THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CESR's Advice to the European Commission on Clarification of Definitions concerning Eligible Assets for Investments of UCITS

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INTRODUCTION

1. 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.

2. The even implementation and interpretation of EU legislation is a crucial dimension of the building up of the internal market in financial services. The European Commission has identified the need to clarify certain definitions of eligible assets of the UCITS Directive as short term priority for the implementation of the amendments made by Directive 2001/108/EC of 21 January 2002 to the UCITS Directive. This approach was endorsed at the European Securities Committee meeting of 5th July 2004.

3. In view of this, DG Internal Market 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.

4. 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.

5. It should be stressed that CESR's technical advice should not be perceived as legal text, even if it is precise to facilitate its comprehension. It is the responsibility of the Commission to draft a proposal for comitology instruments taking into account the technical advice provided by CESR.

6. A feedback statement (CESR/06-013) accompanying the advice explains the decisions taken by CESR in response to the major points raised during the public consultations by market participants.

7. To offer its proposals, CESR organised two consultations and two open hearings in order to have input on the proposals from market participants (both from the professionals and from investors). It also conducted extensive discussions with the members of the Consultative Working Group.

8. Preparation of the advice has been 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.

9. 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.

Areas Covered

10. The advice 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.

DRAFT TECHNICAL ADVICE

DEFINITIONS

11. 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.

12. 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.

13. 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?

Explanatory text

14. 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.

15. 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.

16. 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.*"

17. 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.

18. 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]

19. 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 advice 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.

20. 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.

21. 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.

22. 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.

23. 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.

24. Some respondents to the second consultation asked for additional clarification on the eligibility of transferable securities that themselves invest in or are linked to the performance of other assets, for example commodities, property or loans. In CESR's view, it is not necessary to look at the assets held or activity conducted by the issuer of the transferable security. Of course, if the transferable security embeds a derivative, it will need to be treated as such (see Box 11 and its explanatory text).

The question of liquidity

25. 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.

26. 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, taking into account the frequency with which the UCITS offers unit dealing facilities (redemptions). For example, a daily dealing UCITS will need to maintain a different liquidity profile compared to a UCITS that deals less frequently.

27. 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.

28. 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 the second consultation paper sought to make that clear at appropriate points.

29. 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.

30. A substantial number of respondents to the second consultation questioned the exact meaning of the requirement 'the security must be freely negotiable on the capital markets'. CESR has reflected on this and has deleted the reference to 'freely and to 'in the capital markets', concluding that a UCITS may invest in 'not freely negotiable' transferable securities, provided that it is aware of the existence of limitations to their transferability and that notwithstanding that it will be able to redeem units at the request of the unit holders. In addition, it has been clarified that where a security is listed, a presumption of negotiability applies, but as with the presumption of liquidity, it is not guaranteed, for example in the case there are specific restrictions on the transferability of the security (i.e. the presence of a lock-in clause or of a clause submitting the transfer of a share to the agreement of the other shareholders).

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 negotiable.

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.

8. 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 negotiable. The presumption does not apply if the UCITS knows or ought reasonably to know that any particular security is not negotiable.

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)?

Explanatory text

31. 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).

32. 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).

33. 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 %.

34. 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.

35. 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.

36. 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.

37. Following the first consultation, Boxes 2 and 3 were reversed in the order in which they are presented. CESR believes this makes the presentation of the proposals clearer.

<u>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 Art. 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 UCITS on the security or, where relevant, on the portfolio of the security; and

   - the security must be negotiable.

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 UCITS must assess the negotiability of securities held in the portfolio, with a view to ensuring compliance with the requirements of Art. 37.

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

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.

Explanatory text

38. 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.

39. 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.

40. Following discussion, CESR believes that "appropriate investor protection safeguards" mean that where the asset management activity of the closed end fund is carried out by a firm which carries out asset management activity, that firm must itself be regulated by national authorities for the purpose of investor protection. This means that self-managed closed end funds need not themselves be regulated for the purpose of investor protection.

41. 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.

42. In both the first and second consultation papers 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.

43. 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.

44. 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. CESR has added Level 3 criteria to help a UCITS make an assessment of equivalence. 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.

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

BOX 3

LEVEL 2

1. A "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. This means that where the asset management activity is carried out by a firm which carries out asset management activity, the firm must be subject to national regulation for the purposes of investor protection.

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.

LEVEL 3

5. In assessing whether the corporate governance mechanisms for funds in contractual form are equivalent, the following factors are indicators which can be used as a guidance:

<u>Unit holders' rights</u>

The contract on which the fund is based should provide for:

- right to vote of the unit holders in the essential decision making processes of the fund (including appointment and removal of asset management company, amendment to the contract which set up the fund, modification of investment policy, merger, liquidation);
- right to control the investment policy of the fund through appropriate mechanisms.

It is understood that the patrimony of the fund should be separate and distinct from that of the asset manager and the fund will be subject to liquidation rules adequately protecting the unit holders.

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?

Explanatory text

45. 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.

46. 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.

47. 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.

48. 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)".*

49. 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) liquidity, where they can be repurchased, redeemed or sold at limited cost, in terms of low fees and narrow bid/offer spread, and with very short settlement delay; and
(ii) market depth, where they are traded on a market which is able to absorb a large volume of transactions, with such trading of large amounts having a limited impact on their price; and
(iii) certainty in value, where their value can be accurately determined at any time or at least once a month; and
(iv) low interest risk, where they have a residual maturity of up to and including one year, or regular yield adjustments in line with money market conditions at least every 12 months; and
(v) low credit risk, where such instruments are either:
- *— admitted to an official listing on a stock exchange or traded on other regulated markets which operate regularly, are recognized and are open to the public, or*
- *— issued under regulations aimed at protecting investors and savings, or*
- *— issued by:*
  - *— a central, regional or local authority, a central bank of a Member State, the European Union, the ECB, the European Investment Bank, a non-Member State or, if the latter is a federal State, by one of the members making up the federation, or by a public international body to which one or more Member States belong; or*
  - *— an establishment subject to prudential supervision, in accordance with criteria defined by Community law or by an establishment which is subject to and complies with prudential rules considered by the competent authorities to be at least as stringent as those laid down by Community law, or guaranteed by any such establishment; or*
- *— an undertaking the securities of which have been admitted to an official listing on a stock exchange or are traded on other regulated markets which operate regularly, are recognised and are open to the public".*

50. 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

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

can be converted into cash in no more than seven business days at a price closely corresponding to the current valuation of the financial instrument on its own market".

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.

51. 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.

52. 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.

53. 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.

    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.

Second consultation

54. CESR notes that the most important comments were in favour of deleting reference to "cumulative" when considering the liquidity of a money market instrument. It was highlighted by many representatives of the industry that Level 3 advice may be considered to be inconsistent with the main body of the paper, i.e. paragraph 50. CESR recognizes indeed in paragraph 50 that the fact that some of these conditions are not fulfilled does not imply that the financial instrument should be automatically considered as non-liquid. It was also underlined that the definition of liquidity at instrument level is of a secondary importance to the definition at portfolio level.

55. However, CESR continues to consider that these factors should be examined by the UCITS on a cumulative basis. As indicated during the open hearing arranged by CESR on 7th November 2005, it is indeed hardly conceivable how a MMI could fulfill the liquidity requirement without taking into account all the criteria mentioned in the CESR advice. This exercise to be undertaken by the UCITS does not mean that all these criteria should be fulfilled as it is indicated in paragraph 50 stating that "*the fact that some of them are not fulfilled does not imply that the financial instrument should be automatically considered as non-liquid"*. The CESR advice only strives to provide UCITS the necessary flexibility in the daily management of funds. It should be nevertheless reminded that it is

the responsibility of the UCITS to check the liquidity of instruments and funds in order to ensure that the MMI "*can be sold at a limited cost in an adequately short timeframe taking into account the requirements of Art. 37 of the UCITS Directive that the UCITS should repurchase and redeem its units at the request of any unit holder*" which is the key element of the CESR regulatory framework regarding the liquidity of the MMI. In order to address market participants' concern, it was added in Box 4 of the advice at Level 3 the expression that "*The fact that some of these conditions are not fulfilled does not automatically imply that the financial instruments should be considered as non-liquid*".

56. Regarding the expression used in CESR's advice "sufficient planning in the structuring of the portfolio and in foreseeing cash flows", a minority of comments was concerned about the obligation upon the UCITS to "foresee cash flows in order to match anticipated cash flows with the selling of appropriate liquid instruments". Where the fund investor basis is indeed predominately retail consumers, the remarks underlined that manager would be unable to foresee such cash flows according to these comments.

57. However, CESR's advice does not require UCITS to have precise and ex-post accurate expectations in its future cash flows. It is nevertheless requested that the UCITS monitors its subscription/redemption patterns with relevant tools in order to "*match anticipated cash flows with the selling of appropriately liquid instruments in the portfolio to meet those demands".*

58. Regarding the criterion *"value which can be accurately determined at any time*", the most significant comments raised by industry representatives addressed the provisions of the CESR advice related to the use of amortization method of valuing MMIs.

59. CESR notes that, whereas its proposal was supported by both EFAMA and the French industry association (which represents 45% of money market UCITS), it raised concerns for both IMMFA and the Dublin Funds Industry Association. In that context, CESR welcomed the valuable information provided by both asset managers and industry associations regarding the definition of thresholds to ensure that discrepancies between the amortized cost of a MMI and its value remained non-material, and also regarding escalation procedures.

60. Having taken these elements into account, CESR would like to stress that amortized cost should not be used when the discrepancy between the amortised cost and the value of the MMI is material. CESR notes that, given the materiality thresholds used by industry (up to 50 bp) assessing this discrepancy solely at the UCITS level is not sufficient and that the same assessment must be conducted at the individual instrument level. The advice has been clarified accordingly.

61. Regarding the criteria to be used to determine whether the amortised cost methodology may be used, CESR notes that some respondents called for an increase of the WAM from 60 to 90 days. Taking into account the fact that this was not requested by IMMFA and that there was no unanimity among asset managers on that issue, CESR decided to keep the WAM criterion unchanged.

62. Regarding credit risk, CESR notes that there was an ambiguity in its draft advice as to whether the WAM should be assessed taking into account the credit risk of the instrument or whether credit risk should be assessed separately. Taking into account industry practice in that area, CESR confirmed that the WAM should be assessed taking into account the interest risk and introduced specific requirements for credit risk, in line with industry practice.

63. Regarding the criterion "*normally dealt in on the money market*", the advice includes instruments which have a maturity of less than 12 months, a residual maturity of up to 12 months, or regular yield adjustments in line with money market conditions at least every 12 months (Box 4, Level 2). Many comments have been made in respect of permitting money market instruments with maturities of 397 days. The main arguments in favour include the risk of settlement delays which may result in a breach in the event of a delay in settling the instrument. Furthermore a number of respondents referred to applying a consistent approach to the SEC with their treatment of money market instruments. The CESR advice was said to mean that a UCITS would not be able to remain compliant and purchase the 12 month maturity security.

64. The final CESR advice positively welcomes this remark. It was decided to allow flexibility in the definition of the asset maturity period. CESR decided to replace "12 months" with "397 days" and replace residual maturity of "one year" with "397 days" in the third indent of Box 4 Level 2.

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

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 amortized 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 397 days or a residual maturity of up to and including 397 days as a general rule, or regular yield adjustments in line with money market conditions at least every 397 days. Instruments which do not comply with these maturity criteria can be eligible if it can be demonstrated 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.

The fact that some of these conditions are not fulfilled does not automatically imply that the financial instruments should be considered as non-liquid.

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 397 days or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days. The requirement that the instruments be high-quality instruments should be adequately monitored, taking into account both the credit risk and the final maturity of the instrument.

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, whether at the individual MMI or at the UCITS level. These procedures might include updating the credit spread of the issuer or selling the MMI.

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

Explanatory text

65. 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).

66. 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.

67. 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.

68. 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.

69. 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.

70. 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.

Second consultation

71. Regarding the drafting of paragraph 1 of the Box 5 of the CESR advice, one contribution stated that the suitability of any MMI for investment by UCITS is a matter to be determined by the investment manager of the UCITS taking into account all factors available to it. From its point of view, the key decision in this regard should be the one made at the time when the decision to invest is made and that there should not be an ongoing requirement to monitor the continuing suitability of the MMI.

72. By keeping the wording of this paragraph unchanged, CESR's final advice underlines that no provision of the UCITS Directive allows a lack of ongoing assessment of the eligibility of assets.

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 whenever this presumption cannot 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.

CESR

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 <u>equivalent</u> to that laid down in the first, the second or the third indent of Art. 19(1)(h) <u>and</u> 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.

<u>Explanatory text</u>

73. 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.

74. 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.

75. 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.

76. 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.

77. 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.

78. 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's 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"*.

79. 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 Art. 19(1) and the STEP initiative cannot be solved through Level 2 measures.

80. 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".*

81. 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.

<u>Second consultation</u>

82. During the second consultation, several comments have focused on the drafting of Box 6 against the more general background of STEP initiative and the framework of short-term securities markets in Europe. CESR would like to stress that its advice is restricted to

defining eligibility criteria for MMIs and does not take position on the specific issue of the STEP project.

83. At the same time, CESR noticed a strong support of the whole drafting of this box from the STEP promoters (ACI-Euribor, European Banking Federation) which indicated that relaxing the requirements inserted in Box 6 would "*be perceived as an indication that transparency of the market and investor protection were not a concern for CESR members and the European Commission and would not provide significant gains for the industry*". Moreover, in its written contribution sent to CESR, the European Central Bank explicitly expressed "*a support for the eligibility criteria on money market instruments for UCITS investments purposes, which the CESR submitted to public consultation. (….) The strict application of such criteria across the European markets will reduce their segmentation, thus enhancing their growth potential, and will improve disclosure and transparency. I note that the approach adopted by CESR in its draft advice is coherent with and, to some extent, complementary to the approach adopted of the Short-Term European Paper (STEP) initiative, a market-led initiative promoted by ACI – The Financial Markets Association (ACI) and the European Banking Federation (FBE)".* This ECB contribution underlined that the scope of Box 6 was larger than the strict area of the eligibility of assets for UCITS and encompassed issues related to "*integration, development and transparency of short-term securities market in Europe*".

84. The drafting of Box 6 was more particularly criticized for the use of the expression "independent body" in charge of the control of the information. Five contributions considered that this wording was unclear. Some of these contributions considered that the reference to the independent body as provided for in the third indent was not practical for most MMI as it would require the appointment of a third person not related to the MMI which actually does not exist in the case of most MMI. Others sought clarity as to who may act as an independent body and suggested examples. On that basis they considered that it was not possible to nominate suitable independent bodies and that it is proving onerous for industry representatives.

85. During the open hearing held on 7th November 2005 when the issue related to the use of the expression "*independent body*" in the advice was discussed, it was indicated by representatives of CESR Members that this control was envisaged to be the responsibility of a committee, not of an external auditor or a rating agency.

86. Accordingly, CESR finally decided to leave the wording unchanged but to recommend putting in place transitional measures to enable the issuers of MMI to take the necessary steps to comply with the criteria listed in Box 6 (see paragraph 9 of this advice).

87. Some comments pointed out that the investment in CDs was often based solely on information on the issuer (and not on the issue) and that requiring that information be available both on the issue and the issuer would be unnecessary. This remark was positively taken into account by considering that instruments issued by 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 stringent as those laid down by Community law*" are themselves to some extent regulated for the purpose of protecting investors. Hence, it can be allowed that the information criteria be relaxed for these types of instruments. Box 6 has been redrafted accordingly.

88. CESR also considered that instruments "*issued … by a central (…) authority, or central bank of a Member State, the European Central Bank, the European Union or the European Investment Bank, a non-Member State or, in the case of a Federal State, by one of the members making up the federation,"* are themselves to some extent regulated for the

purpose of protecting investors. Hence, it can be allowed that the information criteria be relaxed for these types of instruments. For instruments issued *"by a regional or local authority" or "by a public international body to which one or more Member States belong*", the relaxing of the criteria of the Box 6 was accepted whenever their issuance is guaranteed by a State or, in the case of a Federal State which is a Member State, by one of the members making up the federation.

89. The condition of provisions of Art. 19(1) third indent indicating that the establishment must be "*subject to prudential supervision […] or 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 interpreted in Box 7 of the advice were also considered as implying that instruments issued by such establishments complied with the requirement that the issue or issuer was regulated for the purpose of protecting investors.

90. For the other money market instruments covered by the provisions of Art. 19(1)(h) of the UCITS Directive, CESR considered that it was essential that information be available:
    a. on the issuer in order to appropriately assess the credit risk;
    b. on the program in order to assess what type of support capture the issuer credit risk indicated in a);
    c. on the issuance in order to get updated information.

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 Art. 19(1)(h) means money market instruments which fulfil the following criteria:

- For MMIs
  - which fall under the second and the fourth indent of Art. 19(1)(h)
  - or which are issued by a local or regional authority of a Member State or by a public international body, where these MMIs are not guaranteed by a Member State, or, in the case of a Federal State which is a Member State, by one of the members making up of the federation:

  - 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 MMIs;

  - 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.

- For MMIs
  - which fall under the first indent of Art. 19(1)(h), except if they are issued by a local or regional authority of a Member State or by a public international body, where these MMI are not guaranteed by a Member State, or, in the case of a Federal State which is a Member State, by one of the members making up of the federation; or which fall under the third indent of Art. 19(1)(h):

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

  - 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.

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.

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>Explanatory text</u>

91. 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 at least as stringent as those set down by Community law.

92. A majority of respondents to the first consultation disagreed with CESR's 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.

93. 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.

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 Art. 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.

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.

Explanatory text

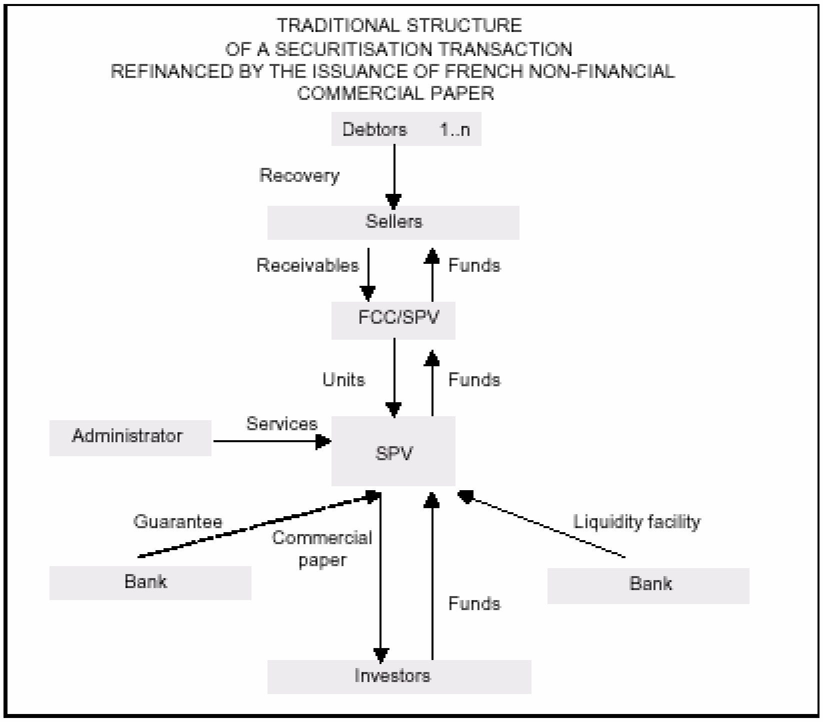
94. The last sub-category defined by the fourth indent of Art. 19(1)(h) refers to entities *which [are] dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line.* CESR has been invited to clarify which instruments are covered by this provision.

95. 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,

[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.
[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*.

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.

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



97. 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.

98. 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

[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).

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].

99. 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.

100. 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. Finally, CESR considered that at this stage Asset Backed Securities and synthetic Asset Backed Securities are not covered by the fourth indent of Art. 19(1)(h) of the UCITS Directive.

101. 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.

Second consultation

102. A number of respondents considered the requirement that the credit institutions providing the banking liquidity line must be rated is too onerous and not workable in practice. For example, they indicated that the current wording requires a credit institution providing the banking liquidity line to an AAA rated ABS to have an AAA rating which is overly burdensome in practice. The creditworthiness of the credit institution is moreover already reflected in the rating of the instrument, therefore no further requirements would be necessary.

103. CESR decided to positively take into account this request by deleting the sentence "credit institutions providing this protection must have a rating that is at least equal to that of the program in question". CESR was convinced that the protection structure is one of the most important factors in the UCITS manager's investment decision and the creditworthiness of the credit institution is already reflected in the rating of the instrument. Therefore, no further requirements seem to be necessary.

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

104. One professional association indicated its disapproval regarding the global approach of Box 8. It did not agree that ABS and synthetic ABS do not fall in the category defined by the fourth indent of Art. 19(1)(h) whenever they are not dealt in on a regulated market. They assumed that it was not the intention of the legislator that the fourth indent of Art. 19(1)(h) would in its applicability be limited to ABCP. It was indicated by a German market participant that the German Investment Act regards such ABS as money market instruments regardless of a two-tier structure. It understood that Art. 19(1)(h) does not offer a comprehensive regulation of (synthetic) ABS. But it considered that it was incorrect that these instruments are not covered at all by this regulation. In fact, those (synthetic) ABS which benefit from a banking liquidity line would be eligible as MMI under Art. 19(1)(h) in conjunction with Art. 1(9) of the Directive.

105. Some other professional associations recognized the accuracy of the CESR position but they demanded a clarification to be made to ensure that ABS remain eligible assets if they are considered transferable securities under Art. 19(1)(a) to (d) or MMI under Art. 19(1)(h).

106. The final CESR advice remains unchanged since the provisions of paragraph 99 of the explanatory text remain accurate. It was unfortunately not in the strict scope of the mandate given by the European Commission to CESR to answer on the global eligibility of ABS or synthetic ABS. Moreover, it is not in the strict scope of CESR's mandate to state whether ABS and synthetic ABS are eligible under the general provisions of Art. 19(1)(h). The demand of CESR's clarification was indeed unfortunately restricted to the clarification of the expression "*entity which is dedicated to the financing of securitisation vehicles which benefit from a banking liquidity line*" which does not allow, from CESR's point of view, the eligibility of ABS and synthetic ABS since this wording specifically addresses a two-tier structure. That does not mean, however, that ABS and synthetic ABS could not be eligible whenever they are capable of being transferable securities, if they meet the requirements of Art. 1(8) and Box 1 or 2.

<u>Level 2 advice</u>

BOX 8

LEVEL 2

1. At this stage, the only specific entities which have been identified by CESR as falling 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).

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.

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.

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?

Explanatory text

107. 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).

108. 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.

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).

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>Explanatory text</u>

109. 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".*

110. As a consequence, CESR's 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.

111. 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.

112. 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.

113. 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.

114. 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.

115. 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>Second consultation</u>

116. Some respondents pointed out that, in their opinion, no reference should be made to Art. 19 (eligible assets), Art. 21 (risk-management process of the UCITS) and Art. 22 (investment limits) since these did not apply to "techniques and instruments". CESR notes that reference to these articles has been introduced to ensure consistency of the Directive, as is illustrated by the end of paragraph 3 of the Level 3 text regarding the impact of the reuse of collateral on the overall leverage of the fund.

117. Regarding the specific issue of collateral, CESR would like to clarify, in answer to concerns raised by one respondent, that paragraph 3 of Box 10 does not imply that UCITS entering into stock lending agreements will be compelled to use multiple counterparties. In such agreements, the counterparty risk is usually equal to the difference between the value of the stocks lent and the cash received as collateral. Market practice will usually ensure that this amount remains well below the counterparty ratios introduced by the Directive.

118. Some respondents mentioned that the general provisions of the Directive from which the requirement of an adequate risk-management process stems from should be clarified. CESR however considered that entering into the detail of these provisions would make the text more complex without introducing any clarification and therefore decided to keep the proposed wording of the first indent of paragraph 1 unchanged.

Level 2 advice/ Level 3 guidelines

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.

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.

Explanatory text

119. 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.

120. 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 ".

121. 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)".

122. 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.

123. 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.

124. 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.

125. 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.

126. 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.

127. Other comments 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 consistency of the UCITS Directive.

128. Alternative comments 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.

129. 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.

130. 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.

131. One comment 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.

Second consultation

132. CESR notes that in a number of cases, comments made during the second consultation had already been made during the first consultation. These comments were based on the same arguments as those used during the first consultation. CESR therefore reiterates the arguments of the above paragraphs as an answer to those comments.

133. Representatives of the industry, though indicating that they appreciated the efforts made by CESR to reduce the scope of the provisions regarding embedded derivatives, requested more clarity regarding the level below which embedded derivatives do not need to be taken into account and expressed fears that the text would lead to diverging interpretations. They concluded that the clarifications introduced would therefore not avoid a significant increase in the compliance burden for the industry.

134. As already indicated in this advice, the aim of identifying embedded derivatives is to ensure coherence between the various provisions of the UCITS directive, especially those provisions regarding risk limits (Art. 22 and Art. 22a) and the impact of derivatives on the UCITS' risk profile (Art. 21). CESR acknowledges that this should not lead to unnecessary regulatory burden when embedded derivatives do not have a significant impact on the UCITS' situation and notes that the aim of the modifications introduced following the first consultation was precisely to clarify this point and the fact that it was

ultimately the responsibility of the asset manager to assess the impact of embedded derivatives.

135. CESR also notes that, though from a theoretical point of view the scope of embedded derivatives might seem extremely wide and consequently unclear, in practice most instruments will easily be classified as embedding or not a derivative and the impact of those instruments embedding derivatives in which UCITS usually invest will as a rule be easily assessable (i.e. convertible bonds). CESR also notes that the concerns raised by industry representatives are general concerns but that at this stage, industry does not seem to have identified specific cases in which regulatory burden would reach excessive levels.

136. Lastly, CESR notes that introducing a precise threshold regarding the impact of embedded derivatives on UCITS to reduce uncertainty would raise a legal issue, since this could be interpreted as introducing new requirements on UCITS, and would probably miss its target, since to take into account all possible situations this threshold would need to be set at a level which would be inappropriately low for most UCITS and would thus generate unjustified compliance costs.

137. Taking these elements into account, CESR decided:
- to further clarify the wording of its advice to reduce uncertainty whilst safeguarding the room for maneuver it feels UCITS should be entitled to;
- to closely monitor the implementation of its advice and use Level 3 clarifications if need be to ensure that its advice be implemented in a harmonized and rational way.

138. The wording regarding leverage (paragraph 3) and tailor-made hybrid instruments (paragraph 4) has been clarified in Box 11 following comments on that issue.

139. Some respondents expressed a concern that the wording used to define embedded derivatives could lead to including closed end funds in the scope and consequently suggested that a criterion be added regarding the existence of an "optional content" in the hybrid instrument. CESR notes that, as a rule, the definition it suggests will not lead to including closed end funds in the scope of embedded derivatives since these are usually managed through a discretionary mandate with very broad predefined rules. Closed end funds that might be included in the scope of embedded derivatives would be very specific products which, though listed as closed end funds, would probably be closer to structured products offering a pay-off linked to predefined market parameters. Given this situation, CESR felt that there was no need to add an additional layer of criterion to the definition it suggests.

140. Some respondents asked that it be clarified whether certain transferable securities linked to the price of gold or oil qualified as transferable securities embedding a derivative and whether these instruments were eligible assets under the UCITS Directive. CESR notes that to be eligible, these instruments would first of all need to comply with both Art. 1(8), which defines a transferable security, and Art. 19(1)(a), (b), (c) or (d), which define the scope of eligible transferable securities. Checking compliance with these articles would need to take into account Box 1 or 2 of this advice.

141. Transferable securities linked to the price of gold or oil qualified as transferable securities would then need to be analyzed through the provisions of Box 11 to determine whether or not they embed derivatives. It would be necessary to make an analysis and to check whether they are host contracts (a transferable security reimbursed at par) embedding a derivative (a future on oil/gold).

142. If there is an embedded derivative, it would then be necessary to check that the embedded derivative complies with the provisions of the UCITS Directive, as stated in paragraph 6 of Box 11. This implies checking coherence with the requirements of this advice on financial derivative instruments (last indent of paragraph 6). In the case the transferable security would embed a derivative, CESR is of the view that these instruments would not be eligible, since the underlying of the derivative component does not fit in the list of possible underlyings given in paragraph 1 of Box 13.

143. One respondent suggested that the definition be modified to better stick to IAS 39 and that the criterion that instruments that have a different counterparty from the hybrid instrument be considered as not being embedded derivatives. CESR notes that the scope of the criterion is unclear and would probably introduce confusion in the definition and therefore decided to keep the current wording of paragraph 2 of Box 11 unchanged.

<u>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 Art. 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 Art. 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 CDOs or asset backed securities are not limited recourse vehicles and the investors' loss can be higher than their initial investment; or
   - they are not sufficiently diversified.

4. Where a product is structured as an alternative to an OTC derivative, its treatment should be similar to that of the OTC derivative instrument, if the consistency of the Directive provisions is to be ensured. This will be the case of tailor-made hybrid instruments, 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.

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 Art. 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 advice.

7. It is the responsibility of the UCITS to check that investment in hybrid instruments embedding derivatives complies with the above mentioned principles. The nature, frequency and scope of checks performed will depend on the characteristics of the embedded derivatives and on their impact on the UCITS, taking into account its stated investment objective and risk profile. Where the UCITS considers that this impact is not significant, controls can be tailored accordingly. In such cases, the UCITS may for instance rely on predefined investment limits to ensure compliance with the above mentioned principles.

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.

Explanatory text

144. 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.

145. 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.

146. 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.

147. 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.

148. Binding requirements to assess equivalence regarding other collective investment undertakings are in CESR's view not necessary. Therefore CESR does not propose the Commission to issue Level 2 measures regarding this issue, but instead presents 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.

Level 3 guidelines

BOX 12

LEVEL 3

1. In CESR's view, the following matters can be used by the competent authorities 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. Where an independent trustee/custodian is not a requirement of local law as regards collective investment schemes, robust governance structures may provide a suitable alternative;

   - 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.

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.

1 *Financial derivative instruments: general considerations*

Explanatory text

149. 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.

150. 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 financial derivative 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.

151. 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, the Directive gives a list of possible underlyings of derivatives. CESR's opinion is that it derives from this list that possible underlyings 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 and are not included in the list of possible underlyings.

152. 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.

Second consultation

153. Few comments were made on Box 13, indicating that respondents generally agreed with the proposed advice. Some respondents pointed out that, given the revised wording of Level 2, reference to "eligible assets" in paragraph 1 of the Level 2 text and the Level 3 text were incoherent with the rest of the text. The advice has been modified to take this into account, and only Level 2 measures are suggested on this issue.

Level 2 advice

BOX 13

LEVEL 2

1. For the purpose of applying Art. 1(2) in conjunction with Art. 19(1)(g) and taking into account Recital 13 of Directive 2001/108/EC, financial derivative instruments mean derivatives whose underlyings consist of :

   - 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 Chapter 2 of this advice concerning financial derivative instruments ("The eligibility of derivative instruments on financial indices").

2 *The eligibility of derivative instruments on financial indices*

Explanatory text

154. 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.

155. CESR notes that the asset management industry, through the comments received to the first consultation, 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.

156. 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.

157. 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) as further partly set out by criteria based on the relevant provisions of the IOSCO regarding indices as inserted in its document "Indexation: securities indices and index derivatives" which also provide additional guidelines for this CESR advice.

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 from 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 capitalization-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.

158. 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 favour of the best performing hedge funds;
    - Treatment of investable/ not investable (because closed to new investments) hedge funds

159. 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.

160. 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.

Second consultation

161. Comments overall welcomed the position taken by CESR that financial indices on non-eligible assets may be eligible underlyings of FDI provided certain conditions are met. Some comments were made on the criteria suggested.

162. Regarding hedge fund indices, both index providers and asset managers provided CESR with their analysis of the specific issues raised by CESR regarding these types of indices and took strong positions in favour of their eligibility. CESR welcomes these comments and shall consider them in due course when it will consider revising its position. However, CESR stresses that the consensus reached on the eligibility of financial indices is very fragile and does not wish to jeopardize it by opening the issue of hedge fund indices at this stage.

163. Regarding other financial indices, respondents asked that it be clarified whether indices on property or indices on commodities (and not on commodity futures) could fall within the scope defined by CESR. CESR notes that the eligibility of these indices should be assessed using the criteria developed in paragraph 1 of Box 14. Regarding the specific case of property indices, CESR notes that it would be highly unlikely that a property index based on private transactions would meet all these criteria. However, this does not rule out the eligibility of other property indices, such as for example property indices based on the share price of companies investing in property. Property indices have therefore been included in the indicative list of paragraph 3.

164. Regarding criteria to be fulfilled by financial indices, respondents asked that it be clarified how diversification rules would apply to indices based on non-eligible financial instruments such as commodity futures. CESR notes that, though the general aim of the diversification rules introduced by the Directive is to ensure that UCITS' risks remain adequately diversified, the nature of eligible assets means that these rules focus on the specific risk of issuers (and not on market risk). Including FDI on financial indices based on non-eligible assets implies that these rules be adapted to the specific risks of such financial indices. CESR therefore suggests the following approach:

- Where the objective of the UCITS is to track or gain a strong exposure on a given commodity index, CESR is of the opinion that the commodity index should comply with the diversification ratios of Art. 22a. This will ensure that the risk profile of the UCITS remains diversified. When assessing these diversification ratios, components which are highly correlated (i.e. futures on oil traded on different regulated markets) should be treated as giving exposure to the same commodity.

- Where the UCITS uses derivatives on commodity indices to diversify its risks, CESR is of the opinion that, provided the exposure on the individual commodity indices complies with the 5/10/40% ratios, there is no need to look at the individual components of these commodity indices to ensure that they are sufficiently diversified.

165. CESR notes that these principles are coherent with those set for financial indices based on eligible assets. In that later case, where the financial index does not comply with the diversification ratios introduced by Art. 22a, a look-through approach must be used to consolidate exposure on individual stocks or bonds gained through the FDI on the

financial index with exposure gained through other FDI or direct investment in these stocks or bonds.

166. Some industry representatives questioned whether indices should be required to comply with the diversification ratios set by Art. 22a since from a practical point of view it seemed relevant to authorize UCITS to track countries or sectors that might be highly concentrated and from a legal point of view their reading of the Directive was that the ratios only applied to direct investment of UCITS in shares and/or fixed income securities in order to track an index.

167. Art. 22a implies that only indices which comply with the diversification ratios of that article can be tracked by UCITS. Yet, index tracking funds can also be built by combining an investment in risk free assets and an OTC derivative which swaps the performance of these risk free assets with the performance of the index. If this OTC derivative is considered as a financial derivative instrument on a financial index and if no look-through approach is therefore required on the exposure of the investment fund on the individual components of the index, then UCITS tracking financial indices which do not comply with Art. 22a could be managed using that alternative management technique. This would circumvent the provisions of Art. 22a. Therefore, if an index composed of eligible assets would not be at least as diversified as provided for by Art. 22a(2) the assets composing the index have to be combined with the other assets in the fund in accordance with Art. 21(3) and Art. 22 (see paragraph 157).

168. Regarding the relevance of authorizing UCITS to track countries or sectors that might be highly concentrated, CESR notes that this is a Level 1 issue: the current wording of Art. 22a clearly restricts the scope of indices that can be tracked by UCITS.

169. CESR therefore kept its advice unchanged regarding the requirement that indices tracked by UCITS comply with the diversification criteria set by Art. 22a. A suggested clarification of the wording was however taken into account.

170. As far as the criteria regarding index management process, transparency and contract design is concerned, two types of comments were made: some advocated minor changes to the wording of these criteria, others requested that these criteria be Level 3 criteria or be suppressed. Regarding the first type of comments, most drafting suggestions were taken into account. Regarding the second type of comments, CESR notes that the fact that these criteria are at Level 2 is essential to ensure the harmonized implementation of the Directive which both regulators and industry representatives have been asking for. CESR further notes that the existence of these criteria in the Level 2 advice is key to the consensus reached regarding the eligibility of financial indices based on financial instruments on non-eligible assets. CESR therefore decided to keep these criteria at Level 2.

171. Lastly, some respondents asked that all FDI be eligible regardless of their underlyings. CESR notes that this issue is a Level 1 issue which is outside the scope of its mandate.

<u>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 complies with the criteria as set by Art. 22a(1) of the Directive, i.e that the index

- is sufficiently diversified. This implies that:

  - the index should be composed in a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index;

  - If the index is composed of eligible assets, it should be at least as diversified as set out under the diversification ratios of Art. 22a(2); otherwise its underlying assets have to be combined with the other assets of the UCITS according to Art. 21(3) and Art. 22 in order to avoid undue concentration;

  - If the index is composed of non-eligible assets, it should be at least as diversified as set out under the diversification ratios according to Art. 22a(2), in case the derivatives on indices are used in order to track such an index or to gain high-exposure in such an index, in order to avoid undue concentration. If derivatives on these indices are used for risk-diversification purposes this diversification does not apply provided the exposure on the individual indices complies with the 5/10/40% ratios.

- represents an adequate benchmark for the market to which it refers. This implies that :

  - the index must measure the performance of a representative group of underlyings in a way that is meaningful and useful;

  - the index should be revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available;

  - the underlyings should be sufficiently liquid to enable users replicate the index if necessary.

- is published in an appropriate manner. This implies that :

  - its publication process should rely on 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;

  - the material information on matters such as index calculation and rebalancing methodologies, index change and information relating to any operational difficulties in providing timely or accurate information must be provided on an as wide and timely basis as possible.

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. CESR is monitoring the issue and is willing to reconsider its position by October 2006, after gaining sufficient experience. CESR Members agree not to authorize setting up new UCITS with such investment policies during this period.

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

3 OTC derivatives

<u>Explanatory text</u>

172. 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.

173. 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.

174. 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.

175. 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>Second consultation</u>

176. Respondents globally agreed with the drafting of Box 15, only one respondent indicated that it considered that the requirements introduced were too burdensome. This respondent did not provide any factual arguments to justify its position. CESR took into account nearly all drafting amendments suggested and also removed the requirement that the valuation model be agreed with the depositary since, as pointed out by industry representatives, there is no such requirement in the Directive.

<u>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 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 a pricing model based on an adequate and accepted methodology;
   - organization and means allowing for a risk analysis realized by a department 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 leads to a valuation which 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 produced by the counterparty be checked 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) produced by a process which has not been qualified by the UCITS.

4 Credit derivatives

<u>Explanatory text</u>

177. 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.

178. 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.

179. 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.

180. 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.

181. 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 IASB. 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.

Second consultation

182. Very few comments were made regarding Box 16, indicating that respondents overall agreed with the drafting suggested. Two respondents raised the issue of asymmetry of information, welcoming the clarification introduced but questioning whether this clarification was precise enough to enable UCITS to determine what steps they should take to take that risk into account. CESR notes that these comments were a minority and feels that the suggested wording strikes an adequate balance between the necessity to point out this specific risk and the risk of setting requirements at a level that UCITS cannot meet.

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.

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.

Explanatory text

183. 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.

184. 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.

185. 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.

186. 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.

187. 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.

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

189. 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.

Second consultation

190. Very few issues were raised during the second consultation regarding Box 17, thus indicating that respondents globally agreed with its drafting. One big asset manager who has many index funds under management expressed its disappointment that CESR had felt unable to comment on the quality of replication. This comment was in line with those in favour of such a measure made during the first consultation by other asset managers. CESR reiterates its view that it would be best if this matter was dealt with by professional associations. However, CESR is willing to monitor this issue and to consider issuing Level 3 guidelines if no significant steps towards standardization are achieved within a reasonable timeframe.

191. One industry association pointed out that the wording of the first paragraph of Box 17 could be misread as meaning that ETFs could not be used by index replicating UCITS. The wording has been clarified and now indicates that direct or indirect investment in index components is a way of achieving index replication.

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 direct or indirect investment in the components of the index, through the use of derivatives, or through 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. Should no significant steps towards this standardization be achieved within a reasonable timeframe, CESR will consider issuing Level 3 guidelines.

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.

Explanatory text

192. 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.

193. 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.

194. 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.

195. 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.

196. 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.

197. 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.

198. 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.

<u>Second consultation</u>

199. As for Box 17, very few comments were made on Box 18, indicating that respondents globally agreed with the wording suggested.

200. One industry association was concerned that the wording of the second indent excludes indices that use negative screening, such as sustainable indices. CESR feels that the current wording of the second indent does allow for such a situation.

201. The same industry association asked that the requirement that the index provider be independent from the UCITS be removed since it felt that the three criteria set by Art. 22a were sufficient. CESR notes that other respondents did not raise that issue and were apparently satisfied with the additional wording which indicated that this requirement did not preclude the index provider to belong to the same group as the UCITS provided adequate Chinese walls existed.

202. Another industry association asked that the requirement that UCITS inform subscribers in their prospectus if they avail of the 20-35% ratio be removed. CESR has not been able to take this comment into account since this requirement stems from Art. 24a(2) of the UCITS Directive.

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.