitions in the UCITS Directive in comitology instruments. Box 1 reads like Level 3 advice to regulators rather than as advice to DG Internal Markets as to how the Directive might be amended.

Question 1 - Do you agree with the approach to the treatment of transferable securities and structured financial instruments outlined in this draft advice?

We agree with the approach except insofar as it relates to unlisted securities which may be held in a UCITS. The nature of such investments may make compliance with the advice regarding valuation difficult to achieve. The tests within paragraph 2 of the draft advice are aimed at the general liquidity of the portfolio and should recognise that in particular instances some investments may not satisfy the tests as completely as other parts of the portfolio; but the crucial test should be to ensure that overall, on an entire portfolio basis, there is sufficient liquidity for funds of this type.

Question 2 - What would be the practical effect if your view of such an approach were adopted?

As stated in the answer to question 1, it might not be possible for unlisted securities to meet the requirements. This would defeat the point of the Directive allowing UCITS to hold a small percentage of investments in start-up schemes and other less liquid securities.

Box 2 Closed end funds as “transferable securities”

This Box refers to “listed closed end funds”. We question whether this term, which is not used in the UCITS Directive is sufficiently widely understood for its effect to be clear in each jurisdiction. Taking the United Kingdom, is it intended to relate only to collective investment schemes which are closed ended, or might it relate also to investment trust companies, i.e. London listed investment companies, which fall outside the definition of collective investment scheme but which are generally described as listed closed end funds? We agree with the opinion of CESR in paragraph 37, that a listed closed end fund on the face of it

qualifies as a transferable security. We would point out that UK investment trust companies have qualified as transferable securities since UCITS 1 came in.

Question 3 - Does the reference to “unacceptable risks” in the context of cross holdings require further elaboration, if so, how should it be elaborated?

Information regarding cross holdings in listed closed end funds is not necessarily freely available, depending on the type of product concerned and the listing rules of the exchange.

Question 4 - Do you consider that 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? If so, do you consider the proposed safeguards sufficient and clear enough?

Where a closed end fund is listed, the requirements of the local Listing Rules, as harmonised by the Prospectus Directive, should be sufficient for the purposes of investor protection. We do not see a reason why a listed closed end fund should be subject to any greater investor protection safeguards than other listed companies. Open ended funds, not being listed, are subject to a different regulatory regime.

Question 5 - Further to the requirements presented in Box 2 b) CESR is considering to clarify the investor protection safeguards with the following options:

- *the UCITS should verify that the listed closed end fund is subject to appropriate restrictions on leverage (for example, through uncovered sales, lending transactions, the use of derivatives) and that it is subject to appropriate controls and regulations in its home jurisdiction; or that*
- *the UCITS should consider the extent to which the listed closed end fund can leverage (for example, through uncovered sales, lending transactions, the use of derivatives).*

For the reasons stated in our answer to question 4 we do not consider that investment in the closed end fund should be subject to verification that does not apply to investments made in other listed companies. The closed end fund may well use gearing to seek improved performance and may employ derivatives and other instruments in ways not permitted to UCITS funds; but this would not of itself make investment trust companies unsuitable. A decision as to the appropriateness of any closed fund as an investment of a UCTIS would be made by the manager on the basis of the information available to it from time to time.

Question 6 - Should/should not UCITS be required to invest only in such listed closed end funds, that invest in transferable securities, that would themselves be eligible under the UCITS Directive?

Again we do not consider that the Directive should be changed, or interpreted, in such a way as to limit investment in listed closed end funds in this manner. Any such limits would exclude UCITS from investing, for instance, in US REITs. We would refer you to the Vandamme Commentary that accompanied the UCITS Directive, where closed end funds were recognised as being transferable securities available to UCITS : to quote “... the units of the undertakings of the closed-end 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”.

Box 3 Other eligible transferable securities

We are not clear as to why the draft Level 2 advice should contain an expression of CESR’s view, that non-listed closed end funds are highly unlikely to meet the requirements as stated in Box 1. Non-listed closed end funds may be as likely to meet these requirements as any other non-listed company where some form of market may exist in the shares; liquidity should anyway be viewed across the whole portfolio.

Question 7 - Are there any practical difficulties in your experience in defining the boundary between Article 19(1)(a) to (d) and Article 19(2)(a)? Do you consider the suggested approach in Box 3 as appropriate subject to our comments above?

We are not aware of practical difficulties. We agree with the second sentence.

Box 4 MMI - General rules for investment eligibility

We question the statement, presumably of CESR’s view, in paragraph 2 of the draft Level 2 advice, namely that Treasury and local authority bills, certificates of deposit, commercial paper and banker’s acceptances will usually comply with that last criteria. While we generally agree with the points in Box 4 the statement would seem inappropriate for Level 2 advice to DG Internal Market.

Box 5 MMI

We have no comments.

Box 6 MMI

We question the word “control” when referring to whether any information memorandum is subject to review by an independent authority.

Box 7 MMI

No comment.

Box 8 Securitisation vehicles

Question 8 - Do you agree with this approach, and especially the proposal that one of the conditions for the eligibility of asset backed securities and synthetic asset backed securities under Article 19(1) is that they be dealt in on a regulated market under the provisions of Article 19(1)(a) to (d)?

As the Consultation Paper states, this particular structure is most commonly found in France. We have no comments on the draft Level 2 advice.

Box 9 Other eligible MMI

No comment.

Box 10 Clarification of “techniques and instruments”

Paragraph 2 would appear to be unnecessary as Article 21(1) already states this. Otherwise we have no comments.

Box 11 Embedded derivatives

We have no comments.

Box 12 Other collective investment undertakings

We have no comments.

Box 13 Financial derivative instruments

We have no comments.

Box 14 Eligibility of derivatives instruments on financial indices

We agree that the criteria for a financial index should be the same as those for stock and debt securities indices in Article 22(a)(1).

Question 9 - In addition to the criteria developed in the draft CESR advice, CESR is considering the following options:

- *only financial indices based on eligible assets should be considered as eligible underlying for derivatives; or that*

- *the wording of Article 19(1)(g) does not require UCITS to apply a look through approach when concluding derivatives on financial indices. These financial indices should nevertheless comply with the three criteria set down by Article 22a.*

In our view the second option is correct, namely that the wording of Article 19(1)(g) does not require UCITS to apply a look through approach. We do not agree with the emphasis given to Recital (13) upon which the counter argument seems to base its views. The issues regarding derivatives on commodity financial indices raises policy questions such as what level of security should a UCITS confer? Is it considered acceptable, as we would suggest, for there to be increased risk with investor protection relying upon increased disclosure and appropriate risk warnings?

Box 15 OTC derivatives

We have no comments.

Box 16 Credit derivatives

This refers to the risks of asymmetry of information. We suggest this always arises to some extent within a market place. We are unclear what ‘adequate measures’ CESR has in mind for the UCITS to take to limit risks of asymmetry of information, outside the normal investment management procedures which can be expected to be in place if fund managers invest in credit derivatives.

Question 10 - What is your assessment of the risk of asymmetry of information in relation to the use of credit derivatives by UCITS? Which kind of measures should UCITS adopt in order to limit the risk of asymmetry of information?

As mentioned above, we see asymmetry of information as being inevitable. We are unclear as to what kinds of measures CESR has in mind for the UCITS to adopt.

Question 11 - Do you consider that the problem of a potential asymmetry of information between issuers and buyers of credit derivatives can be dealt with by limiting the nature of the issuers on which the credit risk may lie [several alternative combinations]?

We do not see these options as being the correct solution to the perceived problem.

Box 17 Index replicating UCITS

We agree with this approach.

Question 12 - Do you consider that the CESR advice should require UCITS to provide an estimate of the quality of the index replication?

We agree that a UCITS should inform investors of the extent to which it is likely to depart from replication of an index. The quality of an index replication should be expressed as a band quality.

Question 13 - If your answer to the previous question is yes, which of the following two estimates would you consider appropriate, or would you consider both or another estimate necessary?

We have no comments on the formulae expressed in the two options.

Question 14 - Should CESR suggest maximum thresholds as far as the estimates described above are concerned? If yes what should these thresholds be?

Clearly, a fund which claims to be replicating an index and, as a result, is able to use the more flexible risk spreading rules allowed by Article 22(a) of the UCITS Directive, does genuinely need to seek to replicate the index subject to a permitted level of tracking error. It is a policy decision as to what should be that permitted level of tracking error. The UCITS should disclose the level it seeks to reflect within the permitted maximum in its investor material and should report on it in its annual report.

Box 18 Index characteristics

We question the meaning of the words “it is accessible to the public” in relation to the publication of an index. It is unclear how widely available any such index needs to be and in what format it is required to be accessible. Availability to customers of a particular index-maker might not constitute the public.