THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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

2nd Consultation Paper

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INTRODUCTION

1. CESR publishes its second consultation paper on its draft technical advice to the European Commission regarding clarification of definitions concerning eligible assets for investments of UCITS. This second consultation will help CESR to define an appropriate regulatory intervention.

Background

2. In the context of the implementation of the so-called 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.

3. 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.

4. In view of this, DG Internal Market has indicated that it 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 requested technical advice of CESR by publishing a mandate to CESR on 28th October 2004: "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 text of the mandate is set out in each specific section of CESR's Level 2 advice.

5. The adoption of implementing legislation on eligible assets of UCITS has been included into the list of priority actions in the Commission Green Paper on the enhancement of the EU framework for investment funds, published 14th July 2005.

6. 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 carry out work on the conduct of business rules on Level 3 of the Lamfalussy procedure regarding collective investment management.

7. 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.

8. 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' representatives.

General observations based on the responses to the first consultation

9. On 18th March 2005 CESR published its first consultation paper on its draft technical advice (CESR/05-064b). The public consultation closed on 10th June 2005. CESR received a high number of responses (more than 50).

10. The Commission asked originally CESR to deliver its technical advice by end of October 2005. Many consultation respondents asked for the possibility for a <u>second consultation</u>, taking into account the difficult nature of this exercise and the interests involved. Therefore, the Commission has on request of CESR extended the deadline of the mandate from the end of October 2005 to mid-January 2006, when CESR is having its first scheduled meeting for 2006. This change has made it possible for CESR to consult the stakeholders for the second time during autumn 2005.

11. The first consultation paper presented the overall draft CESR approach to the substance questions related to eligible assets. It was suggested by many consultation respondents that a distinction be made between possible comitology measures at Level 2 and issues that would need to be addressed at Level 3. The second consultation paper makes a <u>distinction between suggested comitology measures and other measures</u>.

12. A number of consultation respondents stressed that CESR should take into account the cost implications of its recommendations, and that a cost benefit analysis is necessary regarding the possible comitology measures. The second consultation paper therefore includes questions that aim to gather information from market participants to be used to evaluate the <u>possible impacts of the suggested measures</u>.

13. Many consultation respondents stressed that CESR should consider <u>transitional arrangements</u> for those UCITS which have been authorised as such by a Member State but which cease to be a UCITS as a result of the clarification of eligible assets. CESR and the Commission are currently exploring possible ways to deal with such cases, taking into account the protection of the concerned investors and the integrity of the markets. When gathering information on the possible impacts of the suggested measures as explained above, CESR also welcomes assessments of market participants of the number of such UCITS and investors involved.

It is to be noted that many CESR Members have expressed the need to achieve rapidly a level playing field on the issue of eligible assets between Member States. When implementing UCITS III, some Member States have interpreted the Directive allowing large flexibility on the choice of eligible assets, while others have taken a more risk-averse approach, with a strict adherence to the investor protection safeguards of the Directive. To achieve a level playing field in the necessary timetable, the possible transitional arrangements can only be of a very limited nature. Once CESR's advice has been transformed into a legal text by the Commission, CESR and the Commission will address the issue of adaptation to the investment criteria provided by the comitology measures of those UCITS that have invested into assets different from those provided by the comitology measures.

Call for comments

14. CESR invites comments on its views regarding the issues raised. Respondents are invited to accompany any request for changes with detailed reasoning and practical examples of the impact of the proposals. CESR also welcomes specific drafting proposals when respondents are seeking changes to the proposed Level 2 advice/ Level 3 guidelines.

Consultation Period

15. The consultation closes on **21st November 2005**. Responses to the consultation should be sent via CESR's website (www.cesr-eu.org) under the section "Consultations".

16. In order to facilitate the consultation process, CESR will be holding an open hearing on **7th November 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

17. 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.

CESR

DRAFT TECHNICAL ADVICE

DEFINITIONS

18. 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.

19. 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.

20. 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

21. 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.

22. 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.

23. 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."

24. 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 Art. 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.

25. 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]

26. 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. However, financial innovation has, since 1985, given rise to new products that were not anticipated by the Directive. Many of the new financial products could amount to eligible assets for UCITS through being "transferable securities". However, their features might differ from those "transferable securities" which were envisaged by the original Directive. This part of the Paper seeks to address this development and whether the term "transferable security" needs to be clarified in a way that would differentiate the new products – allowing some of them to be eligible assets for UCITS, whilst preventing others from being eligible. This distinction is of course based on the appropriateness of the new products for UCITS – which are themselves at the heart of the retail regimes of all EU Member States. The Directive does not itself distinguish between different types of transferable security for UCITS' eligibility purposes.

27. The Directive draws a distinction between transferable securities that are admitted to trading on a regulated market and those that are not. The former are eligible under Art. 19(1)(a) to (d), whilst the latter are eligible under Art. 19(2)(a). In recognition of the safeguards provided by the market authorities in admitting or listing the security, Art. 19(2)(a) applies a portfolio limit of 10% for holdings eligible under Art. 19(2)(a). The advice which follows in Box 1 relates only to transferable securities that are eligible under Art. 19(1)(a) to (d). Box 2 then deals with criteria to apply to securities eligible under Art. 19(2)(a) and also to those securities that are admitted/ listed but which fail to meet the criteria applied in Box 1. All together the transferable securities covered by Box 2 would be eligible to the UCITS up to 10% of its assets. The purpose of this distinction is to apply appropriately less rigorous criteria to securities eligible under Art. 19(2)(a) taking into account their different nature.

28. In CESR's view the matters set out in Box 1 are relevant when deciding whether an investment amounts to a "transferable security" for eligibility under Art. 19(1)(a) to (d). These factors will clearly affect the transferability of the security.

29. 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.

30. The mandate given to CESR refers specifically to Structured Financial Instruments (SFIs) as an example of recent financial innovations. As mentioned, the Directive's definition of a "transferable security", as amended in 2002, does not subdivide the category of "transferable securities". 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 way as developed below in this draft advice

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

concerning embedded derivatives. In particular, it is CESR's view that when an structured financial instrument includes a derivative element, Art. 21(3) of the Directive applies.

The question of liquidity

31. The concept of transferable securities might encompass a range of products with differing features (shares and bonds, certain structured financial instruments or other types of financial innovations, certain closed end funds as further specified under Chapter 3 Closed end funds as "transferable securities"). In all these cases the UCITS needs nevertheless to be able to fulfil certain other obligations imposed by the Directive such as portfolio liquidity.

32. 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. In order to meet this obligation UCITS are required to maintain an appropriate degree of liquidity, to meet foreseeable redemptions.

33. It is clear that different investment instruments have different levels of liquidity. Within the class of "transferable securities", there is a spectrum of liquidity, meaning that for example some company shares are more liquid than some others. The fact of admission to trading on a regulated market of a transferable security provides a presumption of liquidity but does not guarantee it. This means that 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 liquid. In such a case, where the acquisition of the security is material for portfolio liquidity, the UCITS would need to assess the liquidity of the security sufficiently to establish whether its addition to the portfolio would compromise portfolio liquidity. "Liquidity" in this context means, as elsewhere in this paper, that the security must be capable of being sold at a limited cost in an adequately short timeframe.

34. A number of respondents to the first consultation questioned the CESR position on instrument liquidity and what a UCITS must do in assessing whether an individual transferable security is sufficiently liquid for the portfolio. The first point to be made is that the Directive itself is unclear about the liquidity of individual transferable securities. It is accepted by all CESR Members that the liquidity of financial instruments may vary over time, and some will inevitably be more liquid than others. CESR's view is therefore that the need for instrument liquidity is related to Art. 37, which requires that a UCITS "must re-purchase or redeem its units at the request of any unit-holder". There must therefore be adequate prospective liquidity so that the UCITS is reasonably satisfied that that obligation will be met. The text of this second consultation paper has sought to make that clear at appropriate points.

35. A second point to be made is that portfolio liquidity is created from the sum of the liquidities of the underlying financial instruments. It is therefore not possible to assess the liquidity of the portfolio without paying attention to some degree to the liquidity of its constituent parts. Where a transferable security is admitted to trading on a regulated market the UCITS may consider such a security to be liquid unless the UCITS knows or ought reasonably to know that the security is not liquid. A UCITS may buy or hold transferable securities of varying liquidities. However where the portfolio contains a significant number of less liquid securities, the UCITS must keep the situation under appropriate review, to ensure continued compliance with Art. 37.

Draft Level 2 advice/ Level 3 guidelines

BOX 1

LEVEL 2

1. "Transferable security" means, in the context of Art. 19(1)(a) to (d), that the transferable security must fall within the definition of "transferable security" in Art. 1(8) of the Directive. In particular:

    - the security must not expose the UCITS to loss beyond the amount paid for it or where it is a partly paid security, to be paid for it;

    - the liquidity of the security must not compromise the UCITS' ability to comply with Art. 37 of the Directive;

    - there must be accurate, reliable and regular prices, either being market prices or prices made available by valuation systems independent from issuers;

    - there must be regular, accurate and comprehensive information available to the market on the security or, where relevant, on the portfolio of the security; and

    - the security must be freely negotiable on the capital markets.

2. 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.

3. The risk of the security must be adequately captured in the risk management process of the UCITS.

4. Where the security embeds a derivative element, such derivative element must be taken into account, as required by Art. 21(3).

LEVEL 3

Liquidity

5. There is a presumption, but not a guarantee, that transferable securities admitted to trading on a regulated market as defined in Art. 19(1) are liquid. The presumption does not apply if the UCITS knows or ought reasonably to know that any particular security is not liquid.

6. If the UCITS knows or ought reasonably to know that any particular security is not liquid (so that the presumption of liquidity does not apply) the UCITS must assess its liquidity risk. The liquidity risk is a factor that the UCITS must consider when investing in any financial instrument in order to be compliant with the portfolio liquidity requirement to the extent required by Art. 37. In taking this prudent approach, the following are examples of the matters a UCITS may need to consider:

    - the volume and turnover in the transferable security;

    - if price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy; also evaluation of the opportunity and timeframe to buy or sell;

- where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of available prices;

- 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.

7. The security's risks and their contribution to the overall risk profile of the portfolio must be assessed on an ongoing basis.

Questions:

Q 1. Do you agree with the approach as suggested in Box 1?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

2 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

36. 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).

37. 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).

38. Box 2 sets out the factors relevant to defining the eligibility of transferable securities covered by Art. 19(2)(a). It is also necessary to accommodate in some way securities that meet the criteria of Article 19(1)(a) to (d), but which do not meet the Box 1 standards. These securities also fall to be assessed under Box 2. The global limit for all these investments in the portfolio of a UCITS would be 10 %.

39. The Directive contains only one definition of "transferable security". The term must therefore carry the same meaning wherever used in the Directive. On that basis, the "transferable securities" whether they are eligible under Art. 19(1)(a) to (d) or Art. 19(2)(a) should be submitted to a consistent treatment. However, it is clear that unlisted/ unadmitted securities cannot and need not meet standards identical to listed or admitted securities. However, CESR believes that the same basic criteria can apply to both.

40. There are two issues which must be, however, treated differently for securities eligible under Art. 19(2)(a). First, Box 1 requires that "there must be accurate, reliable and regular prices, either being market prices or prices made available by valuation systems independent from issuers". This cannot be the case for securities eligible under Art. 19(2)(a). However, this does not mean that such securities should be acquired without a view as to their value. Box 2 sets out criteria suitable for such securities.

41. Second, Box 1 requires that "there must be regular, accurate and comprehensive information available to the market on the security or, where relevant, on the portfolio of the security". Once again, the information available on an Art. 19(2)(a) transferable security will be substantially less than that available on those that are eligible under Art. 19(1)(a) to (d). It will not be "comprehensive" and may not be made available with the same regularity. CESR therefore recommends that the requirement for information should be retained for Box 2, but that the requirement for "comprehensive" information should be removed.

42. Consultation respondents may notice that when comparing this second consultation paper with the first one, Boxes 2 and 3 have been reversed in the order in which they are presented. CESR believes this makes the presentation of the proposals clearer.

<u>Draft Level 2 advice/ Level 3 guidelines</u>

BOX 2

LEVEL 2

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 one or more of the conditions respectively described in Art. 19(1)(a) to (d). It must however fall within the definition of "transferable security" in Article 1(8). In particular:

   - the security must not expose the UCITS to loss beyond the amount paid for it or where it is a partly paid security, to be paid for it;

   - the liquidity of the security must not compromise the UCITS ability to comply with Art. 37 of the Directive;

   - there must be a valuation of the security available on a periodic basis which is derived from information from the issuer of the security or from competent investment research;

- there must be regular and accurate information available to the market on the security or, where relevant, on the portfolio of the security; and

- the security must be freely negotiable on the capital markets.

2. 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.

3. The risk of the security must be adequately captured in the risk management process of the UCITS.

4. Where the security embeds a derivative element, such derivative element must be taken into account, as required by Art. 21(3).

LEVEL 3

5. For transferable securities falling within this Box liquidity can not automatically be presumed. The UCITS will therefore need to assess the liquidity of such securities where this is necessary to meet the requirements of Art. 37. The assessment should be done in the same way as in Box 1. If the security is assessed as insufficiently liquid to meet foreseeable redemption requests, the security must only be bought or held if there are sufficiently liquid securities in the portfolio so as to be able to meet the requirements of Art. 37.

6. The security's risks and their contribution to the overall risk profile of the portfolio must be assessed on an ongoing basis.

Questions:

Q 2. Do you agree with the approach as suggested in Box 2?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

3 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

43. CESR has considered carefully the question whether closed end funds are eligible investments for a UCITS and has concluded that such investments are potentially eligible where the closed end fund is constituted as a transferable security. This means also that the above analysis of transferable securities applies equally to such funds. As a transferable security, a closed end fund must therefore comply with either Box 1 or Box 2.

44. In addition, however, CESR is of the opinion that the following matters are relevant in assessing the eligibility of a closed end fund. In particular:

(a) the asset management activity carried on by or on behalf of the closed end fund must be subject to appropriate investor protection safeguards; and

(b) UCITS must not make investments in closed end funds for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive.

45. CESR has not reached an agreement on the specification of "appropriate investor protection safeguards ". Alternative approaches have emerged on this point:

(a) Some CESR Members believe that meeting the standards for listing is a sufficient standard. There have been many enhancements of corporate governance arrangements in recent years which require investment companies to be properly managed.

(b) Several CESR Members believe that the necessary standard is met where the asset management activity of the closed end fund is carried out by an asset management firm which is itself regulated by national authorities for the purpose of investor protection.

46. 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.

47. In the first consultation paper it was suggested that a UCITS should not invest in closed end funds "for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive". Several consultation respondents were unsure what this would amount to. The expression is a reference to the UCITS' purpose in dealing for its portfolio.

48. CESR is of the opinion that these requirements will allow for UCITS to invest into closed end real estate funds and private equity funds. Other types of funds may be included if they can meet the requirements of Box 1 or 2, but some funds may find it difficult to meet those requirements. Some "hedge funds" for example may not make sufficient information available to the market to be eligible.

49. The first consultation paper did not refer explicitly to contractually based funds. CESR Members agree that the starting position should be to treat all closed end funds in the same way. Closed end funds in contractual form are therefore potentially eligible assets where they meet the definition of "transferable security" set out in Art. 1(8) of the Directive – that is, where they amount to "securities equivalent to shares in companies". Crucially, CESR believes that corporate governance mechanisms equivalent to those applicable to companies must apply to such funds in order for the requirement of "equivalence" to be met. Of course, if a contractually based fund is able to meet the definition of Art. 1(8), it will only be eligible if it meets the requirements of either Box 1 (i.e. listed transferable securities that are eligible up to 100% of the assets of a UCITS) or Box 2 (i.e. a UCITS may invest no more than 10% of its assets in such securities), and in addition the requirements of Box 3.

Draft Level 2 advice/ Level 3 guidelines

BOX 3

LEVEL 2

1. "Transferable security" includes a closed end fund which complies with the requirements of Box 1 or Box 2.

2. The asset management activity carried on by or on behalf of the closed end fund must be subject to appropriate investor protection safeguards.

3. UCITS may not make investments in closed end funds for the purpose of circumventing the investment limits provided for UCITS by the UCITS Directive.

4. Closed end funds in contractual form are eligible where their corporate governance mechanisms are equivalent to those applied to companies generally.

Questions:

Q 3. Do you agree with the approach as suggested in Box 3? What is your view of the options presented concerning the specification of the "appropriate investor protection safeguards"?

Is the suggested treatment of contractually based funds appropriate, i.e. is it enough to apply same requirements to closed end funds of the contractual type as to the corporate type of funds, or should CESR explore different criteria for closed end funds of the contractual type? Do listing requirements differ sensibly between funds structured in contractual form compared to those structured as companies?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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?

<u>Draft CESR advice</u>

<u>Explanatory text</u>

50. 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:
    a. MMIs dealt in on a regulated market in accordance with Art. 19(1)(a) to (d) of the UCITS Directive;
    b. 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
    c. 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.

51. 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.

52. 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.

53. 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)*".

54. According to the ECB statistical framework[2], 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) <u>liquidity</u>, 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) <u>market depth</u>, 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) <u>certainty in value</u>, where their value can be accurately determined at any time or at least once a month; and

(iv) <u>low interest risk</u>, 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) <u>low credit risk</u>, 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".

55. 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 unit holders (Art. 37 of the 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 a 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 price closely

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

corresponding to the current valuation of the financial instrument on its own market".

The definition of a MMI given by Art. 1(9) of the 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 correspond to the value at which this instrument could be exchanged, between knowledgeable, willing parties in an arm's length transaction. This can be achieved either by using market data, provided it is available and relevant, or valuation models. 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 definition provided by CESR's advice regarding "liquidity" of MMI is concerned, a majority of the comments received has indicated that the criteria used to assess the liquidity of MMIs should not be understood as cumulative. However, some contributions have emphasized that liquidity would need to be evaluated at two levels: at the security level and at the fund level. Therefore, liquidity should be considered to be relative to the MMI in question as well as its impact on the fund:

- at the money market instrument level, the following factors could be relevant in assessing the liquidity for a money market instrument:
  - frequency of trades and quotes for the security in question,
  - number of dealers willing to purchase and sell the security in question (other than the dealer involved with the sale of the security),
  - willingness of the dealers to make a market in the financial instrument in question, pricing bid/ask spreads, the nature of market place trades (time needed to sell the security, method for soliciting offers and mechanism of transfer),
  - credit rating status of the financial instrument,
  - complexity of the structure of the security, size of issuance/program, asset.

These conditions should be considered as cumulative even if the fact that some of them are not fulfilled does not imply that the financial instrument should be automatically considered as non-liquid;

- beyond the assessment of liquidity of the money market instrument, the contribution of that individual instrument to the overall liquidity of the fund should also be considered. Factors that should be considered include:
  - unit holder structure and concentration of unit holders of the UCITS,
  - purpose of funding (investors), quality of information on the fund's cash flow patterns,
  - prospectuses' guidelines on the limitation of withdrawals.

Against the background of keeping the portfolio' risk profile in mind, sufficient planning in the structuring of the portfolio and foreseeing cash flows (subscriptions & redemptions) in order to anticipate cash flows with selling appropriately liquid securities in the portfolio to meet these demands should be addressed. CESR's advice takes into account this proposition of drafting.

56. As far as the definition provided by CESR's advice regarding "value which can be determined at any time" is concerned, comments have raised two issues. *Firstly*, a minority of comments asked that the use of linearization method for MMI with short maturities (less than 3 months) be authorized. This suggestion has been taken into account since it is now proposed by CESR that for MMI with a residual maturity of less than three months, the use of an amortization method is possible provided the MMI does not have a specific sensitivity to market parameters

(e.g. credit risk). As a general rule, if the funds are indeed required to invest in high-quality instruments with maturity (or remaining maturity) of at most one year and where the fund has a weighted average maturity of 60 days, amortization could be allowed but the funds should be required to react promptly and revalue the NAV if significant events happen that are likely to affect the NAV (significant interest rate changes or changes in credit ratings in the underlying instruments). *Secondly*, a majority of comments have asked that the advice regarding valuation models be clarified to better stress that market valuation should be preferred whenever it is relevant. The current advice tries to clarify the valuation criterion by taking into account this demand.

57. Regarding the definition of the criteria "*normally dealt in on the money market*", many comments have criticized the drafting of the recommendation stating that the "low interest risk" criteria introduced by the recommendation could imply that emerging market MMIs were excluded from Art. 1(9) due to the risk of loss due to changes in interest rates. This criterion has been deleted.

58. Other comments regarding the definition of the criteria "*normally dealt in on the money market*" have pointed out that the CESR's advice might refer both to the criteria of maturity at issuance (as a feature of MMIs) and of residual maturity. The criterion of maturity at issuance of less than 12 months appears indeed in the definition of MMI in the Prospectus and of the Transparency Directives. In both Directives, the distinction between short-term and long-term debt instruments is based on the notion of "original maturity" (i.e. maturity at issuance). This notion is seen as useful to describe, inter alia, the funding strategies of borrowers on the capital markets. This criterion is also specified in the CESR draft advice as a MMI feature.

59. A majority of public comments has requested that the CESR proposition indicating that treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances are deemed to be money market instruments, should be a level 3 advice. The revised draft advice follows this suggestion.

Draft Level 2 advice/ Level 3 guidelines

BOX 4

LEVEL 2

The definition of Money Market Instruments can be clarified as follows:

- with respect to the criterion "liquid": instruments which can be sold at a limited cost in an adequately short timeframe taking into account the requirement of Art. 37 of the UCITS Directive that the UCITS should repurchase or redeem its units at the request of any unit holder.

- with respect to the criterion “value which can be accurately determined at any time”: instruments for which accurate and reliable valuation systems are available and enable the UCITS to calculate a net asset value in accordance with the value at which MMIs held in the portfolio could be exchanged, between knowledgeable, willing parties in an arm’s length transaction. This enables the UCITS to fulfill the requirement set by Art. 1(2) of the UCITS Directive requiring that units be repurchased or redeemed at the request of unit holders. These systems can be based on market data or on valuation models and include systems based on amortised cost methodology.

- with respect to the criterion “normally dealt in on the money market”: as a general rule, this will include instruments which have a maturity at issuance of less than 12 months or a residual maturity of up to and including one year as a general rule, or regular yield adjustments in line with money market conditions at least every 12 months. UCITS should conduct an in depth analysis of the risk profile of instruments which do not comply with these maturity criteria to check that they have the risk profile of money market instruments.

BOX 4

LEVEL 3

When assessing the liquidity of a MMI, the following cumulative factors have to be taken into account:

- at the instrument level:
  - frequency of trades and quotes for the instrument in question;
  - number of dealers willing to purchase and sell the instrument, willingness of the dealers to make a market in the instrument in question, nature of market place trades (times needed to sell the instrument, method for soliciting offers and mechanics of transfer);
  - size of issuance/program;
  - possibility to repurchase, redeem or sell the MMI in a short period (e.g. 7 business days), at limited cost, in terms of low fees and bid/offer prices and with very short settlement delay;
- at the fund level, the following relevant factors should be considered in order to ensure that any individual MMI would not affect the liquidity of the UCITS at the fund level:
  - unit holder structure and concentration of unit holders of the UCITS;
  - purpose of funding of unit holders;
  - quality of information on the fund's cash flow patterns;
  - prospectuses' guidelines on limiting withdrawals.

  These elements must ensure that UCITS will have sufficient planning in the structuring of the portfolio and in foreseeing cash flows in order to match anticipated cash flows with the selling of appropriately liquid instruments in the portfolio to meet those demands.

BOX 4

LEVEL 3

With respect to the criterion "value which can be accurately determined at any time": if the UCITS considers that an amortization method can be used to assess the value of a MMI, it must ensure that this will not result in a material discrepancy between the value of the MMI and the value calculated according to the amortization method. The following UCITS/MMI will usually comply with the later principles :

- MMI with a residual maturity of less than 3 months and with no specific sensitivity to market parameters, including credit risk or
- UCITS investing solely in high-quality instruments with as a general rule a maturity or residual maturity of at most one year or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days.

These principles along with adequate procedures defined by the UCITS should avoid the situation where discrepancies between the value of the MMI as defined at level 2 and the value calculated according to the amortization method would become material. These procedures might include updating the credit spread of the issuer if necessary.

Treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances will usually comply with the criterions "normally dealt in on the money market".

<u>Questions:</u>

Q 4. Do you agree with the approach as suggested in Box 4?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

Given the very low level of interest rates (especially in the eurozone), what are the thresholds currently used by the industry to qualify a discrepancy as being material?

Are these thresholds defined at the instrument and/or at the fund level?

Does the industry use escalation procedures to prevent any discrepancy to become material? Please give details of these escalation procedures (discrepancy threshold, steps taken etc.).

<u>Explanatory text</u>

60. 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).

61. 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 UCITS. It provides a presumption and not a guarantee of liquidity 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 Art. 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.

62. Finally, CESR considered whether other considerations contained in the UCITS Directive, such as the provisions prohibiting uncovered sales (Art. 42) or the investment in precious metals (Art. 19(2)(d)) should have to be taken into account.

63. 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.

64. 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.

65. A majority of respondents has not understood why CESR had wanted to cover by points 2 and 3 of Box 5 precious metals and the prohibition of short selling. These respondents requested that these two points should be deleted as the provisions of Art. 19(2) and Art. 42 clearly prohibit the acquisition of precious metals (including through certificates) as well as uncovered sales. CESR notes that the Commission's request for advice had been drafted in such way that it had to answer to that question.

Draft Level 2 advice/ Level 3 guidelines

BOX 5

LEVEL 2

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 Directive. The fact of the admission to trading on a regulated market of a MMI provides a *presumption* that the conditions of "liquidity" and "accurate valuation" are complied with. These criteria are not automatically fulfilled and in the event that a UCITS believes that this presumption should not be relied upon, the MMI should be subject to an appropriate assessment.

LEVEL 3

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.

Questions:

Q 5. Do you agree with the approach as suggested in Box 5?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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

66. 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.

67. 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.

68. Accordingly, CESR identified initially 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.

69. During the first consultation, a majority of respondents have suggested to replace "issue" with "program" in the first indent in order to reflect commercial reality where on occasion an information memorandum is used to cover a number of issues. This suggestion has been positively taken into account in CESR's advice.

70. A majority of respondents fully supported the STEP project as a means of standardizing dealing practices in Europe, especially if it leads to the opening up of certain investor markets to which the ECP market has previously only had partial access.

71. At the same time, there were concerns that STEP would become the only route for access of UCITS funds throughout Europe and that any formal endorsement of it at the UCITS level would lead to a reduction in borrower choice of short term issuance methods. By not explicitly mentioning the STEP initiative in Box 6, CESR' advice has taken into account this concern. It is not the aim of CESR's advice to oblige some money market instruments to migrate to specific markets. Accordingly, STEP should not be the only way for MMIs to be considered as eligible for UCITS. CESR's advice only provides key features striving to precise the wording of Art. 19(1)(h) - "is itself regulated for the purpose of protecting investors and savings".

72. As a matter of fact, it should be considered that the STEP initiative will encompass a wider range of types of issuers than those specifically provided for in Art. 19(1)(h) (for instance corporate entities and securization vehicles not subject to prudential supervision and not listed on an regulated market). This possibly different scope between Article 19(1) and the STEP initiative cannot be solved through Level 2 measures.

73. The promoters of STEP have mentioned that the information regarding MMIs not dealt in on a regulated market should be controlled by an independent authority whereas other comments have preferred a control by any independent entity such as an auditor. From the point of view of STEP's promoters, this authority should be composed of persons with a high degree of expertise and market experience. These persons should be required to meet the various standards of integrity and should not be subject to instructions from the organizations to which they belong. Nevertheless, the STEP promoters did not precisely mention how this "Chinese wall" organization will be concretely implemented and how conflicts of interests will be addressed. CESR's advice has preferred to use the expression "independent body" defined as "*a body specializing in the verification of legal and financial documentation".*

74. Moreover, the promoters of the STEP initiative have suggested that CESR's advice should make a precise reference to the necessity of establishment of reliable and available statistics allowing to ascertain transparency of the programs. From STEP promoters' point of view, these elements are necessary to create some incentive for European Commercial Papers to migrate towards the STEP initiative. This suggestion has been positively taken into account.

CESR

Draft Level 2 advice/ Level 3 guidelines

BOX 6

LEVEL 2

1. The factors above in Box 4 concerning MMIs apply also to MMIs that are not dealt in on a regulated market.

2. The criterion requiring that the issue or the issuer of MMIs not admitted to or dealt in on a regulated market "*is itself regulated for the purpose of protecting investors and savings*" as referred to under Article 19(1)(h) means money market instruments which fulfil the following criteria:

   - availability of information on both the issue or issuance program and the legal and financial situation of the issuer prior to the issue of the MMI;

   - regular up-dating of this information (i.e. on an annual basis or whenever a significant event occurs);

   - control of this information by an independent body specializing in the verification of legal or financial documentation and composed by persons meeting various standards of integrity and not subject to instructions from the organization they belong and from the issuers;

   - a minimum amount of each issuance of EUR 150.000 or the equivalent in other currencies;

   - free transferability and electronic settlement in book-entry form;

   - availability of reliable statistics regarding the issue or issuance programs.

LEVEL 3

3. 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.

Questions:

Q 6. Do you agree with the approach as suggested in Box 6?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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 <u>at least as stringent</u> 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.

<u>Draft CESR advice</u>

<u>Explanatory text</u>

75. 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.

76. A majority of respondents to the first consultation disagreed with CESR advice indicating that "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. Art. 19(1)(h) third indent of the UCITS Directive refers indeed to "prudential rules considered by the competent authorities to be at least as stringent as those laid down by the Community law". This comment has been taken into account in the revised advice.

77. A minority of respondents requested to enlarge the eligible countries by accepting all the OECD countries and even the countries which are members of the IOSCO. This suggestion has not been accepted since it would enlarge the eligible countries in a way that would not be consistent with the UCITS Directive's conditions without enough requirements. It is demanded by CESR's advice that the in-depth assessment of the issuer mentioned in Box 7 should strive to gather elements allowing to state that the countries have the same prudential rules as the EEA or G10 countries.

Draft Level 2 advice

BOX 7

Level 2

The criterion "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 Article 19(1)(h) third indent means an issuer which is subject to prudential rules and

- which is located in the European Economic Area or
- which is located in G10 countries (including USA, Canada, Japan and Switzerland) or
- which has at least an investment grade rating or
- for which it can be demonstrated based on an in-depth risk-assessment of the issuer that the prudential rules are at least as stringent as those laid down by Community law.

Questions:

Q 7. Do you agree with the approach as suggested in Box 7?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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 securities[3] and synthetic asset backed securities[4], (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

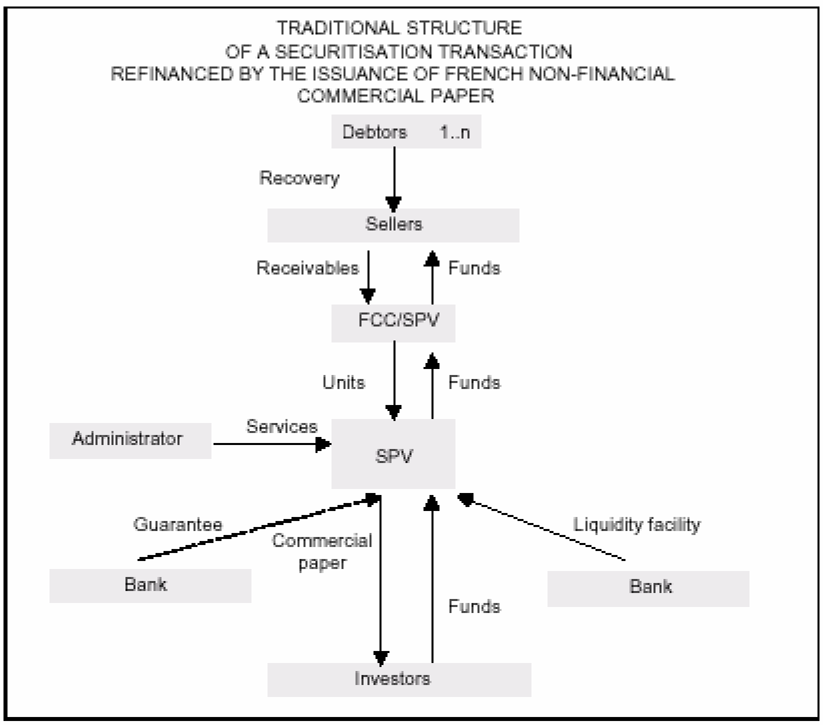
Explanatory text

[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.

78. 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 has been invited to clarify which instruments are covered by this provision.

79. 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 market[5]. Issuance programs for Asset Backed Commercial Papers (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 Créance[6], not accessible to the public) whose units are, in turn, acquired by an SPV that is an issuer of commercial paper.

80. The framework of this structure can be described as follows:



81. 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.

[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 (Art. L. 214-43 of the Monetary and Financial Code). These FCC units are securities (Art. L. 211-2 of the Monetary and Financial Code).

82. 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 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. Regarding the clarification of the UCITS Directive concerning an "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].

83. In CESR's view, it derives from the above analysis that asset backed securities and synthetic asset backed securities do not fall under the provisions of Art. 19(1)(h). This does, however, not mean that they cannot be eligible under other provisions of the UCITS Directive.

84. A large majority of the respondents to the first consultation emphasized the need for CESR to take into account the economic importance of asset backed securities and synthetic asset backed securities and the negative impact of CESR' advice on these financial instruments. But at the same time, a minority of comments coming from professional associations appropriately underlined that CESR had little room to "manoeuvre" within the drafting of this provision in the Directive. It should be recalled that the mandate from the Commission has limited CESR to a strict interpretation of the text of Art. 19(1)(h) fourth indent. It was not under the scope of the mandate to indicate under which other provisions of the Directive asset backed securities and synthetic asset backed securities could be eligible. Some respondents have suggested that the Directive should be amended on this aspect in order to cover any types of securitization vehicles since Level 2 measures are not able to remedy the current drafting of the Directive. In these respondents' view, there should be no ambiguity regarding the eligibility of these assets for UCITS' investments. Accordingly, CESR will draw the attention of the Commission to this issue in its advice.

85. Some respondents have underlined that investor protection is frequently provided by banks through credit enhancement schemes and by liquidity facilities commitments. The credit quality of the structure will be at least equivalent to the quality of the bank.

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

Draft Level 2 advice

BOX 8

LEVEL 2

1. Entities that fall under the fourth indent of Art. 19(1)(h) are a specific category of asset backed commercial papers that are built on a two-tier structure and that are secured by banking credit enhancement. Regarding entities that fall under the fourth indent 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.

2. Unless they comply with the provisions of the fourth indent of Art. 19(1)(h) as clarified in paragraph 1 of this Box (this implies, for instance, that they would be built on a two-tier structure), asset backed securities and synthetic asset backed securities do not fall in the category defined by that indent.

3. Asset backed securities and synthetic asset backed securities may be eligible under other provisions of the UCITS Directive. This may be the case, for instance, if they are dealt in on a regulated market.

Questions:

Q 8. Do you agree with the approach as suggested in Box 8?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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).

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

86. Other money market instruments are those instruments that comply with the definition of a MMI set by Art. 1(9) and clarified above, but which do not fall in the categories defined by Art. 19(1)(a) to (d) and (h).

87. 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

LEVEL 2

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).

Questions:

Q 9. Do you agree with the approach as suggested in Box 9?

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

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.

<u>Draft CESR advice</u>

<u>Explanatory text</u>

88. Art. 1(8) of the Directive provides a list of certain instruments that 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".*

89. 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.

90. 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 on Level 3.

91. 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.

92. 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.

93. The majority of comments received during the first consultation raised the following two questions: Firstly, the use of techniques and instruments should not be restricted to those with a low level of risk; secondly, no restriction should be put on the risk level of the techniques and instruments provided that the other provisions of the UCITS Directive, including the provisions on risk management, are fulfilled. These comments have been taken into account in the revised advice. The relevant provisions of the UCITS Directive have been clarified.

94. Some respondents mentioned that the requirement of Art. 21(1) on the existence of an adequate risk-management process only applies to financial derivative instruments. Therefore, no reference should in their view be made to Art. 21(1) to justify the requirement of an adequate risk-management process for the use of techniques and instruments. This reading of the Directive is subject to debate. To prevent any debate in that area, CESR's advice has been clarified in order to assert that the requirement of a risk-management process stems from the general requirements on UCITS and not from the provisions of Art. 21(1).

<u>Draft Level 2 advice/ Level 3 guidelines</u>

BOX 10

LEVEL 2

1. "Techniques and instruments relating to transferable securities and money market instruments" mean techniques and instruments that are used in a way which:

   - ensures compliance with the requirements of an adequate risk-management process, in line with the general provisions of the Directive, as well as with the detailed risk spreading rules specified by Art. 22 of the Directive;
   - is for the purpose of efficient portfolio management;
   - respects the provisions of the Directive regarding prohibited transactions.

2. "Efficient portfolio management" means investment decisions involving transactions which:

   - are economically appropriate. This implies that they are realized in a cost-effective way;

   - are entered into for one or more of the following specific aims:
     - the reduction of risk;
     - the reduction of cost; or
     - the generation of additional capital or income for the UCITS with an appropriate level of risk, taking into account the risk profile of the UCITS as described in the fund's prospectus and the general provisions of the UCITS Directive, including Art. 19 (eligible assets), Art. 21 (risk-management process of the UCITS) and Art. 22 (investment limits).

LEVEL 3

3. 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 and securities borrowing. The

requirement to comply with the provisions of Art. 21 imply in particular that if UCITS are authorized to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operations must be taken into account to calculate the global exposure of the UCITS.

4. Regarding the coherence between Art. 19 and Art. 21(2), CESR notes that currently only financial derivative instruments are subject to both articles. Therefore, in accordance with the wording of Art. 21(2), financial derivative instruments used under Art. 21(2) must comply simultaneously with the provisions of Art. 19. However, financial derivative instruments used under provisions of Art. 19 are not automatically subject to the "efficient portfolio management" requirement of Art. 21(2).

5. 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.

Questions:

Q 10. Do you agree with the approach as suggested in Box 10?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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

95. 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's 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.

96. 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 ".

97. 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)".

98. 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 the advice.

99. 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.

100. The UCITS Directive pursues a different aim: 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. In doing so, IAS 39 can be used as a basis to develop criteria tailored for the specific objectives of the UCITS Directive.

101. 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.

102. A majority of respondents to the first consultation expressed a concern that given the broadness of the definition, the scope of embedded derivatives would be very large and would imply accordingly high compliance costs. The advice has been clarified in this regard. It establishes a distinction between the scope of embedded derivatives, which remains unchanged, and the requirement to be met by the UCITS. Accordingly, checking compliance with the various provisions of the UCITS Directive (e.g. gross exposure on derivatives ratios or ratios of Art. 22) might not require to compute the individual contribution of all embedded derivatives to the different ratios. For instance, if internal management rules limit the threshold of the exposure on a given issuer to 2% of the UCITS' NAV and if the UCITS holds an embedded derivative giving exposure on a highly diversified portfolio of stocks, the UCITS might conclude that there is no need to calculate exposure on each issuer in order to ensure compliance with the 5% ratio set up by the provisions of Art. 22 of the UCITS Directive.

103. Other comments have advocated to narrow the scope of embedded derivatives to those instruments that embed a derivative materialized by a contract with a third party and which do not benefit from clauses that modify their risk (i.e. active management, credit enhancement and capital guarantee). This issue had already been discussed within CESR and had been rejected since it focuses on the legal feature of the embedded derivative and does not take into account the economic profile of the financial instrument. The second set of criteria would leave out of the scope of embedded derivatives financial instruments which can have a significant impact on the risk profile of the UCITS. It could jeopardize the overall consistence of the UCITS directive.

104. Alternative comments have suggested to focus on the significant change induced by the embedded derivatives on the risk profile of the hybrid instrument and to introduce a waiver for UCITS that invest less than 10% of their assets in such products. But the drafting of the UCITS Directive does not allow for such a waiver. Moreover, given the non-linear risk profile of some derivative instruments, the 10% limit would not restrict in any way the contribution of these embedded derivatives to the risk profile of the portfolio.

105. Some respondents stated that structured financial instruments (SFI) with a fully guaranteed nominal capital should not qualify as SFI embedding derivatives because of their low level of risk. But CESR is of the opinion that the fact that a SFI has a fully guaranteed nominal capital does not mean that investors in the UCITS will not suffer from any losses because of the investment in that SFI. If the value of the SFI is higher than its nominal when an investor enters the UCITS, then this value may decrease and induce losses for that investor. The use of appropriate techniques such as the delta will enable the UCITS to calculate its exposure to the underlying of the embedded derivative and to take that exposure into account when checking compliance with the ratios defined by the UCITS Directive.

106. A minority of respondents recommended not to treat CDOs differently from other securities providing an exposure to a diversified portfolio of issuers. Given the growth of the CDO market, CESR thinks it is important that these structures be specifically dealt with in the advice.

107. One comment has emphasized that a SFI should be considered as embedding a derivative only if significant risk factors of the embedded derivative are not closely related to the economic feature and risk of the host contract. This comment has been taken into account and the definition modified accordingly.

<u>Draft Level 2 advice/ Level 3 guidelines</u>

BOX 11

LEVEL 2

1. For the purpose of applying Art. 1(8) and 1(9) in conjunction with Article 21(3) 3rd sub-paragraph, a transferable security or a money market instrument embeds a derivative where it contains a component

   - by virtue of which some or all of the cash flows that otherwise would be required by the transferable security or money market instrument which function as host contract can be modified according to a specified interest rate, financial instrument price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, and therefore vary in a way similar to a stand-alone derivative;

   - whose economic characteristics and risks are not closely related to the economic characteristics and risks of the host contract; and

   - which has a significant impact on the risk profile and pricing of the transferable security or money market instrument in question.

2. For the purpose of applying Art. 1(8) and 1(9) in conjunction with Article 21(3), a transferable security or money market instrument shall not be deemed to embed a derivative where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such as component shall be deemed to be a separate financial instrument.

3. Given the three criteria developed above in paragraph 1, 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 maximum potential loss resulting from the use of credit derivatives (after compensation with hedging agreements if any) must not exceed the value of assets held by the CDO; or

   - they are not sufficiently diversified.

4. As an exception to the preceding paragraph, 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.

LEVEL 3

5. 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) which could be assumed by a UCITS to embed 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.

6. UCITS using SFIs embedding derivatives must respect the principles of the Directive. These include:

- 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 that does not exceed 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 to the UCITS.

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

- Requirement to check compliance with the above mentioned principles will depend on the characteristics of the embedded derivative and on its impact on the risk profile and pricing of the hybrid instrument. If this impact is not significant, controls can be tailored accordingly.

Questions:

Q 11. Do you agree with the approach as suggested in Box 11?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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

108. 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.

109. Factors to be pondered when considering whether "other collective investment undertakings" are subject to supervision "equivalent to that laid down in Community law" and whether the level of protection of unit holders is "equivalent to that provided for unit holders in a UCITS" , are set out in Box 12. The factors are mainly unchanged compared to the first consultation, but they have been rearranged on the basis of which requirements relate more to equivalent supervision and which requirements to equivalent protection of unit holders.

110. The list of factors in Box 12 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.

111. 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.

112. Binding requirements to assess equivalence regarding other collective investment undertakings are in CESR's view not necessary. Therefore CESR does not intend to give advice to the Commission for Level 2 measures regarding this issue, but instead presents for the second consultation the draft criteria to be issued as Level 3 guidelines for factors to be used as indicators of equivalence. These factors can be used to guide a decision on equivalence.

Draft Level 3 guidelines

BOX 12

LEVEL 3

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:

   - Memoranda of Understanding (bilateral or multilateral), membership of an international organization of regulators, or other co-operative arrangements (such as an exchange of letters) to ensure satisfactory cooperation between the authorities;

   - the management company of the target collective investment undertaking, its rules and choice of depositary have been approved by its regulator; and

   - authorisation of the collective investment undertaking in an OECD country.

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:

   - 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 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.

Questions:

Q 12. Do you agree with the approach as suggested in Box 12?

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

113. 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 Art. 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.

114. Art. 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.

115. 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.

116. 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/ Level 3 guidelines

BOX 13

LEVEL 2

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g), financial derivative instruments mean derivatives whose underlying consist of assets which are eligible for UCITS. In particular, eligible assets in this context include:

   - assets listed in Art. 19(1);
   - financial indices;
   - interest rates;
   - foreign exchange rates or currencies;
   - a combination of these; and
   - financial instruments having one or several characteristics of eligible assets (e.g. dividends).

2. Eligible assets exclude:

   - non-financial indices; and
   - commodities.

3. 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").

LEVEL 3

4. 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.

Questions:

Q 13. Do you agree with the approach as suggested in Box 13?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

2 The eligibility of derivative instruments on financial indices

Explanatory text

117. Art. 19(1)(g) does not give further details on the nature of the financial index as a potential underlying of a derivative instrument. 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 Art. 22*"). However, it does not explicitly rule whether these financial indices should be based solely on eligible assets or whether they may be based on non-eligible assets.

118. CESR notes that the asset management industry, through the comments received to the first consultation, has expressed a strong interest in allowing derivatives on financial indices based on non-eligible assets. According to the comments received, there is a strong client demand in favor of such products since they allow for better risk diversification.

119. CESR also notes that gaining exposure to non-eligible assets through derivatives on financial indices may raise questions regarding the impact of such derivatives on the risk profile of the UCITS and the risk that retail investors may not be able to assess this impact.

120. 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. 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. 22a, thus circumventing this article.

121. To ensure an adequate level of investor protection and to prevent any circumventing of the Directive, CESR is of the opinion that for the purposes of UCITS' investments, financial indices have to comply with:

- the criteria set by the three indents of Art. 22a(1)
- the diversification rules of Art. 22a
- the relevant provisions of the IOSCO regarding indices as inserted in its document "Indexation: securities indices and index derivatives".

The IOSCO document "Indexation: securities indices and index derivatives" (Feb. 2003), promotes:

- contract design that minimizes the scope for manipulation and facilitates the orderly convergence of derivative and cash market prices at the time of contract expiry;
- adequate controls for ensuring orderliness in and between derivatives and cash markets in conditions of turmoil in the financial markets; and
- proper arrangements for the effective coordination of oversight between the index derivatives market and the underlying cash markets.

On a more detailed basis, the IOSCO conclusions on these issues were the following:

- transparency : the Committee encourages

  - contacts between regulators, market operators and index providers, with a view to minimizing the risk of disorderly markets
  - index providers to provide on a as wide and timely a basis as possible material information for market users in respect of such matters as index calculation and rebalancing methodologies, changes in the composition of the index, the timing and implementation of any index changes and information relating to any operational difficulties in providing timely or accurate index information
  - market operators to promote the timely disclosure to the public of the information collected form index providers

- rebalancing : the Committee stresses the importance of market operators, and, as appropriate, regulators :

- seeking and making available to market users as much relevant information as they can obtain in relation to rebalancing, including the method of determining entry prices of securities added to an index,
- increasing surveillance activity as appropriate to monitor trading (and, if appropriate, issuer announcements) around the time of rebalancing; and
- pursuing coordination with other relevant parties, including market operators, index providers and regulatory authorities

- contract design of stock index derivative products :

i) The method of calculation: whether the index is calculated in an appropriate way including the weight given to component stock so that the price movements of a few particular components do not exert undue influence on the movement of the index.

ii) The number of component stocks: whether the index is composed of a sufficient number of stocks of non-affiliated issuers so that the price movements of a few particular components do not exert undue influence on the movement of the index.

iii) The liquidity of component stocks: while there may be great differences in the liquidity of component stocks, whether each component stock has sufficient liquidity so that the trading of such stock does not exert undue influence on the movement of the index.

iv) The dispersion of component stocks within a business sector or across sectors: whether the component stocks are broadly based so that the price movement of stock belonging to a certain business sector does not exert undue influence on the movement of the index.

v) The replacement of component stocks: whether there is a non-arbitrary and well-publicized procedure for reconsideration of the appropriateness of continuing to include index component stocks, either on a regular basis, or as occasion demands.

vi) The selection of component stocks in full consideration of the items i) to iv) above.

vii) Index transparency: whether there is timely and widely available information about the index calculation formula, component selection criteria and index rebalancing.

viii) Clearance and settlement: whether the procedures for clearances and settlement are prudentially designed and interact effectively with the cash market and whether settlement of the contract is at a price reflecting the underlying cash market, minimizes the potential for manipulation or distorsion and is based on a reliable and publicly available cash price.

ix) Orderly markets and anti-manipulation mechanisms: whether appropriate and effective mechanism are in place to maintain orderly markets and prevent manipulation of the markets for the index products and component securities, and whether for non-diversified indices more aggressive surveillance and added protections with respect to prevention of abusive trading may be required.

x) Cooperation arrangements: whether appropriate and effective arrangements are in place so that relevant regulatory and market authorities can share information about the implementation of items i) to ix) above and a about market activity in relevant index products and component securities.

- key elements of the index management process are as follows :

i) Index composition: the index must measure the performance of a representative group of underlyings in a way that is meaningful and useful (i.e. the index must be representative of the market to which it refers). The constituents must be appropriately diversified to ensure that performance is not unduly influenced by the performance of one or two components. These underlyings should be sufficiently liquid, to enable users replicate the full index if necessary. The rules under which constituents can be removed or included must be clearly outlined.

ii) Index weighting and methodologies for calculating index levels: IOSCO recognizes that index providers use different methodologies to calculate index levels. With regard to stock indices these are usually capitalization-weighted (including modified capitalisation-weighted where the weighting of any single component is limited). Price-weighted or equal dollar-weighted methodologies are also utilized.

iii) Index calculation and dissemination process: an efficient index will have robust procedures to collect prices (including procedures to price components where a market price is not available) and to calculate and subsequently publish the index value. Price sources are determined by the index provider.

iv) Index rebalancing: index providers must revise or "rebalance" their indices periodically to ensure that they continue to reflect the markets to which they refer. The criteria and procedures for index rebalancing are set out in the index provider's rules and protocols. This information should be available on as wide and timely a basis as possible.

122. Regarding indices based on hedge funds, CESR notes that these products raise many specific issues including:

- Survivor bias, i.e. the fact that underperforming hedge funds tend to close down and therefore may not be included in the indices;
- Selection bias, i.e. how does the index avoid under or over reporting by unsuccessful or successful hedge funds;

- Consistency of the sector of hedge funds of which the index is deemed to be representative;
- The policy regarding backfilling bias, i.e. permitting newly included hedge funds to backfile their performances, thus potentially generating a bias in favor of the best performing hedge funds;
- Treatment of investable/ not investable (because closed to new investments) hedge funds

These issues are not dealt with by the IOSCO criteria. CESR considers that hedge fund indices raise some specific and in some cases unique issues, and notes that relevant criteria for their construction have not been considered at international level.

123. Finally, CESR has noticed a confusion between financial derivative instruments (FDI) on financial indices and FDI on a concentrated basket of shares. CESR would like to clarify that a FDI on an index which would not comply with the provisions of Art. 22a, e.g. because it is not published in an appropriate way might comply with the UCITS Directive but would not be able to avail of the waiver introduced by the provisions of Art. 22a.

<u>Draft Level 2 advice</u>

BOX 14

LEVEL 2

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g) first indent, financial derivative instruments on a financial index mean those financial derivative instruments which are based on a financial index which:

- Comply with the criteria set by Art. 22a(1) of the Directive, that is that they:

  - be sufficiently diversified;

  - represent an adequate benchmark for the market to which it refers; and

  - be published in an appropriate manner.

- Comply with the diversification rules (including ratios) set by Art. 22a of the Directive

- Comply with the following criteria regarding index management process, transparency and contract design:

Index management process:

i) Index composition: the index must measure the performance of a representative group of underlyings in a way that is meaningful and useful (i.e. the index must be representative of the market to which it refers). The constituents must be appropriately diversified to ensure that performance is not unduly influenced by the performance of one or two components. These underlyings should be sufficiently liquid, to enable users replicate the full index if necessary. The rules under which constituents can be removed or included must be clearly outlined.

ii) Index weighting and methodologies for calculating index levels: Index providers use different methodologies to calculate index levels. With regard to stock indices these are usually capitalization-weighted (including modified capitalisation-weighted indices where the weighting of any single component is limited). Price-weighted or equal dollar weighted methodologies are also utilized.

iii) Index calculation and dissemination process: an efficient index will have robust procedures to collect prices (including procedures to price components where a market price is not available) and to calculate and subsequently publish the index value. Price sources are determined by the index provider.

iv) Index rebalancing: index providers must revise or "rebalance" their indices periodically to ensure that they continue to reflect the markets to which they refer. The criteria and procedures for index rebalancing are set out in the index provider's rules and protocols. This information should be available on as wide and timely a basis as possible.

BOX 14

LEVEL 2

Transparency

Index providers are to provide on a as wide and timely a basis as possible material information for market users in respect of such matters as index calculation and rebalancing methodologies, changes in the composition of the index, the timing and implementation of any index changes and information relating to any operational difficulties in providing timely or accurate index information.

Contract design of stock index derivative products

i) The method of calculation: whether the index is calculated in an appropriate way including the weight given to component stocks so that the price movements of a few particular components do not exert undue influence on the movement of the index.

ii) The number of component stocks: whether the index is composed of a sufficient number of stocks of non-affiliated issuers so that the price movements of a few particular components do not exert undue influence on the movement of the index.

iii) The liquidity of component stocks: while there may be great differences in the liquidity of component stocks, whether each component stock has sufficient liquidity so that the trading of such stock does not exert undue influence on the movement of the index.

iv) The dispersion of component stocks within a business sector or across sectors: whether the component stocks are broadly based so that the price movement of stock belonging to a certain business sector does not exert undue influence on the movement of the index.

v) The replacement of component stocks: whether there is a non-arbitrary and well-publicized procedure for reconsideration of the appropriateness of continuing to include index component stocks, either on a regular basis, or as occasion demands.

vi) The selection of component stocks in full consideration of the items i) to iv) above.

2. Given the complexities of hedge fund indices and the fact that they are still developing, CESR cannot recommend, at this stage, allowing hedge fund indices to be considered as financial indices. However, CESR is monitoring the issue and is willing to reconsider its position in 12 months, after gaining sufficient experience.

3. Indices based on financial derivatives on commodities may be eligible provided they comply with the above criteria.

Questions:

Q 14. Do you agree with the approach as suggested in Box 14?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

3 OTC derivatives

<u>Explanatory text</u>

124. 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 a harmonized implementation of the Directive throughout Europe.

125. Many respondents to the first consultation requested CESR to clarify the requirement that an independent third party review the value of OTC derivatives. Various suggestions were made to restrict this requirement to those OTC derivatives whose valuation is delicate, to waive this requirement and to authorize cross-valuation by independent entities within the asset management company. The advice has been clarified to better emphasize that the UCITS should have an adequate organization to ensure the reliability of the valuation of OTC derivatives. This implies that the valuation be reviewed by a department independent from the UCITS operator or, if this is not sufficient to ensure a reliable valuation of OTC derivatives, by an independent third party. In that later case, the UCITS remains responsible of the correct valuation of OTC derivatives. The UCITS has the possibility to adapt the scope of the means involved in its organization by taking into account the degree of complexity of the financial product.

126. Many respondents emphasized that the requirement to value the OTC derivative on a daily basis is not consistent with the fact that UCITS may calculate their NAV on a less frequent basis. However, these comments seem to have disregarded the requirement set by the provisions of Art. 19(1)(g) of the Directive which precisely state that OTC derivatives should be valued on a daily basis.

127. Many other comments indicated that the requirement to define risk limits at least on a semi-annual basis goes beyond the requirements of the UCITS Directive that the UCITS inform the competent authorities of its risk-management processes. This requirement has been deleted and replaced by a reminder stating that the organization of the UCITS implies that risk limits to be defined.

<u>Draft Level 2 advice</u>

BOX 15

LEVEL 2

Fair value

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g) third indent (OTC derivatives), the criterion "fair value" means the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Process for accurate and independent assessment and reliable and verifiable valuation on a daily basis

2. For the purpose of applying Art. 21(1) in conjunction with Art. 19(1)(g) third indent, the criteria "*process for accurate and independent assessment of the value of OTC derivatives*" means:

   - regarding the accurate assessment of the value of the OTC derivative: a process which enables the UCITS throughout the life of the derivative to value the investment concerned with reasonable accuracy at its fair value on a reliable basis reflecting an up-to-date market value

   - regarding the independent assessment of the value of the OTC derivative: a process which has been agreed between the UCITS and the depositary and which complies with the requirement that the UCITS does not rely solely on market quotations. If no reliable up-to-date market value is available, fair value should be based on the pricing model which has been agreed between the UCITS and the depositary. When doing so, reference should be made to an accepted methodology

   - organization and means allowing for a risk analysis realized by an entity independent from commercial or operational units and from the counterparty or, if these conditions cannot be fulfilled, by an independent third party. In the latter case, the UCITS remains responsible for the correct valuation of the OTC derivatives. Lastly, this organization of the UCITS implies that risk limits are to be defined.

3. For the purpose of applying Art. 21(1) in conjunction with Art. 19(1)(g) third indent, the criteria ""*reliable and verifiable valuation on a daily basis*" means :

   - a valuation of the contracts by the UCITS on a daily basis which is conducted in a way that can be controlled and which guarantees that the valuation corresponds to the fair value (as defined above) of the OTC derivative. This can be achieved :
     - Either by requiring that the valuation provided by the counterparty be checked against that performed by an independent third party at an adequate frequency. The UCITS remains responsible for the correct valuation of OTC derivatives and must, inter alia, check that the independent third party can adequately value the types of OTC derivatives it wishes to conclude.
     - Or by requiring that the valuation be performed by an independent third unit within the UCITS. Independent in this context means a unit:
       - Which is independent from the department in charge of managing the UCITS.
       - Which has the adequate means (both human and technical) to perform this valuation. This implies that the UCITS use its own valuation systems, which can however be provided by an independent third party. This excludes the use of valuation models provided by a party related to the UCITS (such as a dealing room with which OTC derivatives are concluded) which have not been reviewed by the UCITS. This also excludes the use of data (such as volatility or correlations) which have not been qualified by the UCITS.

Questions:

> *Q 15. Do you agree with the approach as suggested in Box 15?*
>
> *Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.*

4 Credit derivatives

Explanatory text

128. 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.

129. Art. 19(1)(g) does not specify the parameters of the assets which can be used as an underlying of a derivative. In particular, it does not explicitly exclude credit risk as a potential underlying of a derivative. 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.

130. 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.

131. In order to limit such information asymmetry, CESR asked in its first consultation paper 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.

132. Some respondents to the first consultation stated that the risk of asymmetry of information is not specific to credit derivatives and accordingly a specific treatment of credit derivatives is not relevant. Other comments emphasized that restricting issuers on which a UCITS may conclude a credit derivative would not deal with the issue of asymmetry of information. More globally, many comments have stated that it would be very difficult for UCITS to take relevant measures to deal with the issue of the asymmetry of information. CESR's advice has taken into account these critics as well as the issues raised by the document "Credit Risk transfer" (March

2005) drafted by IOSCO, BCBS and IAS. However, CESR is of the opinion the risk-management process of the UCITS with respect to credit derivatives has to take into account the risks of asymmetry of information.

Draft Level 2 advice/ Level 3 guidelines

BOX 16

LEVEL 2

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:

    a. The credit derivative complies with the conditions of eligibility of derivative instruments;

    b. The end of the transaction can only result in the delivery or in the transfer of assets eligible for UCITS, including cash.

3. For the purpose of applying Art. 21(1) in conjunction with Art. 19(1)(g), the criterion of a "risk-management process which enables the management or the investment company to monitor and measure at any time the risk of positions and their contribution to the overall risk-profile of the portfolio" means a process which in respect to credit derivatives, in addition to the requirements that exist for all OTC derivatives, takes into account the risks of asymmetry of information, in particular with related parties acknowledging private information on firms referenced by credit derivatives.

4. It is recalled that credit derivatives are OTC derivatives and must therefore comply with the provisions of this advice regarding OTC derivatives (Box 15).

LEVEL 3

5. This means for a UCITS a need

    a. to take into account the risk of asymmetry of information when concluding credit derivatives with counterparties which may have access to non-public information, especially with firms referenced by credit derivative instruments; and

    b. to undertake this assessment with the highest care when this counterparty is a related party of the UCITS.

Questions:

Q 16. Do you agree with the approach as suggested in Box 16?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

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

133. 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 Directive.

134. The aim of the unit holder of an index replicating UCITS is to receive a performance as close as possible to the performance of the index, 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.

135. 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.

136. 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.

137. A majority of respondents to the first consultation indicated that index funds should be allowed to use derivatives to track an index. A minority was against such a use. Some comments questioned the reason why UCITS should be required to provide an estimate of the quality of the replication.

138. In their comments, industry associations tended to be in favor of a flexible approach where UCITS would be left free to provide such an estimate or not, whereas some market participants were in favor of a more prescriptive approach and noted that standardized methods are necessary for the sake of comparability between index tracking funds.

139. During the first consultation, no majority opinions were raised regarding the choice between option A and B presented, but some respondents pointed out that option B was relevant only for index tracker funds that did not use derivatives.

Draft Level 2 advice/ Level 3 guidelines

BOX 17

LEVEL 2

1. A UCITS is deemed to replicate the composition of a certain index if its only aim is to replicate the composition of the underlying assets of the index. 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 Directive.

LEVEL 3

2. CESR notes that a standardized method of calculation for the assessment of the quality of replication by the UCITS would enhance competition between index funds and improve the quality of products accessible to retail investors. It therefore calls for the professional associations to achieve such a standardization, taking into account the regulations already in force in some Member States in that area.

Questions:

Q 17. Do you agree with the approach as suggested in Box 17?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

2 Index characteristics

Extract from the mandate from the Commission

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

a. factors to be taken into account in assessing whether the composition of the index is "*sufficiently diversified*" as provided for by Art. 22a(1) 1st indent;

b. conditions under which the *index can be deemed to "represent an adequate benchmark for the market to which it refers*" as provided for by Art. 22a(1) 2nd indent; and

c. the index is "*published in an appropriate manner*" as provided for by Art. 22a(1) 3rd indent.

Draft CESR advice

Explanatory text

140. 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; and
- be published in an appropriate manner.

141.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 Art. 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.

142.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.

143.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.

144.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.

145.Some respondents to the first consultation encouraged CESR to allow some exemptions to the dispersion rules for sectorial indices stemmed from a large index. It was suggested that CESR's advice should take into account that the requirement not to exclude a major issuer of the market could be difficult to meet in the case of style indices constructed to meet specific rules and should therefore be deleted.

146.To some extent, these issues have been addressed in the IOSCO document "Indexation: securities indices and index derivatives" (Feb. 2003), which promotes:

- contract design that minimises the scope for manipulation and facilitates the orderly convergence of derivative and cash market prices at the time of contract expiry;
- adequate controls for ensuring borderlines in and between derivatives and cash markets in conditions of turmoil in the financial markets; and
- proper arrangements for the effective coordination of oversight between the index derivatives market and the underlying cash markets.

Draft Level 2 advice

BOX 18

LEVEL 2

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 diversification rules set by Art. 22a. 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.

Questions:

Q 18. Do you agree with the approach as suggested in Box 18?

Please give your view on the possible impacts of the proposed approach to your activity/ more broadly to the UCITS market, based on your experience.

ANNEXES TO THE CONSULTATION PAPER

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