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Potential effect of Article 8(2) (b) of Directive 2007/16/EC

The International Swaps and Derivatives Association, Inc. (**ISDA**), which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985 and today has over 825 member institutions from 56 countries on six continents. These members include most of the world's major financial institutions that deal in privately negotiated derivatives, as well as many of the businesses, government entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

ISDA would like to raise concerns on behalf of its members over the possible impact of Article 8(2)(b) of Directive 2007/16/EC (the Eligible Assets Directive or **EAD**) on the ability of funds regulated under the Directive 85/611 EEC on Undertakings for Collective Investment in Transferable Securities (**UCITS**) to access the senior unsecured credit default swaps (**CDS**) markets. In particular, ISDA is concerned as to whether the provisions of Article 8(2)(b) of the Eligible Assets Directive should be read as preventing UCITS from investing in market standard CDS where the documentation states the deliverable obligation as bond or loan.

ISDA would therefore like to seek further clarification on the intended effect of Article 8(2)(b) from the Committee of European Securities Regulators (**CESR**).

ISDA understands the policy position in limiting the financial derivative investments into which UCITS can invest in OTC derivatives where the underlying of the derivative is a financial instrument into which a UCITS may invest directly or a financial index. However, Article 8(2)(b) of the EAD has caused concern among our members. This states that OTC derivatives must not:

> "result in the delivery or in the transfer, *including in the form of cash*, of assets other than those referred to in Article 19(1) and (2) of Directive 85/611/EEC".

The language highlighted in italics above could be interpreted to indicate that CDS whose reference assets are bonds, but which could result in the delivery or the transfer of a loan that does not meet eligibility criteria, even where that delivery takes the form of cash settlement, are no longer permitted to be held by UCITS. This wording raises concerns for both UCITS and dealer participants in the CDS markets. For the reasons set out below, we do not believe that this was the intended effect of Article 8(2)(b).

ISDA would like to highlight that the italicised wording in the above drafting was amended only in the final draft of the EAD. If the interpretation referred to above was intended, consideration of such a fundamental change in the scope of the eligible assets regime would have benefited from earlier, publicised consultation with industry, given the potential consequences of the drafting and impact on the market as set out below.

We respectfully submit on behalf of our members that the position should be that CDS have been, and continue to be, eligible assets for UCITS, provided that they are cash-settled with respect to the ineligible asset. We discuss below our reasoning for this submission.

Since the implementation in 2003 of the UCITS Product Directive (2001/108/EC) (the **UCITS Product Directive**), UCITS have been able to invest in OTC derivatives, subject to certain qualifications. It has been unclear to what extent investment in credit derivatives where the underlying includes loans that do not meet eligibility criteria has been allowable, given a recital in the UCITS Product Directive to the effect that operations in derivatives may never be used to circumvent the principles and rules set out in the UCITS Directive, that is, a UCITS may not use derivatives to achieve synthetic exposure to an ineligible asset. CESR has run a number of consultations in this regard, and in addition, the European Commission published a draft Regulation and subsequent draft Directive. These all indicated that credit derivatives would be eligible assets for UCITS provided that they did not result in the delivery of assets other than eligible assets, including cash. The consultation and draft legislation therefore indicated that CDS could be eligible, provided that they were cash-settled with respect to any ineligible asset. On this basis, regulators in some Member States have allowed UCITS to enter into cash-settled CDS. The wording in Article 8(2)(b) therefore raises fresh concerns for both UCITS and dealer participants in the CDS markets.

The CDS market has become standardised over the last few years. This has had significant benefits in terms of liquidity and the management of operational risk. CDS, including cash settlement techniques, are not just advantageous from a pricing and liquidity perspective but are also fully compatible with investor expectations of how bond portfolios are constructed. The market trades on standard ISDA documentation which specifies both bonds and loans in the pool of deliverable obligations.

In a standard CDS, the protection buyer has the right, following a credit event, to specify the deliverable asset (which is to be delivered or, where the parties have agreed that the transaction will be cash settled, to be the subject of cash settlement). The other party (the protection seller) may not refuse to accept delivery of, or cash settlement by reference to, a loan. The interpretation of Article 8(2)(b) set out above would therefore arguably prevent a UCITS from entering into CDS as protection seller on standard market documentation, as otherwise it would risk breaching its investment powers in the event that the counterparty chose to settle by reference to a loan that does not meet eligibility criteria. This in turn risks a transaction being outside the investment powers of the UCITS, with potential adverse regulatory consequences to the manager (breach of applicable regulation) and legal consequences for counterparties (*ultra vires* contracts may be void or unenforceable) and managers/depositaries (legal claims for entering into *ultra vires* contracts).

There will be a large cost to the markets, and in particular UCITS and their investors, if the effect of the EAD is to prevent UCITS entering into CDS on standard terms. Market participants would need to create bespoke documentation when entering into a CDS to remove any possibility that a non-eligible asset be referenced in the deliverable obligations. Given the difficulty of hedging such contracts, it is unlikely that dealers would offer them to UCITS customers, at least not on any meaningful scale. Furthermore, even if offered, such contracts would not benefit from the substantial liquidity of the market standard contract, and therefore be subject to worse pricing (which again would inevitably have a negative effect on returns to investors).

Further, the consequence of such a significant limitation will result in UCITS funds being forced to unwind a significant number of trades following implementation of the EAD in each Member State. This would cause disruption to the market and potentially have a negative impact on the pricing available to UCITS on unwinding, as well as potentially causing processing issues at a time when firms are working to reduce documentation backlogs at the behest of regulators.

As a practical matter, if the clarification requested above is not obtained, the EAD will adversely impact the way in which dealers are able to transact with UCITS by reason of the difficulty of identifying whether dealers are dealing with a UCITS at the time a trade is agreed. This is because in practice, trades are typically agreed with the asset manager and then allocated post-trade date to the relevant funds, which may or may not include UCITS. Without clarity on the correct interpretation of the EAD, the way in which trades are agreed with funds (including UCITS) would have to be revisited, causing significant operational difficulties for dealers and their fund manager customers.

There is presently a great deal of uncertainty in the markets, from both dealers and their UCITS fund manager clients, as to the interpretation of Article 8(2)(b) and how they should proceed with existing and future trades in light of the EAD. This is causing concern to market participants and adversely affecting the CDS markets. In light of the imminent (and in some Member States present) implementation of the EAD into Member State's national laws further guidance and/or clarification on this point is urgently required.

If you do not agree with our position, it would be helpful to have clarity on the status and treatment of existing transactions because dialogue with various regulators so far indicates a divergence in their views on the status (and therefore the treatment) of trades entered into (i) prior to the issue date of the EAD, (ii) between the issue date and the implementation date of the EAD, and (iii) following the implementation date of the EAD.

Our members have also asked us to seek confirmation as to the position of transactions referencing CDS indices, such as iTraxx and CDX. Our understanding, which is consistent with the way in which such indices are currently treated in certain EU jurisdictions, is that, whatever the position of CDS, such transactions are eligible investments for UCITS provided that the relevant indices are "financial indices" which satisfy the criteria set out in Article 9(1) of the EAD. We believe that this would be the case notwithstanding that these indices do not operate in the same way as "traditional" financial indices but rather are essentially based on "baskets" of CDS transactions. We would be grateful if you would confirm this.

Given that the deadline for implementation of the EAD is approaching, the lack of clarity is becoming a major issue in the market. We would therefore respectfully request that you give this matter your urgent attention.

We note that the UK Financial Services Authority issued a Handbook Notice[1] on 29 February that contains the following statement:

> *"4.29 COLL 5.2.20R(7)(b) relates to derivatives for which the underlying is an eligible asset, but which, when settled normally, would potentially settle in an ineligible asset.*
>
> *Although the wording of the final version of the EAD is ambiguous on this point, we are satisfied its intention is to permit investment in such derivatives, provided the settlement asset, if ineligible, is converted to cash or another eligible asset prior to receipt by the scheme."*

In essence, the FSA has accepted the arguments stated above. Whilst this is not, of course, binding on CESR, we believe it to be persuasive and we hope that CESR will act accordingly.

We are at your disposal to expand on any of the points set out in this letter. If it would be helpful, we would be delighted to attend a meeting with you to discuss these issues further. Please contact David Geen, ISDA's General Counsel, at +44-20 3088 6222 (dgeen@isda.org).

Yours sincerely,

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cc:

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[1] Handbook Notice 73: http://www.fsa.gov.uk/pubs/handbook/hb_notice73.pdf.