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5th December 2005

Dear Mr Demarigny,

CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS - 2nd Consultation Paper

The International Swaps and Derivatives Association welcomes the opportunity to comment on CESR's 2nd Consultation Paper on its Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS (October 2005, CESR/O5-064b). We have focused on those issues most relevant to our members and have not addressed every question raised in the consultation paper.

In summary, we would highlight the following issues:

- We remain concerned by the proposals to seek to import an analysis of liquidity, availability of valuations, etc. into the analysis of whether an instrument is a "transferable security".
- We consider that CESR's advice should recognise that the definition of financial derivative instruments covers commodity derivatives which are traded on regulated markets.
- We also consider that CESR's advice should recognise that the reference to "financial indices" as eligible underlyings of OTC financial derivative instruments includes any broad based index, regardless of the nature of the factor or asset whose price is measured by the index.

Box 1 - Definition of transferable securities

We do not agree that the factors set out in paragraph 1 of Box 1 are relevant when deciding whether an investment amounts to a transferable security for eligibility under article 19(1)(a) to (d) of the Directive. We continue to believe that it is unhelpful to confuse issues relating to liquidity with issues relating to whether a security is a "transferable" security, i.e. is capable of being transferred.

We agree that decisions about portfolio liquidity have to take into account the liquidity of individual instruments in the portfolio. However, the definition simply requires an assessment of whether the security is capable of being transferred. There is no justification in the directive for seeking to modify the definition to include additional criteria relating to instrument liquidity.

In particular, CESR's proposed interpretation would undermine the coherence of the various directives which use the concept of "transferable securities", such as the Markets in Financial Instruments Directive and the Collateral Directive. Indeed, the definitions in those directives are arguably somewhat more restrictive than the UCITS directive in so far as they focus on whether a security is "negotiable on the capital market" and not merely whether it is "transferable". However, those definitions clearly cover a broad range of instruments with very varying degrees of liquidity.

The proposed requirements as to liquidity and the availability of prices or valuations are clearly issues related to liquidity rather than transferability. A security could be capable of being transferred even if there is restricted liquidity or prices are only available on an irregular basis.

In addition, it is unclear what standard is intended to be set by the proposed requirement for the availability of "regular, accurate and comprehensive information" on a security. In the EU, issuers of securities that are admitted to trading on regulated markets will be required to publish periodic accounts and price-sensitive information (subject to certain rights to delay disclosure) but there is no assurance that even this information is accurate or comprehensive. It is even less clear how it would be possible to apply this standard in relation to other markets approved for investment by the competent authorities e.g. under article 19(1)(c). The directive's purpose in requiring admission to trading on qualifying markets, as envisaged by article 19(1)(a) to (d), was presumably to provide a minimum degree of assurance about the availability of information. However, the absence of information does not mean that the security is not a transferable security, i.e. that it is capable of being transferred. (In any event, the reference to information on "the portfolio of the security" appears to be in error).

We think it unhelpful to introduce the "negotiable on the capital market" test, to supplement the test of whether the instrument is "transferable" when it seems that directives either use one or the other test (and the use of the word "freely" before "negotiable" raises more questions than it answers).

In our view, the factors listed in paragraph 1 of Box 1 are factors that should be listed in paragraph 6 of Box 1 as factors that a UCITS may need to consider in determining whether it is able to meet its obligations under article 37.

Box 13 - derivative financial instruments

The advice should make clear that financial derivative instruments dealt in on a regulated market which are commodity linked derivatives fall within article 19(1)(g). Even before the implementation of the Markets in Financial Instruments Directive (MiFID), the description of regulated markets in article 19(1)(a), (b) and (c) is broad enough to cover many exchanges which trade commodity futures and options. This will become clear when MiFID is implemented as it will extend the definition of regulated market referred to in article 19(1)(a) so that it extends to commodity derivative exchanges. In any event, it is highly appropriate that the list of eligible assets should include contracts which are traded on liquid, transparent and well supervised national markets. Investment in these contracts is not, in any event, remotely comparable to an investment in the underlying asset.

Box 14 - financial indices

We continue to believe that it is inappropriate and inconsistent with the level 1 text to seek to limit the broad term "financial indices" in article 19(1)(g) by reference to the criteria in article 22a(1). It is clear that article 22a(1) is intended to refer to a narrower subset of financial indices meeting the specific criteria set there (for the specific reasons which motivate article 22a(1)). There is no corresponding reason to limit the scope of the investment powers under article 19(1)(g) to exclude, for example, indexes designed to track narrow baskets of stocks where the UCITS would be able to invest in the individual components.

We are concerned by the proposed exclusion of hedge fund indices which are clearly indices of a financial nature and thus within the scope of article 19(1)(g). However, we welcome the clarification that financial indices on commodity derivatives are eligible investments.

On the other hand, we continue to believe that the reference to "financial indices" should allow UCITS to invest in or use cash settled derivatives linked to financial measures of a broad range of underlying factors, such as inflation and economic statistics and commodity and other prices.

In any event, it seems to us that in this context it would be entirely appropriate to allow UCITS to invest in or use derivative financial instruments based on financial indices which meet the criteria in article 22a(1) regardless of the nature of the underlying factor measured by the index. Gaining economic exposure to a sector by investing in an instrument linked to an index is fundamentally different from investing in the assets underlying that index. The derivative can provide diversification, risk spreading and liquidity in a cost-effective way and without the problems of illiquidity that would arise with the direct investment.

Furthermore, this will allow firms to develop a broader range of UCITS which will provide investors with alternatives types of return which are not correlated to e.g. equity markets. This will enable to diversify their risks.

Therefore, we consider that the eligible underlyings of derivatives should include indices meeting the standards in article 22a(1), regardless of the nature of the underlying factor measured by the index.

We consider that the proposed criteria regarding the index management process, transparency and contract design are inappropriate for level 2 measures. In any event, they are more appropriate to cases where the UCITS itself presents itself as an index tracking product. The criteria under consideration here relate solely to the question of what instruments potentially come within article 19(1)(g).

Other points

Box 2 - other transferable securities

See our comments on Box 1 above.

In addition, it is inconsistent with Box 1 to include the third bullet point in paragraph 1 of Box 2 (when it does not appear in Box 1). In any event, this bullet point is not appropriate. The availability of a valuation may be an important issue for a UCITS but it does not affect the status of the instrument as a "transferable security".

Box 3 - closed ended funds

With respect to the proposal to require "appropriate investor safeguards" with respect to the asset management of closed ended funds, we again consider that it is inappropriate to seek to alter the level 1 text by imposing requirements that are unrelated to the question of whether a security is transferable or not. However, clearly, the UCITS manager will need to consider the extent to which there are appropriate investor protections if it is considering an investment in a closed ended fund.

Box 10 - techniques and instruments relating to investments

We agree with the approach suggested in Box 10. In particular, we welcome the inclusion of the specific references to collateral, repurchase agreements, securities lending/borrowing and guarantees as potentially appropriate techniques and instruments.

Box 11 - embedded derivatives

We do not consider that it is appropriate to single out the factor that an instrument is "tailor made" or "structured to meet the specific needs of a UCITS" as indicating that a transferable security "embeds" a derivative. Many issuers will issue securities which meet the specific

requirements of an investor (e.g. as to maturity, coupon, etc.) where those securities can by no means be regarded as embedding a derivative.

Box 12 - third country collective investment undertakings

We welcome CESR's proposal to give more open-ended guidance as to factors that are taken into account in determining equivalence of supervisory arrangements for third country collective investment undertakings.

Box 15 - valuation of OTC derivatives

We consider that this advice is excessively prescriptive and detailed.

Box 16 - credit derivatives

We welcome CESR's proposal to leave any issues that might exist with respect to asymmetry of information to the UCITS risk management process. In practice, this issue should not arise to a significant extent bearing in mind the existence of standards, such as those in the Market Abuse Directive, which prohibit the misuse of non-public price sensitive information to gain an advantage in trading derivatives. In particular, the prohibitions on insider dealing in that directive apply to dealings in financial instruments whose value depends on financial instruments admitted to trading on a regulated market and are likely to apply to many transactions in credit derivatives. See the European Supplement to the "Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants" published in May 2005 by the European Working Group of the Joint Market Practices Forum.¹

We do not propose to comment on the sections of the draft advice concerning money market instruments or index replicating UCITS.

¹ Available at <http://www.isda.org/press/euroJmpf05.pdf>