

CESR's Draft Advice on Clarification of Definitions concerning Eligible Assets for Investment of UCITS - 2nd Consultation Paper - Response from JPMorgan Asset Management

Please find below JPMorgan Asset Management's response to the second consultation on CESR's advice on clarification of definitions concerning eligible assets for UCITS. We welcome the opportunity that CESR has given the industry to comment a second time on the advice, and believe that this second round will add significant value to the final submission to the Commission.

In addition to the points made below, we should also emphasise the need for some form of transitional provisions for these regulations. In addition to the case of a UCITS that is obviously in breach of the provisions, most UCITS have in recent years taken advice from their legal counsel as to the eligibility of certain instruments, and it is important that, once the regulations are finalised, each UCITS has the opportunity to refresh that legal advice.

Clarification of Art. 1(8) (Definition of Transferable Securities)

1. Treatment of "structured financial instruments"

Q1: We agree with the approach as suggested in Box 1, except that we think that the subjective measure of the liquidity of the portfolio or any single asset should be at the discretion of the UCITS, subject to compliance with Article 37. An implication of this is that liquidity should not be cumulative.

2. Other eligible transferable securities

Q2: We have two comments to make regarding the CESR recommendations:

- The requirement that 'there must be regular and accurate information available to the market' could be interpreted as ruling out private placements. We would prefer the requirement to read 'there must be regular and accurate information available to the UCITS'
- When a security has zero value or is suspended, a UCITS will normally continue to hold that security in its portfolio. In fact, a depositary may not allow a UCITS to remove such a security as part of a 'cleaning-up' exercise, in case it is of value at some future date. The level 2 advice may prevent a UCITS from holding these types of securities.

3. Closed-ended funds as "transferable securities"

Q3: We agree with the approach as suggested in Box 3.

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

1. General rules for investment eligibility

Q4: We have three comments to make with the Box 4 recommendations:-

A. The recommendations are that money market instruments should have a residual interest rate maturity of no more than 365 days or, in order for a money market fund to use amortised valuations, it should not invest in instruments with a residual interest rate maturity of more than 365 days. We think that the level in both cases should be 397 days.

We believe there is a good case for the investment in 397 day securities, when combined with a maximum weighted average maturity of 60 days (this latter limit being a Standard & Poor's AAA rating requirement, as well as a recommended regulation from CESR). This is because:-

- (a) The longer maturity provides additional yield to the portfolio. For example, in US dollar markets there is frequently a material yield pick-up available between 12 months and 13 months. The resulting increase in yields from investing in 13 month securities would, of course, be of benefit to the shareholders in the funds.
- (b) The risk is limited by the maximum 60 day weighted average maturity requirement.
- (c) Sometime the additional maturity is required to take account of the longer settlement period for new issues (which can be up to 1 week, and in some cases 2 weeks). On this point, if CESR finds that it is not able to recommend 397 days maturity, then 365 days should be defined as from settlement date to maturity date.

The investment policies of our own money market funds currently allow for investment in securities that have an initial or remaining maturity not exceeding 397 days. However, we do not normally use many 397 day securities in our funds (usually no more than 2% to 3% of the portfolio) as this is limited by the maximum 60 weighted average maturity requirement.

The issuance of 397 day securities for money market funds is also a standard market convention in the United States (as described under section 270.2a-7 of the Investment Companies Act of 1940). Due to this market convention, most of the supply of newly issued US dollar money market securities is in 397 day or greater securities. This would put the UCITS funds at a disadvantage, as we would not have the ability to purchase newly issued 397 day securities. The same would also apply in the secondary market, when securities with an initial maturity of greater than 13 months roll down to have a remaining maturity of 13 months. These securities in the secondary market often trade cheaper than their primary market equivalents, so again, the proposed regulations would put the UCITS funds at a disadvantage.

B. Assessing liquidity at instrument level as well as fund level, as described in Box 4, would preclude us from investing in certain money market instruments such as promissory notes, which are loan agreements with only the original issuing house as a market-maker. We believe that the liquidity requirements of Article 37 should be applied only at a fund level - there is no requirement under the UCITS Directive to apply them either cumulatively or at instrument level.

C. At the bottom of Box 4, under level 3 advice, Medium Term Notes should also be included in the list of instruments that are 'normally dealt in on the money market'.

Q5: We agree with the approach as suggested in Box 5.

2. Art 19(1) (h)

Q6: In Box 6:-

- (a) The second indent of paragraph 2 should read 'availability of information on both the issue or issuance programme or the legal and financial situation of the issuer prior to the issue of the MMI'. This is because there is no issue or issuance programme, as such, for Certificates of Deposits.
- (b) It is our belief that the third indent of paragraph 2 applies only to ECPs in the STEP programme, and therefore not to money market instruments in general. It should therefore be removed from the advice.

In addition, because of the nature of these recommendations, we believe that the regulations in level 2 of Box 6 should be guidelines in level 3.

Q7: We agree with the approach as suggested in Box 7.

Q8: We agree with the approach as suggested in Box 8.

3. Other eligible money market instruments

Q9: We agree with the approach as suggested in Box 9.

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

Q10: We agree with the approach as suggested in Box 10. We would ask, however, that derivatives, which are the main use of 'techniques and instruments', are added to the list in level 3.

Embedded derivatives

Q11: We agree with the approach as suggested in Box 11, except that we do not believe that convertible bonds where both the bond and the option are issued

by the same underlying issuer should be included in the definition of a transferable security with an embedded derivative.

Other collective undertakings

Q12: We agree with the approach as suggested in Box 12.

Financial derivative instruments

1. Financial derivative instruments: general considerations

Q13: We agree with the approach as suggested in Box 13.

2. The eligibility of derivative instruments on financial indices

Q14: We agree with the approach as suggested in Box 14.

3. OTC derivatives

Q15: We agree with the approach as suggested in Box 15, except that we do not understand why a UCITS needs to agree its OTC derivative pricing model with the depositary, as this is additional to any requirements in the UCITS Directive.

4. Credit derivatives

Q16: We do not understand why CESR should single out credit derivatives as subject to risk asymmetry, and therefore believe that references to risk asymmetry in Box 16 should be removed. Otherwise, we agree with the approach as suggested in Box 16.

Index replicating UCITS

1. UCITS replicating the composition of a certain index

Q17: We agree with the approach as suggested in Box 17.

2. Index characteristics

Q18: We agree with the approach as suggested in Box 18.