



THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/05-064b

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

Consultation Paper

MARCH 2005



EXECUTIVE SUMMARY

Background

1. In the context of the implementation of the UCITS III Directive (Directive 85/611/EEC as amended by Directives 2001/107/EC and 2001/108/EC), the issue has arisen whether or to what extent some financial instruments could be considered eligible investments (i.e. “eligible assets”) for a UCITS in compliance with the relevant provisions of the UCITS Directive, in particular the definitions of “transferable securities” under Art. 1 (8), of “money market instruments” under Art. 1 (9) and the list of authorised investments under Art. 19.
2. The even implementation and interpretation of EU legislation is a crucial dimension of the building up of the internal market in financial services. The European Commission has identified the need to clarify certain definitions of eligible assets of the UCITS Directive as short term priority for the implementation of the amendments made by Directive 2001/108/EC of 21 January 2002 to the UCITS Directive. This approach was endorsed at the European Securities Committee meeting of 5th July 2004.
3. In view of this, DG Internal Market intends to make use of the delegated powers conferred by Art. 53a of the UCITS Directive to the Commission, to clarify some of the definitions pertaining to eligible assets which are contained in the UCITS Directive. In its preparation of possible draft comitology instruments, the Commission has requested technical advice of CESR.
4. The Lamfalussy approach for securities markets regulations comprises four levels: framework principles included in legislation adopted by the European Parliament and Council (Level 1), measures implementing those Directives and adopted by the Commission after advice from the Committee of European Securities Regulators (CESR) and the agreement of the European Securities Committee (Level 2), co-operation among regulators (Level 3) and enforcement (Level 4). CESR’s work on the eligible assets of UCITS is on Level 2.

Purpose

5. The purpose of this consultation document from CESR is to seek comments on the draft technical advice that CESR proposes to give to the European Commission on possible modifications to the UCITS Directive in the form of clarification of definitions concerning eligible assets for investments of UCITS.

Consultation Period

6. The consultation closes on **10 June 2005**. Responses to the consultation should be sent via CESR’s website (www.cesr-eu.org) under the section “Consultations”.
7. In order to facilitate the consultation process, CESR will be holding an open hearing on **9 May 2005** in Paris at CESR’s premises, 11-13 avenue de Friedland. You can register for the open hearing via the website of CESR (www.cesr-eu.org) under the heading “Hearings”.



Areas Covered

8. The consultation covers:

- the factors to be used in determining whether financial instruments whose underlying involves products of varying degrees of liquidity and/or which may not be directly eligible for investment by a UCITS, meet the formal and qualitative requirements for recognition as a ‘transferable security’ within the meaning of the UCITS Directive;
- whether and under which conditions shares of closed end funds or different variants of closed end funds fall under the definition of transferable securities as provided for by Art. 1 (8), having regard to Art. 19 (1) (a) to (d) and other relevant considerations contained in the UCITS Directive;
- the factors to be used to determine the eligibility of certain categories of money market instruments dealt in on a regulated market according to Art. 19 (1) (a) to (d), and whether the fact that they are dealt in on a regulated market is sufficient for them to be considered “money market instruments” meeting the general conditions specified at Art. 1 (9);
- whether and under which conditions certain categories of money market instruments fall within the scope of Art. 19 (1) (h) which deals with money market instruments “other than those dealt in on a regulated market”;
- the factors to be used to determine whether and under which conditions other investment funds than UCITS fall within the scope of the definition of “other collective investment undertaking”;
- the factors to be used to determine whether and under what conditions a derivative financial instrument, especially a credit derivative instrument, falls within the scope of the definition of derivative financial instruments as set out in Art. 19 (1) (g);
- the factors to be used to determine whether, and under what conditions, UCITS can be recognised as falling within the scope of the term of “replicating the composition of a certain index” of Art. 22a (1), having regard to the additional criteria set out in the provision and the elements relating to overall limits in investment in securities issued by any one issuer.

Further Details

9. Full details of CESR’s draft advice can be found in the consultation paper.



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INTRODUCTION

10. CESR publishes its consultation paper on its draft technical advice to the European Commission regarding possible modifications to the UCITS Directive in the form of clarification of definitions concerning eligible assets for investments of UCITS. This document is aimed at receiving responses to its content and to a number of specific questions included in the document itself.
11. It should be stressed that CESR's draft technical advice should not be perceived as legal text, even if it is precise to facilitate its comprehension in the consultation phase. It is the responsibility of the Commission to draft a proposal for comitology instruments taking into account the technical advice provided by CESR.
12. CESR has included a number of questions to highlight those areas in which it would be particularly helpful to have views. Comments are, of course, welcome on all aspects of the proposed CESR advice but, if changes are required, any reasoning accompanied by practical examples of the impact of the proposals will be very useful. CESR also welcomes specific drafting proposals when respondents are seeking changes to the proposed Level 2 advice.
13. Respondents to this consultation paper should post their responses on CESR's Website (www.cesr-eu.org) under the section "Consultations". CESR will publish a feedback statement on the consultation justifying its final choices vis-à-vis the main arguments raised during the consultation.
14. The amending UCITS Directives (2001/107/EC and 2001/108/EC) were published in the Official Journal of the European Union on 13th February 2002. Member States had to transpose and apply the Directives in the domestic laws or regulations not later than 13th February 2004. The second amending Directive (2001/108/EC) focused essentially on the "product", the investment fund. It extended the range of financial assets in which UCITS may invest. As a result, UCITS are now permitted to invest not only in listed shares and bonds as before, but also in bank deposits, money market instruments, financial derivatives (i.e. standardised option and futures contracts dealt on regulated exchanges and over-the-counter) and in units of other collective investment undertakings. The new rules also recognise investment management techniques widely employed such as "tracking" an index (i.e. investment in securities of different issuers provided for in a given index). The European Commission has identified the need to clarify certain definitions of eligible assets of the UCITS Directive as short term priority for the implementation of the amendments made by the Directive 2001/108/EC.
15. On 28th October 2004, the Commission published "The Formal Mandate to CESR for Advice on Possible Modifications to the UCITS Directive in the Form of Clarification of Definitions concerning Eligible Assets for Investments of UCITS". The Commission asked CESR to deliver its technical advice in the form of an "articulated" text by 31st October 2005. The text of the mandate is set out in each specific section of CESR's Level 2 advice.
16. Preparation of the advice is being undertaken by the Expert Group on Investment Management. The Group is chaired by Mr Lamberto Cardia, Chairman of the Italian securities regulator, the Commissione nazionale per le società e la Borsa (CONSOB) and supported by Mr Jarkko Syyrilä from the CESR Secretariat. The Expert Group set up two



working sub-groups on this issue, coordinated by Mme Pauline Leclerc-Glorieux from the AMF and Mr Dan Waters from the FSA. The Expert Group is assisted by the Consultative Working Group on Investment Management composed of 16 market practitioners and consumers.

17. CESR published a Call for Evidence on 28th October 2004 with a work-plan containing indications of the most relevant steps in the process of approval of its technical advice. More details on CESR's work plan and a summary of responses to the Call for Evidence are given in the annexes to the consultation paper.
18. CESR draws the attention of the respondents to the fact that the draft advice on the eligible assets of UCITS relates closely to the conduct of business rules as stated by the UCITS Directive, to be applied in the collective investment management activity. As mentioned in the mandate of the CESR Expert Group on Investment Management, CESR will during 2005 carry out work on the conduct of business rules on Level 3 of the Lamfalussy procedure regarding collective investment management.



DRAFT TECHNICAL ADVICE

DEFINITIONS

19. References in this advice to the "Directive" mean, unless the context requires otherwise, Directive 85/611/EEC of the Council of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as subsequently amended.
20. References in this advice to terms defined in the Directive shall have the meaning given to them in the Directive unless the context requires otherwise.
21. In the following advice, the general term "UCITS" refers :
 - to the investment company, if the UCITS is self-managed, and
 - to the management company, if the UCITS is not self-managed, or if the UCITS is set up in a contractual form or unit trust form.



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

1 *Treatment of “structured financial instruments”*

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used in determining whether financial instruments whose underlying involves products of varying degrees of liquidity and/or which may not be directly eligible for investment by a UCITS, meet the formal and qualitative requirements for recognition as a ‘transferable security’ within the meaning of the UCITS Directive.

Is the fact of admission to trading on a regulated market as foreseen in Art. 19 (1) (a) to (d) sufficient for them to be considered “transferable securities” of Art. 1 (8), eligible for investment by UCITS ?

In view of other considerations contained in the UCITS Directive, are there other factors which should be taken into account?

Draft CESR advice

Explanatory text

22. The UCITS Directive as amended has as its goal the establishment of a unified regime for the operation and promotion of regulated open ended collective investment undertakings throughout the European Union. This is to be achieved through the introduction of a set of common rules that seek to provide sufficient guarantee to permit such undertakings domiciled and regulated in one Member State to be marketed in another Member State without additional requirements in relation to matters covered by the Directive.
23. UCITS are authorised by Member States to be sold to private retail and institutional investors alike. Therefore 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.
24. The Directive defines 'transferable securities' in Art. 1 (8) as:
 - "- shares in companies and other securities equivalent to shares in companies ('shares'),*
 - bonds and other forms of securitised debt (debt securities),*
 - any other negotiable securities which carry the right to acquire any such transferable securities by subscription or exchange,*

excluding the techniques and instruments referred to in Art. 21."
25. Art. 1 (2) states that a UCITS is an undertaking "the sole object of which is the collective investment in transferable securities and/or in other liquid financial assets referred to in Article 19 (1) of capital raised from the public and which operates on the principle of risk spreading". Therefore generally only those 'transferable securities' and other liquid financial assets listed in Art. 19 (1) are eligible for inclusion in UCITS.



26. It is clear that the legislators have provided a broad class of "transferable securities", which will encompass both the investment opportunities that were available when the Directive was created, and those that have arisen subsequently. It is also notable that the definition of "transferable security" was only added to the UCITS Directive in 2002, indicating again a legislative desire to provide for a breadth of investment opportunity as "transferable securities".¹
27. The purpose of the requirement for portfolio liquidity is to ensure that UCITS will be readily able to meet foreseeable demands from investors to redeem their investment at a fair value, as required in Art. 37 of the Directive.
28. It is clear that different investment instruments have different levels of liquidity. Even within the class of "transferable securities", there is a spectrum of liquidity, meaning that for example some company shares are more liquid than others. The fact of admission to trading on a regulated market of a transferable security provides a presumption of liquidity, and UCITS are able to rely on that presumption in making investment decisions unless they are or should be, aware of circumstances that indicate that a particular transferable security is not sufficiently liquid for the portfolio. UCITS are responsible for ensuring that there is sufficient overall liquidity to meet their obligations arising from Art. 37.
29. Innovation within the markets since the introduction of the original UCITS Directive in 1985 has led to the development of new financial instruments. Such instruments, whilst often legally constituted as a share or bond for example, may nonetheless not always have the necessary characteristics to qualify as a transferable security. If such instruments were used significantly as investments within a UCITS' portfolio this could potentially pose a threat to the liquidity of the UCITS making it difficult for investors to redeem their units at a price that fairly reflects the value of the investment or, in the worst case, at all. This might in turn undermine the operation of the UCITS regime and would not be in the interests of investor protection.
30. The objective behind the amending Directive 2001/108/EC was to extend the range of permitted investments for UCITS. Therefore, as a general principle in considering eligible assets we should not seek to disallow investment by UCITS in assets which were permitted under the 1985 Directive as this was not the intent of the amending Directive. All investments, however, must be consistent with the investor protection principles. This is particularly relevant when considering investment in types of products which might not have been available at the time the original Directive was drafted. It is also desirable that the Directive be applied in a flexible manner so as not to inhibit product innovation.
31. The Directive does not itself distinguish between different types of transferable security for UCITS eligibility purposes. It does not, for example, refer to "structured financial instruments". However, CESR believes it is necessary and appropriate for UCITS to assess properly the nature and quality of transferable securities which it may consider purchasing, to ensure adequate portfolio liquidity and also compliance with its investment objectives.
32. In CESR's view the potential loss of the UCITS in respect of holding a transferable security must be limited to the amount paid for it. This means that the risk of the UCITS regarding the transferable security would have to be limited to the investment made, and there should be no unforeseeable additional payments to be made by the UCITS, for example in cases of default of the issuer of the transferable security.
33. In CESR's view UCITS should consider the following matters when deciding whether an investment they are considering purchasing amounts to a "transferable security":

¹ Art. 1 (2) of the Directive 2001/108/EC.



- Liquidity – The UCITS should consider, on reasonable grounds, that if the transferable security is added to its portfolio, it will continue to be able to comply with Art. 37 of the Directive. The transferable security must not compromise the overall liquidity of the UCITS. Volume and turnover in the transferable security will need to be considered in assessing liquidity. In addition, for price-driven markets, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument. In assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.
- Valuation – There must be accurate, reliable and generally independent valuation systems available in relation to the instrument. Pricing in the instrument should ideally be readily available, regular and independent of the issuer. The UCITS's overall valuation must fairly and accurately reflect the value of its underlying assets.
- Information – The UCITS should assess the extent to which the issuer of the transferable security regularly makes information available to the market by providing accurate and comprehensive information on the transferable security or, where appropriate on the portfolio of the product in question.
- Transferability – The manager should assess whether the security:
 - is offered on a limited basis;
 - has constraints on who may buy and sell the security.

These factors will clearly affect the transferability of the security.

- In addition, the acquisition of any transferable security must be consistent with the stated investment objectives of the UCITS. These objectives will, of course, have to be consistent with the requirements of the UCITS Directive.
 - The UCITS should be able to assess on an ongoing basis the risk of the transferable security and its contribution to the overall risk profile of the portfolio.
34. The combined duties of the directors of the UCITS, its depositaries and auditors can make a substantial contribution to the sound conduct of business of a UCITS. CESR would expect those responsible for overseeing the investments held by the UCITS to be fully conversant with the investment restrictions and actively monitor compliance with those obligations. UCITS must, as well as verifying whether individual securities are and continue to be eligible, ensure the UCITS as a whole is able to handle reasonably foreseeable requests for redemption.
35. The mandate given to CESR refers specifically to Structured Financial Instruments (SFIs). As mentioned, the Directive's definition of a "transferable security", as amended in 2002, does not subdivide the category of "transferable securities" in any way. CESR believes that where SFIs take the form of transferable securities, they should be treated as such and that the UCITS should take into account the same criteria, set out above, as should be applied in the case of any other transferable security. Where an SFI embeds a derivative, it should be treated in the same way as any other embedded derivative as developed below in this draft advice.
36. In CESR's view, when an structured financial instrument includes a derivative element, Art. 21(3) of the Directive applies.



Draft Level 2 advice

BOX 1

1. To be an eligible asset for a UCITS under Art. 19 (1) (a) to (d), a transferable security must fall within the definition of "transferable security" in Art. 1 (8) of the Directive. In addition, the potential loss of the UCITS in respect of holding the security must be limited to the amount paid for it.
2. The UCITS should take into consideration the following factors in deciding whether or not any security is a "transferable security" (as defined):
 - Liquidity – The UCITS should consider, on reasonable grounds, that if the transferable security is added to its portfolio, it will continue to be able to comply with Art. 37 of the Directive. The transferable security must not compromise the overall liquidity of the UCITS. Volume and turnover in the transferable security will need to be considered in assessing liquidity. In addition, for price-driven markets, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument. In assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered.
 - Valuation – There must be accurate, reliable and generally independent valuation systems available in relation to the instrument. Pricing in the instrument should ideally be readily available, regular and independent of the issuer. The UCITS's overall valuation must fairly and accurately reflect the value of its underlying assets.
 - Information – The UCITS should assess the extent to which the issuer of the transferable security regularly makes information available to the market by providing accurate and comprehensive information on the transferable security or, where appropriate on the portfolio of the product in question.
 - Transferability – The manager should assess whether the security:
 - is offered on a limited basis;
 - has constraints on who may buy and sell the security.

These factors will clearly affect the transferability of the security.

 - In addition, the acquisition of any transferable security must be consistent with the stated investment objectives of the UCITS. These objectives will, of course, have to be consistent with the requirements of the UCITS Directive.
 - The UCITS should be able to assess on an ongoing basis the risk of the transferable security and its contribution to the overall risk profile of the portfolio.
3. When a structured financial instrument includes a derivative element, Art. 21 (3) of the Directive applies.



Questions:

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

Q 2: What would be the practical effect in your view if such an approach were adopted?

2 Closed end funds as “transferable securities”

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice as to whether and under which conditions shares of closed end funds or different variants of closed end funds fall under the definition of transferable securities as provided for by Art. 1 (8), having regard to Art. 19 (1) (a) to (d) and other relevant considerations contained in the UCITS Directive.

Draft CESR advice

Explanatory text

37. CESR has considered carefully the question whether listed closed end funds are eligible investments for a UCITS and has concluded that such investments are potentially eligible where the listed closed end fund is constituted as a transferable security. This means also that the above analysis of transferable securities applies equally to such funds.
38. In addition, however, CESR is of the opinion that a UCITS should take account of certain following matters in deciding on the eligibility of a listed closed end fund. In particular, a UCITS should:
 - (a) consider whether the listed closed end fund in question that takes the form of a transferable security, may be engaging in cross-holdings in other closed end funds that take the form of transferable securities, in such a way as to cause unacceptable risks for the listed closed end fund, and through it, for the UCITS itself;
 - (b) ensure that the asset management activity carried on by or on behalf of the listed closed end fund is subject to appropriate investor protection safeguards; and
 - (c) not make investments in listed closed end funds for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive.
39. Regarding safeguards for investor protection mentioned under point b), some CESR members are of the opinion that it would be necessary to require that the UCITS should verify that the listed closed end fund is subject to appropriate restrictions on leverage (for example through uncovered sales, lending transactions, and the use of derivatives) and that it is subject to appropriate controls and regulation in its home jurisdiction. Others see that it would be enough to require 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).



40. As stated above in Box 1, CESR members agree that the acquisition of any transferable security by a UCITS must be consistent with the stated investment objectives of the UCITS, and that these objectives will have to be consistent with the requirements of the UCITS Directive. However, CESR members' views differ on whether UCITS should be allowed to invest only in such listed closed end funds, that invest in transferable securities, that would themselves be eligible under the UCITS Directive. On the one hand, some members consider that the requirements of the Directive concerning eligible assets should not be circumvented by investing the assets of a UCITS to such listed closed end funds, that give the UCITS an exposure to non-eligible assets (e.g. hedge funds, commodities, precious metals), so these kinds of listed closed end funds should not be eligible for investment by a UCITS. On the other hand, some other CESR members consider that it is not necessary to require UCITS to invest only in such listed closed end funds, that invest in transferable securities, that would themselves be eligible under the UCITS Directive.

Draft Level 2 advice

BOX 2

1. The factors in Box 1 concerning listed transferable securities apply also to listed closed end funds. Where a listed closed end fund takes the form of a transferable security, as defined by the Directive in Art. 1 (8) and Art. 19 (1) (a) to (d), the UCITS should in addition:
- (a) consider whether the transferable security in question may be engaging in cross-holdings in other closed end funds that take the form of transferable securities in such a way as to cause unacceptable risks for the listed closed end fund, and through it, for the UCITS itself;
 - (b) ensure that the asset management activity carried on by or on behalf of the listed closed end fund is subject to appropriate investor protection safeguards; and
 - (c) not make investments in listed closed end funds for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive.



Questions:

Q 3: Does the reference to "unacceptable risks" in the context of cross-holdings require further elaboration, and if so, how should it be elaborated?

Q 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?

Q 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 regulation 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).*

Q 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?

Regarding especially questions 5 and 6, please give your view on the possible practical impacts of the different options, based on your experience. Please give concrete examples of the impacts in terms of what kind of instruments would be actually left out/ taken aboard by the option chosen. Please give quantitative examples of the impacts in terms of the sphere of eligible instruments for UCITS, if possible.

3 Other eligible transferable securities

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on any factors to be used to assess whether possible investments in transferable securities should be considered as falling within the scope of (i) transferable securities dealt in on a regulated market according to Art. 19 (1) (a) to (d) and (ii) "other transferable securities" under Art. 19 (2).

Is it sufficient that a 'transferable security' not be dealt in on a regulated market in order to fall within the scope of "other transferable securities" under Art. 19 (2)?

Are there other factors which should be taken into account in determining whether particular categories of transferable securities fall within the scope of Art. 19 (2) (a)?

Draft CESR advice

Explanatory text

41. According to Art. 19 (2) (a) of the Directive, a UCITS can invest up to 10% of its assets in transferable securities and money market instruments that do not meet the eligibility requirements in Art. 19 (1).
42. In CESR's view for an investment to be eligible under Art. 19 (2) (a), it must be a transferable security that does not comply with the conditions respectively described in Art. 19 (1) (a) to (d). The same criteria as discussed above in Box 1 for transferable securities will apply, as



appropriate, also to transferable securities that fall within Article 19 (2) (a). CESR has considered, whether non-listed closed end funds would meet the requirements as stated in Box 1, but considers this highly unlikely.

Draft Level 2 advice

BOX 3

1. For an investment in a transferable security to be eligible under Art. 19 (2) (a), it must be a transferable security that does not comply with the conditions respectively described in Art. 19 (1) (a) to (d).
2. The draft advice above in Box 1 in relation to transferable securities that fall within Art. 19 (1) (a) to (d) of the Directive, will also apply, as appropriate, to such transferable securities that fall within Art. 19 (2) (a). In CESR's view, non-listed closed end funds are highly unlikely to meet the requirements as stated in Box 1.

Questions:

Q 7: Are there any practical difficulties in your experience in defining the boundary between Art. 19 (1) (a) to (d) and Art. 19 (2) (a)? Do you consider the suggested approach in Box 3 as appropriate?



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

1 General rules for investment eligibility

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine the eligibility of certain categories of money market instruments dealt in on a regulated market according to Art. 19 (1) (a) to (d).

Is the fact that they are dealt in on a regulated market sufficient for them to be considered “money market instruments” meeting the general conditions specified at Art. 1 (9)?

In view of other considerations contained in the UCITS Directive, are there other factors/criteria which should be taken into account?

Draft CESR advice

Explanatory text

43. The UCITS Directive defines money market instruments (‘MMIs’) as instruments normally dealt in on the money market, which are liquid and have a value which can be accurately determined at any time. It sets additional criteria to determine which of these MMIs are eligible assets for UCITS. These criteria define three categories of eligible MMIs:
 - MMIs dealt in on a regulated market in accordance with Art. 19 (1) (a) to (d) of the UCITS Directive;
 - MMIs other than those dealt in on a regulated market which meet the criteria set by Art. 19 (1) (h) of the UCITS Directive; and
 - MMIs that do not fall in one of these two categories are eligible assets but are subject to a 10% ceiling along with other instruments in accordance with Art. 19 (2) (a) of the UCITS Directive.
44. The mandate requests CESR to clarify the factors to be used when assessing the eligibility of MMIs to UCITS. Before clarifying the meaning of the additional criteria which define the three categories of eligible MMIs, it is necessary to clarify which factors should be taken into account to determine if a given instrument is a MMI.
45. As a preliminary view, Recital 4 of the Directive 2001/108/EEC, which states that “money market instruments cover those transferable instruments which are normally not traded on regulated markets but dealt in on a money market, for example treasury and local authority bills, certificates of deposit, commercial paper, medium-term notes and banker's acceptances” should be recalled.
46. Furthermore, for the purpose of ensuring an equivalent and effective protection of investors throughout the Community and a level playing field for UCITS operators, CESR found appropriate to take into account the ECB framework concerning the consolidated balance sheet of the monetary financial institutions sector (CONSLEG 2001R2423 – 01/05/2004) in order to determine whether a given instrument is dealt as a MMI. This choice allows the UCITS Directive to be consistent with the ECB regulatory framework concerning the collection of statistical information by the European Central Bank (ECB/2001/13). It is also



consistent with the Commission services' suggestion inserted in a document of the UCITS Contact Committee of 22 October 2003 stating that "*the Commission services would welcome if Members of the Contact Committee would further work on common standards for eligible assets, e.g taking into account the proposals already made by some members (ECB-regulation, ACI-STEP Task Force)*".

47. According to the ECB statistical framework², MMIs are defined as follows: "money market instruments" shall mean those classes of transferable debt instruments which are normally traded on the money market (for example, certificates of deposit, commercial paper and banker's acceptances, treasury and local authority bills) because of the following features:
- (i) *liquidity*, where they can be repurchased, redeemed or sold at limited cost, in terms of low fees and narrow bid/offer spread, and with very short settlement delay; and
 - (ii) *market depth*, where they are traded on a market which is able to absorb a large volume of transactions, with such trading of large amounts having a limited impact on their price; and
 - (iii) *certainty in value*, where their value can be accurately determined at any time or at least once a month; and
 - (iv) *low interest risk*, where they have a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months; and
 - (v) *low credit risk*, where such instruments are either:
 - admitted to an official listing on a stock exchange or traded on other regulated markets which operate regularly, are recognized and are open to the public, or
 - issued under regulations aimed at protecting investors and savings, or
 - issued by:
 - a central, regional or local authority, a central bank of a Member State, the European Union, the ECB, the European Investment Bank, a non-Member State or, if the latter is a federal State, by one of the members making up the federation, or by a public international body to which one or more Member States belong; or
 - an establishment subject to prudential supervision, in accordance with criteria defined by Community law or by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law, or guaranteed by any such establishment; or
 - an undertaking the securities of which have been admitted to an official listing on a stock exchange or are traded on other regulated markets which operate regularly, are recognised and are open to the public".
48. Regarding the liquidity criteria, three elements should be taken into account:
- the MMI must not jeopardize the overall liquidity of the UCITS if that UCITS is to meet its obligation to redeem units at the request of unitholders (Art. 37 of the UCITS Directive);
 - based on the provisions of the ECB statistical framework, it must be possible to repurchase, redeem or sell a MMI at a limited cost, in terms of low fees and narrow bid/offer spread and with very short settlement delay; and
 - based on the Recommendation 2004/383/EC on the use of derivative instruments for UCITS, those instruments should be considered as "liquid", "*which can be converted into cash in no more than seven business days at a*

² See Annex I, article 1.7 of CONSLEG : 2001R2423 – 01/05/2004.



price closely corresponding to the current valuation of the financial instrument on its own market”.

49. The definition of a MMI given by Art. 1 (9) of the UCITS Directive requires that it must be possible to determine at any time and accurately the value of a MMI. This requirement stems from the necessity to calculate the net asset value (NAV) of the UCITS to enable subscriptions and redemptions. The valuation of a MMI should be based on market data, when available and relevant, or on valuation models, such as models based on discounted cash flows. When using such models, any changes in the credit risk of the issuer must be taken into account. A method that would discount cash flows using the initial discount rate of the MMI without adjusting that discount rate to take into account changes in the credit spread of the issuer would not comply with these requirements.

Draft Level 2 advice

BOX 4

1. Factors to be taken into account when assessing whether a given instrument is a MMI as defined by Art. 1 (9) of the UCITS Directive are :
 - as far as the criteria “liquid” is concerned: the liquidity of the MMI must be taken into account in the context of Art. 37 of the UCITS Directive. The portfolio must retain sufficient liquidity so that the UCITS can repurchase or redeem its units at the request of any unit holder. At an instrument level, it must be possible to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), at limited cost, in terms of low fees, narrow bid/offer spread, and with a very short settlement delay;
 - as far as the criteria “value which can be accurately determined at any time” is concerned: UCITS should ensure that accurate and reliable valuations are available so as to meet the obligation by the UCITS Directive to calculate the NAV of the UCITS’ units. The valuation of a MMI should be based on market data, when available and relevant, or on valuation models, such as models based on discounted cash flows. When using such models, any changes in the credit risk of the issuer must be taken into account. A method that would discount cash flows using the initial discount rate of the MMI without adjusting that discount rate to take into account changes in the credit spread of the issuer would not comply with these requirements;
 - as far as the criteria “normally dealt in on the money market” is concerned, in addition to the above mentioned factors, the fact that the instrument has a low interest risk, where it has a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months should have to be taken into account.
2. Treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances will usually comply with that last criteria.

Explanatory text

50. The mandate given to CESR raises the question of factors to be taken into account when assessing the eligibility of MMIs which fall under the scope of Art. 19 (1) (a) to (d). More



especially, the mandate questions whether the fact that these MMIs are traded in on a regulated market imply that they comply with the definition of MMIs provided by Art. 1 (9).

51. It is the opinion of CESR that the fact of the admission to trading in on a regulated market is one of the elements to be assessed by the management company. It provides a *presumption* of liquidity (i.e. "*the MMI can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market*") and of accurate valuation of the eligible asset. This liquidity condition should be considered in the wider context of ensuring the liquidity of the total portfolio as evidenced by the ability to redeem units upon request of unit holders. However, based on the provision of the article 1 (2), it always remains the responsibility of the UCITS to check whether this condition of "liquidity" is respected by the MMI and whether the MMI is accurately valued.
52. Finally, CESR considered whether other considerations contained in the UCITS Directive, such as the provisions prohibiting uncovered sales (Art. 42 of the UCITS Directive) or the investment in precious metals (Art. 19 (2) (d) of the UCITS Directive) should have to be taken into account.
53. Given the clarification of the above definition of a MMI, CESR's view is that there is no scope for gaining exposure to precious metals through the investment in such instruments.
54. Regarding uncovered sales, in line with the clarification introduced by the Commission Recommendation 2004/383/EC on the use of derivative instruments for UCITS, short selling of MMIs should not be allowed.

Draft Level 2 advice

BOX 5

1. When assessing whether a given MMI is eligible under Art. 19 (1) (a) to (d) of the UCITS Directive, consideration must be given to the overall coherence of the provisions set by the UCITS Directive. The fact of the admission to trading on a regulated market of a MMI provides a *presumption* that the condition of "liquidity" (i.e. "*the MMI can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market*") and "accurate valuation" are complied with. However, it is the responsibility of the UCITS to ensure that the liquidity criteria is met.
2. Given the clarification of the above definition of MMI, CESR's view is that there is no scope for gaining exposure to precious metals through the investment in such instruments.
3. Regarding the specific issue of the prohibition of uncovered sales, CESR is of the opinion that Art. 42 implies that short selling of MMIs by a UCITS is not authorised.

2 Art. 19 (1) (h)

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the following issues:

- CESR is invited to clarify the pre-requisite of the 1st paragraph of Art. 19 (1) (h) requiring that the issue or issuer of such money market instruments other than those dealt in on a regulated market “*is itself regulated for the purpose of protecting investors and savings*”, e.g. whether this pre-requisite should encompass other issuers than credit institutions. It should also be clarified how such pre-requisite can be complied with in addition with each of the four indents of Art. 19 (1) (h). For instance, how can such pre-requisite be combined with the additional criteria of the first indent, i.e. “*issued or guaranteed by a central, regional or local authority*[...]”?
- CESR is invited to clarify the concept of “*equivalent investor protection*”, i.e. to clarify the factors referred to in Art. 19 (1) (h) fourth indent which need to be taken into account in deciding whether and under what conditions money market instruments other than those dealt in on a regulated market are “*issued by other bodies provided that investments in such instruments are subject to investor protection equivalent to that laid down in the first, the second or the third indent of Art. 19 (1)(h) and provided that the issuer is:*
 - (i) *a company whose capital and reserves amount to at least EUR 10 million and which presents and publishes its annual accounts in accordance with Directive 78/660/EEC,*
 - (ii) *an entity which, within a group of companies which includes one or several listed companies, is dedicated to the financing of the group; or*
 - (iii) *an entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line”.*

Where appropriate and necessary, these clarifications should consider the Recommendation on the use of derivatives by UCITS, where relevant.

Draft CESR advice

Explanatory text

55. The UCITS Directive provides general criteria to assess whether a MMI that is not dealt in on a regulated market is an eligible asset. It does not give an exhaustive list of eligible MMIs. In accordance with the mandate, CESR is of the opinion that the clarification of the definitions of eligible MMIs should not aim at providing such a list but rather at identifying criteria that should be taken into account when assessing the eligibility of a given MMI.
56. When discussing these criteria, CESR has taken into account steps taken by the industry and regulatory bodies to homogenize the status of and the information provided by issuers of MMIs.
57. Accordingly, CESR has identified the following key areas to be considered by asset managers when assessing the eligibility of a MMI:
 - whether an information memorandum providing information on both the issue and the legal and financial situation of the issuer is available prior to the issue of the MMI;
 - whether this information memorandum is regularly updated (i.e. on an annual basis or whenever a significant event occurs);
 - whether this information memorandum is subject to control by an independent authority;



- whether each issuance has a minimum amount of EUR 150.000 or the equivalent in other currencies; and
- whether free transferability and electronic settlement in book-entry form are possible.

Draft Level 2 advice

BOX 6

1. The factors above in Box 4 concerning MMIs apply also to MMIs that are not dealt in on a regulated market.
2. It remains the responsibility of the UCITS to ensure whether a MMI that is not dealt in on a regulated market is an eligible asset.
3. The following key areas should be considered by the UCITS when assessing the eligibility of a MMI:
 - whether an information memorandum providing information on both the issue and the legal and financial situation of the issuer is available prior to the issue of the MMI;
 - whether this information memorandum is regularly updated (i.e. on an annual basis or whenever a significant event occurs);
 - whether this information memorandum is subject to control by an independent authority;
 - whether each issuance has a minimum amount of EUR 150.000 or the equivalent in other currencies; and
 - whether free transferability and electronic settlement in book-entry form are possible.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the following issue:

- CESR is invited provide advice on the factors to be used in deciding whether and under what conditions money market instruments other than those dealt in on a regulated market are “*issued by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law*” as referred to in Art. 19 (1) (h) third indent. In particular, CESR is invited (i) to clarify the concept of “*at least as stringent*” and (ii) to determine whether, and if yes, to which extent, such criteria and the abovementioned pre-requisite of the 1st paragraph of Art. 19 (1) (h) overlap each other.

Where appropriate and necessary, these clarifications should consider the Recommendation on the use of derivatives by UCITS, where relevant.

Draft CESR advice

Explanatory text

58. For the purpose of defining establishments subject to prudential rules at least as stringent as those laid down by Community law, CESR has taken into account the collateral regulatory



framework of the ECB for the implementation of its monetary policy in the euro area and more specifically the introduction of a “Single list” (May 2004). This would restrict issuers to the European Economic Area and G10 countries (USA, Canada, Japan and Switzerland). CESR has also considered the rating of establishments by agreeing that investment grade establishments should be deemed to comply with the condition of Art. 19 (1) (h). UCITS who wish to use assets from establishments and issuers which do not meet these requirements could also conduct their own in-depth analysis in order to be able to demonstrate that these establishments and issuers are covered by prudential rules as least as stringent as those set down by Community law.

Draft Level 2 advice

BOX 7

1. It is the responsibility of the UCITS to check that the requirement that prudential rules are at least as stringent as those laid down by Community law is met.
2. There is a presumption that establishments located in the European Economic Area and G10 countries (USA, Canada, Japan and Switzerland) or having investment grade rating are subject to prudential rules at least as stringent as those laid down by Community law. Measures to guarantee compliance with the requirements by the UCITS can be tailored accordingly.
3. In all other cases, these measures should be based on an in-depth analysis of issuers.

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the following issues:

In the case of the last factor above (i.e. “*entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line*”) CESR is invited to clarify which instruments would be covered by this provision, for instance considering the questions of (i) whether and under what conditions it encompasses asset backed securities³ and synthetic asset backed securities⁴, (ii) the quality of the “*banking liquidity line*” referred to therein and (iii) of the question as to which category of banks (credit institutions) are covered by the term “*banking*”.

Where appropriate and necessary, these clarifications should consider the Recommendation on the use of derivatives by UCITS, where relevant.

Draft CESR advice

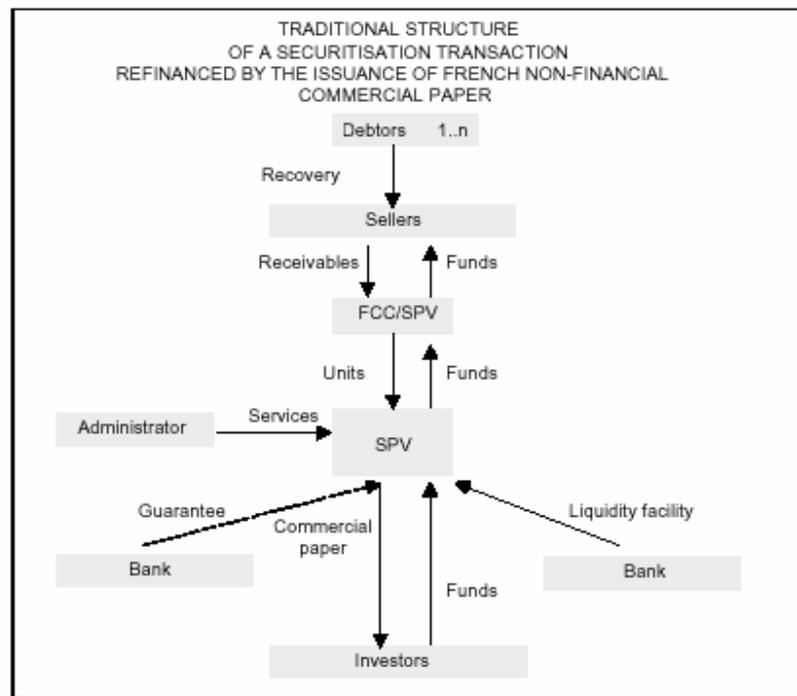
Explanatory text

59. The last sub-category defined by the fourth indent of Art. 19 (1) (h) refers to entities *which [are] dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line*. CESR is invited to clarify which instruments are covered by this provision.

³ Securitized debts based on a “true sale” of assets from the originator of the securitisation to a special purpose vehicle.

⁴ Securitized debts based on a transfer of credit risks from the originator of the securitisation to a special purpose vehicle by the means of a credit derivative.

60. In France which seems to be the main source of the enunciated sub-category, such a wording refers to securitisation transactions refinanced via the issuance of commercial paper – which constitute a highly active compartment of the French securitisation market⁵. Issuance programs for Asset-Backed Commercial Paper (ABCP or "Titres Courts Adossés à des Actifs, TCAA in French) consist of the issuance of commercial paper by an SPV (Special Purpose Vehicle) to refinance various securitized assets, such as trade receivables, bank claims, or even bonds. Some operations include additional issuance of euro-commercial paper or American commercial paper (USCP). In these operations, assets are assigned directly to an SPV or FCC (Fonds Communs de Créance⁶ not accessible to the public) whose units are, in turn, acquired by an SPV that is an issuer of commercial paper.
61. The framework of this structure can be described as follows:



62. Securitisation vehicles devoted to acquiring assets originating from a single seller exist alongside "multi-seller" vehicles (also known as "*conduits*"). In the latter case, several sellers use the same structure designed to acquire a large number of assets. This provides economies of scale and gives medium-sized companies access to this type of securitisation.
63. Operations generally provide liquidity cover making it possible to address the cash flow risk associated with discrepancies between the collection of receivables and the due dates of redemption of securities, and the temporary inability to issue commercial paper as a result of market developments. In general, these back-up credit lines have a value at least equal to that of the redemption of the securities. Less frequently, this cover is provided not by a traditional liquidity facility but by a commitment on the part of the bank arranging the purchase and

⁵ For further information, see the article "Securitisation transactions refinanced on the French Commercial Paper Market", in *Banque de France monthly report n°106, October 2002*.

⁶ The "*fonds commun de créances*" is a jointly owned entity exclusively devoted to acquiring claims and issuing representative units of these claims (Article L. 214-43 of the Monetary and Financial Code). These FCC units are securities (Article L. 211-2 of the Monetary and Financial Code).



resale of SPV or FCC units that constitute the assets of the issuing vehicle. In order to satisfy rating agencies' requirements, credit institutions providing this protection must have a rating that is at least equal to that of the program in question. Other avenues are also explored by the originators of these operations, such as seeking liquidity commitments from highly-rated companies or using medium term notes (MTN), which, by definition, do not require liquidity cover and allow the financing maturity to be extended.

64. Regarding the clarification of the UCITS Directive concerning "entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line", it should be understood that the banking liquidity line should be secured by a financial institution which itself complies with the third indent of Art. 19 (1) (h). Based on the French regulatory framework which seems to be the major source of the provision of the UCITS Directive, "*credit institutions providing this protection must have a rating that is at least equal to that of the program in question*"⁷.
65. In CESR's view, it derives from this above analysis that asset backed securities and synthetic asset backed securities do not fall under the provisions of the Art. 19 (1) (h). That does not preclude them from being eligible assets under the provisions of Art. 19 (1) (a) to (d) or Art. 19 (2) (a). One CESR member is of the opinion that asset backed securities (true sale) fall under the provisions of Art. 19 (1) (h) (e.g. a floater constructed as a MMI).

Draft Level 2 advice

BOX 8

1. Asset backed securities and synthetic asset backed securities do not fall in the category defined by the fourth indent of Art. 19 (1) (h) whenever they are not dealt in on a regulated market. This does not preclude them from being eligible under the provisions of Art. 19 (1) (a) to (d) or Art. 19 (2) (a). Regarding entities that fall under the fourth indent of of Art. 19 (1) (h), the banking liquidity line has to be secured by a financial institution which itself complies with the third indent of Art. 19 (1) (h). Credit institutions providing this protection must have a rating that is at least equal to that of the program in question.

Questions:

Q 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 Art. 19 (1) (a) to (d)? If not, please give practical examples of the potential impacts.

3 Other eligible money market instruments

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide technical advice on the factors to be used to determine the limit between money market instruments according to Art. 19 (1) and "other money market instruments" under Art. 19 (2).

⁷ See "Securitisation transactions refinanced on the French Commercial Paper Market", in *Banque de France monthly report n°106, October 2002*.



Is the fact that they are not dealt in on a regulated market sufficient for them to be considered “other money market instruments” under Art. 19 (2)?

In view of other considerations contained in the Directive, are there other factors which should be taken into account?

Draft CESR advice

Explanatory text

66. Other money market instruments are those instruments that comply with the definition of a MMI set by Art. 1 (9) and clarified above but do not fall in the categories defined by Art. 19 (1) (a) to (d) and (h).
67. When assessing whether a given MMI is eligible under Art. 19 (2) (a) consideration should be given to the overall coherence with the provisions set by the UCITS Directive and more especially with the provisions set by Art. 1 (9). The requirements concerning liquidity and accurate valuation have therefore to be fulfilled.

Draft Level 2 advice

BOX 9

1. Other money market instruments are those instruments that comply with the definition of a MMI as set by Art. 1 (9) of the UCITS Directive, i.e. are normally dealt in on the money market and fulfil the requirements of liquidity and accurate valuation, and which have been clarified above, but do not, however, fall in the categories defined by Art. 19 (1) (a) to (d) or (h).



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

Extract from the mandate from the Commission

DG Internal Market requests CESR to clarify the factors which need to be taken into account in determining whether and under what conditions certain instruments should fall under Art. 21 (2) 1st subparagraph as “*techniques and instruments relating to transferable securities and money market instruments*”. In formulating its advice, CESR is invited to clarify of the notions of “*used for the purpose of efficient portfolio management*” under Art. 21 (2).

Where appropriate and necessary, these clarifications should also take account of the Recommendation on the use of derivatives by UCITS.

Draft CESR advice

Explanatory text

68. Art. 1 (8) of the Directive provides a list of certain instruments which are to be considered as transferable securities, and specifies that such instruments shall exclude techniques and instruments described under Art. 21. According to this article, “*The Member States may authorize UCITS to employ techniques and instruments under the conditions and within the limits which they lay down provided that such techniques and instruments are used for the purpose of efficient portfolio management*”. However, “*When these operations concern the use of derivative instruments, these conditions and limits shall conform to the provisions laid down in the Directive*”.
69. As a consequence, CESR's draft advice focuses on two points:
- Under what circumstances can certain techniques and instruments fall under the scope of Art. 19 and Art. 21 (2);
 - The clarification of the notion of *efficient portfolio management*, i.e. setting the general rules for a UCITS willing to use these techniques and instruments, whether these operations concern the use of derivatives or not.
70. As Art. 21 (2) gives Member States the latitude to authorize UCITS to use techniques and instruments without an indicative list, the clarification of the factors which need to be taken into account in determining whether and under what conditions certain techniques and instruments can be eligible should therefore aim at identifying the criteria to be used to assess the compatibility of a given technique or instrument, rather than providing an exhaustive list and specifying under what circumstances each technique or instrument can fall under the scope of Art. 21 (2). The advice however mentions the most widely used techniques and instruments for illustrative purposes.
71. CESR suggests that the first factor to be taken into account should be Recital 13 of the Directive 2001/108/EC, according to which operations in derivatives may never be used to circumvent the principles and rules set out in the Directive. Another factor to be taken into account is the notion of efficient portfolio management, for which CESR provides a clarification.



72. Finally, CESR recommends the following interpretation of Art. 28 of the Directive, in relation to UCITS' obligations concerning information to be supplied to unit holders, as far as techniques and instruments are concerned. The use of techniques and instruments should not result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its applicable sales documents.

Draft Level 2 advice

BOX 10

1. Techniques and instruments relating to transferable securities and money market instruments should respect the general principle set out in Recital 13 of the Directive 2001/108/EC and may never be used to circumvent the principles and rules set out in the Directive. In particular, adequate measures should be adopted in order:
 - to ensure compliance with the requirements of an adequate risk management process, in line with Art. 21 (1) of the Directive, as well as with the detailed risk spreading rules specified by Art. 22 of the Directive; and
 - to avoid transactions which are not permitted by the Directive.
2. Techniques and instruments must be used for the purpose of efficient portfolio management.
3. UCITS are considered to use efficient portfolio management if they respect all of the following requirements:
 - The transactions are economically appropriate. This implies that they are realized in a cost-effective way;
 - The transactions are entered into for one or more of the following three specific aims:
 - the reduction of risk;
 - the reduction of cost; or
 - the generation of additional capital or income for the UCITS with an acceptably low level of risk.
4. Based on the above-mentioned criteria, techniques and instruments relating to transferable securities and money market instruments include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending.
5. Regarding the coherence between Art. 19 and Art. 21 (2), CESR notes that currently only financial derivative instruments are subject to both articles, and that in accordance with the wording of article Art. 21 (2), financial derivative instruments used under Art. 21 (2) must comply simultaneously with the provisions of Art. 19.
6. Art. 28 of the Directive defining the obligations concerning the information to be supplied to unit holders by UCITS implies that techniques and instruments relating to transferable securities and money market instruments can not result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its applicable sales documents.

Embedded derivatives

Extract from the mandate from the Commission

DG Internal Market requests CESR to clarify the factors which need to be taken into account in determining whether and under what conditions certain instruments should fall under the sub-category of transferable securities according to Art. 1 (8) as set out under Art. 21 (3), i.e. transferable securities “*embedding a derivative element*”. This clarification could be used to determine the treatment of the derivative component of the “structured financial instruments” referred to above.

Where appropriate and necessary, these clarifications should also take account of the Recommendation on the use of derivatives by UCITS.

Draft CESR advice

Explanatory text

73. An embedded derivative can be defined as a derivative instrument that is embedded in another contract, the host contract. As the Directive requires that all derivatives be considered for the application of Art. 21 and Art. 22 by a UCITS, a proper definition of embedded derivatives is designed to ensure that the Directive is not bypassed by embedding a derivative in another contract or financial instrument. As a consequence, CESR clarification should provide criteria in order to identify embedded derivatives, allowing UCITS to separate these financial instruments from their host contracts and thus to properly estimate or implement:
- a risk management process, enabling the UCITS to "*monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio*" (Art. 21 (1));
 - the "*accurate and independent assessment of the value of OTC derivative instruments*" held by the UCITS (Art. 21 (1));
 - the "*global exposure relating to derivative instruments*" of the UCITS (Art. 21 (3));
- and
- the risk diversification ratios set by Art. 22 and linked articles.
74. Paragraph 10 of the IAS 39 defines an embedded derivative as "a component of a hybrid (combined) instrument that also includes a non-derivative host contract with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative. An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable. A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument".
75. Further to that definition, paragraph 11 of the IAS 39 specifies that "an embedded derivative shall be separated from the host contract and accounted as a derivative under this standard if:

- the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract;
- a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- the hybrid (combined) instrument is not measured at fair value with changes in fair value recognized in profit or loss (e.g. a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated)".

76. CESR is of the opinion that the definition of embedded derivatives provided in paragraph 10 of the IAS 39, as well as the first criteria set by paragraph 11 of the IAS 39, should be taken into account in its advice, as the CESR approach should take into consideration the specific characteristics of UCITS in the application of the IAS 39.
77. The definition of embedded derivatives by the IASB aims at ensuring that all financial instruments are measured at their fair value, including hybrid (combined) instruments. IASB therefore clarifies which embedded derivatives should be separated from their host contract in order to ensure the fair valuation of the hybrid instrument.
78. The UCITS Directive goes one step further: not only must hybrid instruments be estimated at their fair value, as all financial assets, but their derivative component must also be taken into account for the implementation of an adequate risk management process by a UCITS, and for an adequate estimate of its exposure and of its risk spreading. CESR should therefore clarify under what conditions hybrid instruments should be considered as embedded derivatives for the purpose of applying Art. 22 of the Directive.
79. The case of counterparty limits calls for a more detailed analysis: when a UCITS holds an embedded derivative, it is exposed to the credit risk of the issuer of the hybrid instrument and to the risks that derive from the embedded derivative. Depending on the hybrid instrument, these risks may include counterparty risk. In such cases, this counterparty risk will need to be taken into account for the purpose of applying Art. 22 of the Directive. This will be the case for example if the issuer of the bond can waive the payment of coupons should a counterparty to an underlying OTC derivative default. However, in most cases, the issuer of the bond will not be able to transfer the counterparty risk to the UCITS and no specific treatment of that risk will be needed.



Draft Level 2 advice

BOX 11

1. A hybrid (combined) instrument including a non-derivative host contract embeds a derivative if:
 - some or all of the cash flows that otherwise would be required by the 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; and
 - the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.
2. A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.
3. In order to clarify the scope of the above definition, CESR considers appropriate to provide an illustrative and non-exhaustive list of structured financial instruments (SFIs) embedding a derivative:
 - credit linked notes;
 - SFIs whose performance is linked to the performance of a bond index;
 - SFIs whose performance is linked to the performance of a basket of shares with or without active management;
 - SFIs with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management;
 - convertible bonds; and
 - exchangeable bonds.
4. Given the two criteria developed above, collateralized debt obligations (CDOs) or asset backed securities using derivatives, with or without an active management, will generally not qualify as SFIs embedding derivatives, except if:
 - they are leveraged, i.e. the initial net investment is smaller than what would be required for other types of contracts that would be expected to have a similar response to changes in market factors, or
 - they are not sufficiently diversified.
5. A tailor-made hybrid instrument, such as a single tranche CDO structured to meet the specific needs of a UCITS, should be considered as embedding a derivative from the Directive point of view. Such a product offers an alternative to the use of an OTC derivative, for the same purpose of achieving a diversified exposure with a pre-set credit risk level to a portfolio of entities. Its treatment should therefore be similar to that of an OTC derivative instrument, if the consistency of the Directive provisions is to be ensured.

6. UCITS using SFIs embedding derivatives must respect the following principles, as stated in the Directive:

- Embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108/EC);

- In compliance with the third indent of Art. 21 (3) of the Directive, *"when a transferable security or money market instrument embeds a derivative, the latter must be taken into account when complying with the requirements of (Art. 21)"*. As a consequence, the UCITS must:

- employ *"a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio"* (Art. 21 (1));

- have a global exposure relating to derivative instruments inferior or equal to the total net value of its portfolio (Art. 21 (3));

- comply with all the investment limits set by Art. 22 and Art. 22a: "A UCITS may invest [...] in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits set laid down in Article 22 " (Art. 21 (3)). More specifically:

- UCITS using SFIs embedding derivatives should refer to the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments by UCITS in order to comply with the risk spreading rules required by Art. 22 of the Directive, as this Recommendation sets out how the underlying assets of financial derivative instruments should be taken into account when assessing compliance with the risk limits set by the above-mentioned article; and

- Embedded derivatives will generally not be taken into account when calculating counterparty limits, except if these products enable the issuer of the hybrid instrument to pass the counterparty risk of underlying derivatives over to the UCITS.

- Coherence must be ensured with the requirements set for financial derivative instruments, as developed below in this draft advice.



Other collective investment undertakings

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation:

- a. the “other collective investment undertaking” in question is subject to supervision “*equivalent to that laid down in Community law*” as referred to in Art. 19 (1) (e) first indent.
- b. the level of protection of unit holders is “*equivalent to that provided for unit-holders in a UCITS*” as referred to in Art. 19 (1) (e) second indent.

Draft CESR advice

Explanatory text

80. Most CESR members have so far limited experience with the conditions mentioned in Art. 19 (1) (e). In most cases these requirements are considered on a case by case basis.
81. Factors to be pondered when considering whether “other collective investment undertakings” are subject to supervision “*equivalent to that laid down in Community law*” would include:
 - a) Memorandums of Understanding (bilateral or multilateral) and membership of an international organization of regulators, such as the IOSCO, to ensure satisfactory cooperation between the authorities;
 - b) rules guaranteeing the autonomy of the management of the collective investment undertaking, and management in the exclusive interest of the unit holders;
 - c) the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision;
 - d) availability of pricing information and reporting requirements;
 - e) redemption facilities and frequency;
 - f) restrictions in relation to dealings by related parties;
 - g) the management company of the target collective investment undertaking, its rules and choice of depositary have been approved by its regulator; and
 - h) registration of the collective investment undertaking in an OECD country.
82. Factors to be pondered when considering whether the level of protection of unit holders is “*equivalent to that provided for unit holders in a UCITS*” relate to the level of protection for unit holders in the other collective investment undertaking, which is to be equivalent to that provided for unit holders in a UCITS. Requirements to asset segregation, borrowing, lending, and uncovered sales of transferable securities and money market instruments are equivalent to the requirements of the Directive.
83. This list is not to be regarded as exclusive. There is a need for flexibility so that other jurisdictions and types of collective investment undertakings will be considered on the basis of submissions made for that purpose. Such submissions would need to be detailed and comprehensive and should contain supporting documentation from the jurisdiction in question.



84. Some CESR members consider that collective investment undertakings registered in OECD countries are in principle subject to a supervision equivalent to the one laid down in Community law and as such are generally eligible.

Draft Level 2 advice

BOX 12

1. In CESR's view, the following matters can be used to assess whether a collective investment undertaking is subject to supervision "equivalent to that laid down in Community law", as provided in Art. 19 (1) (e), first indent. These factors are indicators of equivalence, which can be used to guide a decision on equivalence:

- Memorandums of Understanding (bilateral or multilateral) and membership of an international organization of regulators, such as the IOSCO, to ensure satisfactory cooperation between the authorities;
- rules guaranteeing the autonomy of the management of the collective investment undertaking, and management in the exclusive interest of the unit holders;
- the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision;
- availability of pricing information and reporting requirements;
- redemption facilities and frequency;
- restrictions in relation to dealings by related parties;
- the management company of the target collective investment undertaking, its rules and choice of depositary have been approved by its regulator; and
- registration of the collective investment undertaking in an OECD country.

Binding requirements to assess equivalence are in CESR's view not necessary.

2. In CESR's view, the following matters can be considered in deciding whether the level of protection of unit holders is "equivalent to that provided for unit holders in a UCITS", as referred to in Art. 19 (1) (e), second indent. These factors are indicators of equivalence, which can be used to guide a decision on equivalence:

- the extent of asset segregation; and
- the local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the collective investment undertaking.

Binding requirements to assess equivalence are in CESR's view not necessary.



Financial derivative instruments

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation, a derivative financial instrument, especially a credit derivative instrument, falls within the scope of the definition of derivative financial instruments as set out in Art. 19 (1) (g).

Where appropriate and necessary, this clarification should take account of the Recommendation of the Commission on the use of financial derivative instruments.

Draft CESR advice

1 Financial derivative instruments: general considerations

Explanatory text

85. UCITS are defined in Art. 1 (2) of the Directive as "undertakings the sole object of which is the collective investment in transferable securities and/or other liquid financial assets referred to in Article 19 (1)", the latter including financial derivative instruments. CESR's mandate is to determine under what conditions financial derivative instruments can be considered as eligible assets for UCITS.
86. Article 19 (1) (g) gives UCITS the possibility to invest in financial derivative instruments provided they comply with the general rules regarding their underlyings and the valuation and counterparties of their OTC derivative transactions. As a consequence, the clarification of the factors which need to be taken into account in determining whether and under what conditions, in a given situation, a derivative financial instrument falls within the scope of the definition of Art. 19 (1) (g) should aim at identifying the criteria to be used to assess the eligibility of a given financial derivative instrument, rather than providing a precise definition of these instruments.
87. It should be remembered as a general principle that in line with Recital 13 of the Directive 2001/108/EC, operations in derivatives may never be used to circumvent the principles and rules set out in the Directive. As a consequence, underlyings of derivatives must be eligible assets. CESR's opinion is that these include a combination of eligible assets (e.g. a basket of eligible transferable securities), as well as financial instruments having one or several characteristics of eligible assets (e.g. interest rates, dividends or exchange rates). The Directive does not allow direct investments in commodities, and non-financial indices are not considered as possible underlyings for a derivative as they are not eligible assets according to Art. 19 of the Directive.
88. In addition to this general principle, CESR considers that further explanations should be provided regarding:
 - the eligibility of derivative instruments on financial indices;
 - OTC derivatives; and
 - credit derivatives.



Draft Level 2 advice

BOX 13

1. Operations in derivatives may never be used to circumvent the principles and rules set out in the Directive, as stated in Recital 13 of the Directive 2001/108/EC. As a consequence, underlyings of derivatives must be eligible assets.
2. In particular, eligible assets include:
 - a combination of eligible assets; and
 - financial instruments having one or several characteristics of eligible assets (e.g. interest rates, dividends or exchange rates).
3. Eligible assets exclude:
 - non-financial indices; and
 - commodities.
4. Regarding investments giving an exposure to commodities, reference is made to point 2 of this draft advice concerning financial derivative instruments ("The eligibility of derivative instruments on financial indices").

2 The eligibility of derivative instruments on financial indices

Explanatory text

89. While the UCITS Directive clearly specifies in Art. 21 (3) that UCITS investing in derivative instruments on financial indices can benefit from an exemption to comply with the look-through approach set by Art. 22 regarding risk spreading rules ("*The Member States may allow that, when a UCITS invests in index-based financial derivative instruments, these investments do not have to be combined to the limits laid down in Article 22*"), CESR is of the opinion that derivative instruments on financial indices should be eligible only if the index complies with the requirements set by Art. 22a (1). In the opposite case, UCITS would have the possibility to gain exposure on a portfolio of assets which would not comply with the derogatory rules set by Art. 22 a, thus circumventing this article.
90. CESR members' views differ on whether financial indices based on non-eligible assets should be considered as eligible underlyings for a derivative. On the one hand, some members consider that Recital 13 of Directive 2001/108/EC, stating that "*Operations in derivatives may never be used to circumvent the principles and rules set out in this Directive*", implies that financial indices giving an exposure to non-eligible assets (e.g. hedge funds, commodities, precious metals) should not be eligible for investment by UCITS. On the other hand, some other members consider that Art. 21 (3) of the UCITS Directive implies that where the underlying to a financial derivative instrument is a financial index, there is no requirement to look through to the constituents of that index.



Draft Level 2 advice

BOX 14

1. A financial index used as an underlying in an eligible derivative instrument must comply with the provisions of Art. 22a (1) of the Directive, that is:
 - be sufficiently diversified;
 - represent an adequate benchmark for the market to which it refers; and
 - be published in an appropriate manner.

Questions:

Q 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 underlyings for derivatives; or that*
- *the wording of Art. 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 Art. 22a.*

In the context of the above, and as far as derivatives on commodity financial indices are concerned, it is considered, whether

- *derivatives on financial indices on financial instruments based on commodities would be considered as eligible; or whether*
- *derivatives on financial indices on commodities would be considered as eligible.*

Please give your view on the possible practical impacts of the different alternatives, based on your experience. Please give concrete examples of the impacts in terms of what kind of instruments would be actually left out/ taken aboard by the different alternatives. Please give quantitative examples of the impacts in terms of the sphere of eligible instruments for UCITS, if possible.

3 OTC derivatives

Explanatory text

91. CESR is of the opinion that the fair value of financial derivative instruments dealt on over-the-counter markets should be clarified based on the IAS 39, in order to ensure an harmonized implementation of the Directive throughout Europe.
92. The scope of this clarification is not linked to the necessity for the UCITS to employ a process for an accurate and independent assessment of the value of OTC derivative instruments, as required by Art. 21 (1) of the Directive. Nevertheless, such a clarification should be combined with the general requirements set by Art. 21 (1) of the Directive on risk management, in order to ensure that UCITS using OTC derivatives can measure and monitor at any time the risk of the positions and their contribution to the overall risk profile of the portfolio.



Draft Level 2 advice

BOX 15

1. The fair value of an OTC derivative corresponds to the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
2. The valuation of the contracts by the UCITS should be made on a daily basis, and be compared with an estimate provided by an independent third party at least on a monthly basis.
3. The definition of the fair value of an OTC derivative combined with the general requirements set by Art. 21 (1) of the Directive on risk management imply that an adequate risk-management process for OTC derivatives has the following characteristics:
 - the UCITS must have taken reasonable care to determine that, throughout the life of the derivative, it will be able to value the investment concerned with reasonable accuracy at its fair value, on the basis of the pricing model which has been agreed between the UCITS and the depositary, or on some other reliable basis reflecting an up-to-date market value which has been so agreed. When doing so, reference should be made to an accepted methodology; and
 - the UCITS should have the organization and the means to allow for a risk analysis realized by a department independent from commercial and operational units, and submitted to the supervisory bodies of the UCITS in order to set risk limits at least on a semestrial basis.

4 *Credit derivatives*

Explanatory text

93. A credit derivative is a derivative designed to transfer credit risk from one party to another, generally dealt over the counter. For example, in the case of a credit default swap, the protection buyer delivers a premium periodically to the protection seller, in exchange for credit risk hedging of an asset held in its portfolio. If a credit event occurs, the protection seller delivers a contingent payment to the buyer, either under the form of a cash settlement, or by buying the underlying assets at a price specified in the contract. The transaction ends after the first credit event.
94. CESR believes that credit derivatives are of a great interest for UCITS. In fact, by synthetically creating or eliminating credit exposures, they can allow institutions to more effectively manage credit risks. On the one hand, institutions can buy protection and hedge the credit risk of an asset they hold in their portfolio. On the other hand, they can sell protection and take exposure on a specified credit risk, while receiving compensation, without having to invest in the corresponding assets, thus having a more cost-effective access to financial instruments with low liquidity.
95. However, credit derivatives also carry risks due to an information asymmetry between financial institutions and UCITS on the underlyings of credit derivatives. On the one hand, a financial institution buying protection can benefit from an information asymmetry on the risk associated with the credit derivative underlying, if it is the creditor of the company issuing the underlying. For example, an institution can buy protection to a UCITS on a company for



which the institution has private information on the risk of default. On the other hand, a financial institution selling protection can overprice the credit derivative to a UCITS compared to the protection provided, for the same reason. Although the existence of an asymmetry of information between the buyer and the seller of a financial product is not specific to credit derivatives, it may be exacerbated by the leverage generally associated with the financing of such products.

96. In order to limit such information asymmetry, CESR is asking the respondents' views on whether the definition of eligible credit derivatives for UCITS should specify that issuers on which the credit risk lies must be subject to a regulation requiring them to provide public information on their financial statements.
97. In addition, the eligibility of credit derivatives requires a clarification of Art. 5a (1) (c) and Art. 5h of the Directive. In fact, the UCITS must demonstrate that its organization and its means of the investment allow for a daily estimate of the contracts, an adequate appraisal of the risks associated with credit derivatives and an internal control independent from the operational units.

Draft Level 2 advice

BOX 16

1. A credit derivative is a financial instrument allowing the transfer of the credit risk of an underlying asset or assets, independently from the other risks associated with the asset (exchange rate risk, index risk, interest rate risk).
2. A credit derivative is an eligible asset for a UCITS provided that the following conditions are met:
 - The credit derivative complies with the conditions of eligibility of derivative instruments;
 - The end of the transaction can only result in the delivery or in the transfer of assets eligible for UCITS, including cash;
 - The UCITS has taken adequate measures in order to limit risks of asymmetry of information, especially when dealing with related parties;
 - A UCITS investing in credit derivatives can demonstrate that it has the organization and the means to allow for:
 - a daily estimate of the contracts by the UCITS, that will be compared with an estimate provided by a third party at least on a monthly basis;
 - a risk analysis realized by a department independent from commercial and operational units, and submitted to the supervisory bodies of the UCITS in order to set risk limits at least on a semestrial basis; and
 - an internal control independent from the operational units.
 - Coherence is ensured with the requirements set for OTC derivative instruments including the requirements on valuation, as developed above in Box 15 of this draft advice.



Questions:

Q 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? Please explain the arguments for your view.

Q 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 to:

- one or several sovereign issuers;*
- one or several public international bodies, provided that at least one Member State is a member of the(se) public international bodi(es);*
- one or several regional or local authorities of Member States;*
- one or several legal entities, either issuers of bonds admitted to trading on a regulated market that have been graded at least once by a rating agency, or issuers of shares quoted on a regulated market; or*
- a combination of the above?*



Index replicating UCITS

1 UCITS replicating the composition of a certain index

Extract from the mandate from the Commission

DG Internal Market requests CESR to provide advice on the factors to be used to determine whether and under what conditions, in a given situation, a UCITS can be recognised as falling within the scope of the term of “replicating the composition of a certain index” of Art. 22a (1) having regard to the additional three criteria set out in the provision and the elements relating to overall limits in investment in securities issued by any one issuer.

Draft CESR advice

Explanatory text

98. CESR considers necessary to specify that its mandate is limited to index replicating UCITS investing primarily in shares and/or debt securities, and using the more flexible risk spreading rules allowed by Art. 22a of the UCITS Directive.
99. The aim of the unit holder of an index replicating UCITS is to receive a performance as close as possible to the index performance, through an exposure to the same risk-return profile as the index. The difference between the performance of the benchmark and the performance of the replicating portfolio constitutes a first appraisal of the quality of an index replication. It is often completed with an estimate of the tracking error, corresponding to the standard deviation of this difference.
100. A 100% replication is not always possible due to management commissions, custody commissions or transactions costs for instance, resulting in a difference between the performance of the benchmark and the performance of the replicating portfolio. In addition, several market factors, such as the quotation dates or the currencies of the securities composing the index, tend to increase the tracking error, thus further degrading the quality of the index replication.
101. CESR is of the opinion that the use of derivatives and/or techniques and instruments under Art. 21 (2) of the Directive as referred to above in this draft advice allow investment managers to improve the quality of the index replication, by minimizing the tracking error in a cost-effective way.

Draft Level 2 advice

BOX 17

1. A UCITS is deemed to replicate the composition of a certain index if it has the aim to replicate the composition of its underlying assets. This aim can be achieved through the use of derivatives, or any other techniques and instruments as referred to in Art. 21 (2) of the UCITS Directive.



Questions:

Q 12: Do you consider that the CESR advice should require UCITS to provide an estimate of the quality of the index replication? Please give practical examples of the possible impacts of using estimates in this regard.

Q 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?

Option A: The tracking error of the UCITS, based on the following formula:

$$TE = \sqrt{52} \sqrt{\frac{1}{N-1} \sum_{s=1}^N (R_s - \bar{R})^2}$$

where :

- R_s denotes the performance error during week s between the UCITS and its reference index, based on the evolutions of the UCITS net asset value and the index value from week $s-1$ to week s , that is:

$$R_s = \ln \left(\frac{UCITS\text{assetvalue}_s}{UCITS\text{assetvalue}_{s-1}} \right) - \ln \left(\frac{indexvalue_s}{indexvalue_{s-1}} \right)$$

- \bar{R} is the average of the performance error over a year ($N=52$ weeks):

$$\bar{R} = \frac{1}{N} \sum_{s=1}^N R_s$$

When appraising the quality of the index replication, the following elements should be taken into account since they may increase the tracking error:

- The index is composed of securities quoted on markets with different closing hours;*
- The quotation dates of the securities composing the index and the publication date of the UCITS net asset value do not match together;*
- The securities composing the index are mainly securities quoted in different currencies;*
- There is a time difference between the publication of the UCITS net asset value and the publication of the index value;*
- The index and the UCITS net asset values are published in two different currencies; or*
- The index replication involves the use of derivatives.*

Option B: The percentage of the index replication of the UCITS, based on the following formula:

$$DP = 100\% - \frac{\sum_{i=1}^n |W_i^I - W_i^F|}{2}$$

where:

DP = duplication percentage in %

n = number of equity classes in the fund and in the index (upper summation limit)

I = index

F = fund

W_i^I = weighting of equity *i* in index *I* in %

W_i^F = applicable weighting of equity *i* in the equity portion of the fund in %

Q 14: Should CESR suggest maximum thresholds as far as the estimates described above are concerned? If yes, what should these thresholds be? If you see the use of thresholds as problematic, please give practical examples of the possible impacts.

2 Index characteristics

Extract from the mandate from the Commission

<p>DG Internal Market requests CESR to provide advice on the following considerations:</p> <ol style="list-style-type: none"> factors to be taken into account in assessing whether the composition of the index is “<u>sufficiently diversified</u>” as provided for by Art. 22a (1) 1st indent; conditions under which the <u>index can be deemed to “represent an adequate benchmark for the market to which it refers”</u> as provided for by Art. 22a (1) 2nd indent; and the index is “<u>published in an appropriate manner</u>” as provided for by Art. 22a (1) 3rd indent.

Draft CESR advice

Explanatory text

102. In addition to the general rules introduced above by CESR in order to determine whether a UCITS can be deemed to replicate the composition of a certain index, three conditions must be met, in accordance with art. 22a (1) of the Directive, to assess whether a specified index can be eligible for replication by a UCITS. Such an index must:

- be sufficiently diversified;
- represent an adequate benchmark for the market to which it refers;
- be published in an appropriate manner.

103. CESR considers that in compliance with Art. 22a of the Directive, a minimum condition for estimating that an index is sufficiently diversified is that the index respects the risk dispersion rules set by the article: “... *the Member States may raise the limits laid down in Article 22 to a maximum of 20% for investment in shares and/or debt securities issued by the same*



body...". In addition, "*Member States may raise the limit (...) to a maximum of 35% where that proves to be justified by exceptional market conditions (...). The investment up to this limit is only permitted for a single issuer*". In the latter case, however, UCITS should provide an appropriate information to the subscribers in the prospectus in order to justify these exceptional market conditions, in line with Art. 28 of the Directive: "*Both the simplified and the full prospectuses must include the information necessary for investors to be able to make an informed judgement of the investment proposed to them, and, in particular, of the risks attached thereto*". In CESR's view this information need not to indicate the individual issuers, the weighting of which follows the higher investment limits as stated by Art. 22a, but include general information of the market conditions that make it necessary to apply the higher investment limits.

104. CESR considers that the methodology used by index providers will as a rule ensure that the index represents an adequate benchmark of the market to which it refers. It notes however that this methodology should generally not result in the exclusion of a major issuer of the market to which it refers.
105. A third condition for an index to be eligible for replication by a UCITS is that it should be published in an appropriate manner. In CESR's view, an obvious interpretation of this condition is that the index should be accessible to the public.
106. In addition, in order to avoid conflicts of interests, index providers should be independent from the index replicating UCITS in question. This does not preclude them from forming a part of the same economic group with the existence of adequate Chinese walls.

Draft Level 2 advice

BOX 18

1. A specified index can be eligible for replication by a UCITS if it meets the three conditions set by Art. 22a (1) of the Directive. These conditions should be interpreted as follows:
 - An index is sufficiently diversified if it respects the risk dispersion rules set by Art. 22a of the Directive. In addition, UCITS should provide an appropriate information for the subscribers in the simplified prospectus, if the limit for investment in shares and/or debt securities issued by the same body is raised above 20% and to a maximum of 35% for a single issuer, in compliance with Art. 22a (2), in order to justify exceptional market conditions;
 - The methodology of the index provider will as a rule ensure that the index represents an adequate benchmark for the market to which it refers. This methodology should generally not result in the exclusion of a major issuer of the market to which it refers;
 - An index is published in an appropriate manner if:
 - it is accessible to the public; and
 - the index provider is independent from the index replicating UCITS in question. This does not preclude them from forming a part of the same economic group with the existence of adequate Chinese walls.



ANNEXES TO THE CONSULTATION PAPER



ANNEX A

Call for Evidence – summary of the main points made

CESR published a Call for Evidence on 28th October 2004 (Ref: CESR/04-586) inviting all interested parties to submit views as to what CESR should consider in its advice to the European Commission. The deadline for responses was 29th November 2004. CESR received 15 submissions which can be viewed on CESR's website under "Consultations". The following is a short summary of the principal recurring issues which emerged in the responses to the Call for Evidence. A full list of those who responded can be found at the end of this annex.

General comments

The respondents were largely supportive to the objective of clarifying the definitions pertaining to eligible assets which are contained in the UCITS Directive. It was seen all the more important as the European investment management industry is engaged in a worldwide competition and for these reasons needs a stable, clear and cost-efficient regulatory environment. In this context as full as possible a clarification of the definitions was considered a priority.

CESR was asked, however, to avoid unnecessarily rigid interpretations and thereby increase investors' choice of regulated and supervised savings products. It was also raised, that a level-playing field between UCITS and other competing retail savings products in the EU should be achieved. This was seen to imply flexibility when interpreting the rules concerning the eligible assets of UCITS under the UCITS III legal framework whilst maintaining at the same time the existing levels of investor protection and transparency. CESR was asked to have a pragmatic approach when drafting its advice.

Few respondents raised concerns about the scope of comitology in the UCITS Directive and the sphere of definitions in the Directive that can be clarified on Level 2.

Transferable securities

Almost all respondents stressed the necessity for the security to be freely transferable, i.e. transferable to a third party without the specific consent of any other party to the transaction.

The majority of respondents expressed the view that a security that is admitted to or dealt in on a regulated market and can be freely transferred should be regarded as a liquid instrument. It was seen, that in practice, however, there are different degrees of liquidity in terms of number of potential counterparties, trading volumes etc. Many respondents mentioned that for the management of a UCITS the degree of liquidity of its eligible assets has to be taken into account with a view to ensuring redeemability for the investor. The key issue was seen to be the liquidity of the fund as such as opposed to each instrument/security individually. The possibility to value the fund accurately was also considered essential. It was mentioned, that the question whether an instrument is sufficiently liquid, should remain the responsibility of the fund manager. It was stressed that all UCITS must abide by the overarching principal for the fund to be subject to prudent spread of risk and to comply with its investment objectives and policy as disclosed in the legal instrument constituting the UCITS and the prospectus of the UCITS. These factors were considered essential to guarantee investor protection.



Structured financial instruments

In most respondents' view there is no reason to consider that structured financial instruments would not fall under the definition of transferable securities. A "look-through" approach, i.e. a general principle prohibiting underlyings that would not be eligible instruments for the UCITS directly, was seen problematic by some respondents. As decisive factor was considered that the fund manager takes care that the use of the underlying in an eligible security does not affect the characteristics of that security in a way that is not in line with the investment objective of the fund, its risk profile as well as the general principles of the UCITS Directive. The necessity of the fund manager to have an appropriate risk management process in place was stressed.

Closed end funds

In general, the respondents believed that closed end funds fulfil the basic criteria of a transferable security in the meaning of Article 1(8) of the UCITS Directive and should be treated as such. It was pointed out, though, that investments in such securities must comply with the fund's objectives and risk profile, general diversification rules, the redeemability requirement, etc. Regarding the underlyings of such funds a comparable consideration as for the underlyings of structured financial instruments should be applied in many respondents' view. On the other hand some respondents were of the view, that these instruments should not be used by the UCITS for the specific purpose of circumventing investment restrictions applicable to UCITS.

Money market instruments

Many respondents suggested, that if money market instruments are dealt in on a regulated market they should be regarded as instruments that are liquid and able to be valued accurately. CESR was asked to provide some investment criteria for money market instruments other than those dealt in on a regulated market by some respondents. CESR was asked to adopt a pragmatic approach in this regard, based on the practical situation of issuers. In this context it was mentioned that CESR might focus on criteria for equivalent regulation and investor protection, quality of issuers etc. Securitisation structures and vehicles that are relevant in that market were seen as necessary to be taken into account when developing these rules. It was stressed that the market for securitisation is becoming more and more important in Europe.

As regards the special characteristics of money market instruments, it was pointed out that there is very little activity in the secondary market for money market instruments because of their short maturities. The nature of money market investors is generally buy and hold to maturity.

Credit derivatives

Credit derivatives were seen to constitute a useful tool to manage risk, both credit risk and duration, in relation to bond portfolios. Therefore they were seen necessary to be eligible assets for UCITS by most of the respondents. Some respondents raised the need to make a difference in the applicable rules concerning e.g. exposure and diversification rules depending on whether the UCITS is buying protection (hedging) via credit derivatives, or whether it is selling protection. The necessity to have an adequate risk management process in place was stressed.

Efficient portfolio management

The concept of "used for the purpose of efficient portfolio management" as stated in Art. 21 (2) of the UCITS Directive was seen to mean that the techniques and instruments relating to transferable securities and money market instruments should be used in the best interest of the shareholders/unit holders of the UCITS. It was also stressed that these transactions must be economically appropriate. The use of efficient portfolio management techniques was seen appropriate in order to



reduce costs of investments, to maintain sufficient liquidity by the UCITS, to achieve the investment policy of the UCITS and the mitigation of risks of all kinds related to the implementation of the investment policy of the UCITS.

Another possible aim was seen to be to generate additional capital or income for the UCITS with no or an acceptably low level of risk. In addition to the use of derivative instruments securities lending was mentioned as one possible technique for efficient portfolio management by UCITS.

Most respondents called for a broad definition of efficient portfolio management, to facilitate its practical application. The main limit for the use of efficient portfolio management techniques was seen to be that these techniques must be consistent with the overall investment objectives of the fund in question.

Index replicating UCITS

It was stressed that there are currently in Europe a number of approaches to indexation ranging from where the fund actually holds all the securities contained in an index, at the appropriate weightings, to purely replicating the performance of an index. It was recommended that CESR provides interpretation of “replicating an index” in order to ensure consistency across Member States. It was stressed by many respondents that the index must be publicly available, through any widely available media. Some respondents also asked CESR to clarify what determines the eligibility of an index-based financial derivative instrument.

Respondents to the Call for Evidence

Banking

DekaBank Deutsche Girozentrale

Insurance, pension & asset management

Association Française de la gestion financière (AFG)
Association of the Luxembourg Fund Industry (ALFI)
Dublin Funds Industry Association (DFIA)
FEFSI
Fidelity Investments
Institutional Money Market Funds Association (IMMFA)
Investment Management Association (IMA)
JPMorgan Fleming Asset Management
Schroders

Investment Services

Bundesverband Investment und Asset Management (BVI)
International Primary Market Association (IPMA)

Legal & Accountancy

Arendt & Medernach

Regulated markets, exchanges & trading systems

Euronext
London Stock Exchange

Annex B Indicative CESR work plan on the clarification of definitions of the UCITS Directive

