

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isdaeurope@isda.org
website: www.isda.org

Brussels, 9th June 2005

Dear Mr. Demarigny,

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

The International Swaps and Derivatives Association welcomes the opportunity to comment on CESR's Advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS (March 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 are very 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.

Application of definitions

We do not agree with the suggestions, throughout the consultation paper, that issues relating to liquidity, availability of valuations, etc. are factors to be taken into account in determining whether a particular instrument is or is not a "transferable security" or otherwise is eligible for investment under articles 1(2) and 19(1) of the Directive. The Directive clearly sets out objective

eligibility criteria for investments, which are, for the most part, independent of subjective elements such as liquidity, availability of valuations, etc.

The Directive expressly identifies those cases where additional criteria of this kind are relevant to eligibility. For example, under article 19(1)(g), there are specific criteria regarding the availability of valuations and the ability to effect offsetting transactions in relation to OTC derivatives. Under articles 2(9) and 19(1)(h), there is a specific criterion that money market instruments be "liquid". These provisions would be redundant if the Directive were interpreted in the way that CESR suggests.

In addition, the definition in the Directive is very similar to that in the current Investment Services Directive, which is interpreted in a very different way. The fact that a debt or equity security has limited liquidity does not mean that it is not a transferable security for the purposes of the authorisation and other requirements of that Directive. CESR's proposed interpretation would have an adverse effect on the coherence between Directives.

Furthermore, we strongly disagree with the suggestion, in the Commission's mandate, that the fact that the issuer of a "structured financial instrument" itself invests in assets which are illiquid might mean that the security should not be treated as a transferable security. The assets and investments of most industrial and commercial companies are illiquid without this prejudicing the treatment of their securities as transferable securities. It would be inconsistent and inappropriate to apply a different treatment to an instrument merely because it might be labelled a structured note.

That is not to say that UCITS can disregard issues such as liquidity, availability of valuations, etc. in making their investment decisions. These issues are clearly relevant to a UCITS because of the general obligation set out in article 37 to re-purchase or redeem units on request. For these purposes, a UCITS can look at these issues on a portfolio basis, rather than asset by asset as CESR's advice would appear to suggest. The UCITS can also take into account the techniques mentioned in article 37(2) in determining the appropriate overall level of liquidity of the UCITS. We believe that this is the appropriate way to address liquidity issues, rather than through the artificial method suggested by CESR.

It may be appropriate for CESR to provide guidance at "Level 3" with respect to the factors that UCITS can take into account in relation to their obligations under article 37. However, we doubt that it is appropriate for the Commission to adopt measures under article 53a with respect to such issues, which appear to go beyond the clarification of definitions to ensure the uniform application of the Directive (or the alignment of terminology or framing of definitions to take account of subsequent measures).

Specific comments

We had the following specific comments on the consultation paper.

<i>Clarification of Art. 1(8) (Definition of Transferable Securities)</i>

1. Treatment of "structured financial instruments"

Box 1 (and Q1 and Q2): As already indicated, we do not consider that the factors listed in paragraph 2 (liquidity, valuation, information, etc.) are relevant for determining whether a

particular investment is or is not a "transferable security", although they may be relevant to a UCITS when determining its overall ability to comply with article 37.

The enumerated factors suggest (under "transferability") that the fact that the security is "offered on a limited basis" or "whether there are constraints on who may buy and sell the security" will "clearly affect the transferability of the security". However, in many cases, fixed income and other securities are issued and offered by way of private placement. In addition, many securities will be subject to resale restrictions (e.g. because of securities laws). While these factors may be relevant when considering the liquidity of a security, they are not relevant to its "transferability", except in cases where the restrictions on transfer are such as to preclude, in effect, any resale of the security.

In addition, it may be difficult to translate some of the advice into legal text. For example, the advice in a number of places suggests best practice rather than minimum requirements (e.g. when it suggests that independent analysis of prices "may indicate" relative liquidity or that pricing should "ideally" be readily available, etc.).

2. *Closed end funds as "transferable securities"*

Box 2 (and Q3 - Q6): See comments above with respect to the factors listed in Box 1.

More generally, the advice (and the additional specific questions) suggest the imposition of a number of specific controls with respect to investments by UCITS in "closed ended funds".

There is no definition of a closed ended fund in the Directive and it can be difficult to distinguish a closed ended fund from an ordinary holding company or investment company. We are concerned that the proposal to impose additional restrictions on investment in this specific class of assets could give rise to significant confusion.

Furthermore, the proposed additional criteria appear to have little to do with the stated objective of clarifying whether a particular security is a transferable security which is eligible for investment under article 19(1) (or even guidance on the application of article 37). They appear to be designed to pursue additional objectives which go beyond the regulatory framework envisaged by the Directive and thus be more suited to co-ordination of national policies at "Level 3". We do not consider that it is appropriate for the Commission to adopt measures under article 53a which introduce wholly new sets of eligibility criteria into article 19(1) under the guise of "clarifying definitions".

3. *Other eligible transferable securities*

Box 3 (and Q7): See comments above with respect to the factors listed in Box 1.

In addition, we strongly disagree with paragraph 2 of Box 3 in so far as it suggests that the absence of a listing almost inevitably means that an investment is ineligible for investment (on the grounds of liquidity). We consider that this suggestion is inconsistent with the policy expressed by the Directive which clearly contemplates that UCITS can invest in unlisted investments. There is no reason to single out unlisted closed ended funds in the way that the consultation paper suggests. Furthermore, as the Directive itself recognises there is more than one way of ensuring liquidity. A listing may in many cases be a relatively poor indicator of liquidity.

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

Boxes 4 - 9: We support the comments of the International Primary Market Association on this section.

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

Box 10: We consider that these criteria are appropriate. However, we consider that paragraph 4 should make clear that the techniques and instruments include:

- Providing and taking collateral;
- Entering into repurchase guarantees;
- Taking guarantees; and
- Securities lending and borrowing.

Embedded derivatives

Box 11: We do not consider that it is helpful to refer to "structured financial instruments" in the manner proposed. It seems clear that the consultation document simply means to refer to "transferable securities".

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 the 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.

Other collective investment undertakings

Box 12: We do not consider that it is appropriate to restrict investment to funds registered in OECD countries, as there may be other jurisdictions where standards of supervision are at least equivalent to those under the UCITS Directive and other related directives.

Financial derivative instruments

Box 13: 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 on which commodity futures and options are traded. This will become clearer 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 a direct investment in the underlying asset.

Whether or not exchange traded commodity derivatives are themselves eligible assets, OTC derivatives linked to the exchange traded contract (or an index of the prices of futures contracts) should be treated as eligible, as “financial derivative instruments”.

See comments on Boxes 14 and 15 below.

Box 14: The criteria set out in box 14 are derived from article 22a(1), which are designed to address the particular issues to which that article relates, concerning index-tracking UCITS. However, it is not appropriate to prohibit UCITS from any investment in derivatives based on other kinds of index. For example, the proposed text would appear to prohibit investment in instruments linked to indexes created to track narrow tailor made baskets even though the UCITS would be permitted to invest in the underlying instruments.

We consider that the reference to "financial indices" allows 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.

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 and whether that factor would be permissible for direct investment by a UCITS. 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 investors to diversify their risks.

Q.9: Therefore, we consider that the eligible underlyings of derivatives should include:

- Indices based on eligible assets, interest rates, foreign exchange rates or currencies, regardless of whether the index meets the standards set out in article 22a(1); and
- Indices meeting the standards in article 22a(1), regardless of the nature of the underlying factor measured by the index.

Box 15: We consider that the advice on the valuation of OTC derivatives goes beyond the requirements for the clarification of definitions. It is not necessary to clarify article 19(1)(g) in this regard.

Paragraph 95: The discussion of possible information asymmetries does not appear to take into account the significant growth in liquidity in the market for credit default swaps. It also does not appear to take into account the effects of the implementation of the Market Abuse Directive. 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

In any event, as the consultation paper accepts, the risk of asymmetries of information is not unique to credit derivatives. Fundamentally, the issue relates to the likelihood, or otherwise, of the UCITS being able to value its assets in a reliable manner. This issue is already addressed specifically in the eligibility criteria in article 19(1)(g) in relation to OTC derivatives. We have already made clear that we do not consider it desirable or appropriate to include provisions about the availability of valuations in relation to the definition of transferable securities.

Box 16: The advice in paragraph 2 should make clear that a credit derivative complies with the conditions of eligibility of derivative instruments relating to the eligibility of the underlying assets of the derivative where, as stated in the second indent, the performance of the transaction can only result in the delivery or transfer of assets eligible for investment, including cash. As it is presented, the first and second indents of paragraph 2 appear to include duplicative requirements with respect to the eligibility of the underlying.

As already indicated, we do not consider that it is desirable or appropriate to include eligibility conditions regarding the risk of asymmetry of information.

In addition, we do not consider that it is desirable or appropriate to include eligibility conditions regarding the internal organizational arrangements of the UCITS, as proposed in the fourth indent of paragraph 2 of the draft advice. This confuses the investment eligibility requirements of article 19 with the provisions of article 21 concerning a UCITS' risk-management process. Requirements of this kind are more appropriate to Level 3 guidance on the implementation of article 21. They are not appropriate criteria for defining the eligibility of investments.

Q10: We do not consider that the risk of asymmetry of information is significant. UCITS should take this into account when considering their ability to value an instrument in a reliable way, in the same way as for any other investment.

Q11: As already indicated, we do not consider it necessary to include further eligibility criteria. However, with respect to the proposed list of eligibility criteria:

- It would be inappropriate to include an additional rating criteria in relation to issuers whose bonds are admitted to trading on a regulated market when no such criterion is applied in relation to a direct investment in those bonds (article 19(1)(a)).
- The eligibility criteria should extend to credit derivatives transferable securities dealt in on another regulated market in a Member State (within article 19(1)(b)) or admitted to official listing or dealt in on a third country market (within article 19(1)(c)) as well as recently issued transferable securities (within article 19(1)(d)).

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

Index replicating UCITS

We do not propose to comment on this section of the draft advice.

* * *

This Association hopes that the above is of assistance to CESR in its deliberations. We would welcome an opportunity to participate in further dialogue if this would be helpful to CESR in finalising its advice to the European Commission.

Yours sincerely,

Jonathan Taylor
Chairman of the European Regulatory Committee
International Swaps and Derivatives Association