THE EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS [1] COMMENTS ON

CESR'S ADVICE ON CLARIFICATION OF DEFINITIONS CONCERNING ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

JUNE 2005

[1] The EACB represents, promotes and defends the interests of its members and co-operative banks in general. Co-operative banks are among the major players in Europe's financial and economic system: 130 million customers, approximately 700.000 staff members , 60,000 branches or outlets and a 17% share of the deposit s market.

Introduction

The European Association of Co-operative Banks (EACB) welcomes the opportunity to provide comments on CESR's draft technical advice on Clarification of Definitions concerning Eligible Assets for Investments of UCITS.

GENERAL COMMENTS

1) Excessive "detail" is an obstacle to fair competition among financial instruments

In EACB opinion, the UCITS Directive already provides comprehensive investor protection safeguards with regard to the UCITS product, which are complemented by the regulation of fund management company and distributors in MiFID. In this respect the EACB believes that such regulation adequately addresses the investor protection and wishes to call on CESR to avoid excessive "detail". Referring to the Commission's opinion expressed in the mandate to CESR requesting technical advice on MiFID of 25 June 2004, we would like underline that such mandate specifies that *"CESR should also pay particular attention to striking the right balance between the objective of establishing a set of harmonized conditions … and the need to avoid excessive intervention in respect of the management and organization of the investment firms. …The advice should ensure clarity and legal certainty but avoid formulations which would lead to over prescriptive, excessively detailed legislation, adding undue burdens to the firms and hampering innovation in the field of financial services"*. Although the mandate pertains to MiFID, we strongly believe that such principle should be applied to all financial services regulation, and specifically to the clarification of definitions concerning eligible assets of UCITS.

Excessively detailed and restrictive regulation reduces the attractiveness of UCITS products, prevents innovation, and hurts the competitiveness of the European investment fund industry vis-à-vis other financial services providers. The promotion of a fair and competitive integrated EU financial market has also been singled out by the Commission as a key objective, and the EACB believes that it cannot be achieved if UCITS are overregulated in comparison to other financial products.

2) Distinction between Level 2 and Level 3

Given the very detailed nature of the current advice, we believe that CESR should clarify which parts represent "definitions" and which parts would fall under future CESR conduct of business rules. This is of great importance, although such "Level 3" regulation is inseparable from broad definitions.

3) Cost implications

The EACB believes that CESR should take into account the cost implications of its recommendations, which seem to be significant in some instances, and try to minimize the burden for the industry. Overall, the cost of regulation should be in line with the importance of the regulation towards achieving a single market for investment funds, while maintaining the existing high level of investor protection.

SPECIFIC COMMENTS

CLARIFICATION OF ART. 1(8) (DEFINITION OF TRANSFERABLE SECURITIES)

1) Treatment of "structured financial instruments"

The EACB considers parts of BOX 1 to be Level 2 advice (Para. 1 and 3 respectively), while Para. 2 consist of Level 3 guidance.

The EACB agrees with CESR's definition of transferable security at Para. 1 BOX 1, but would like to underline that the liquidity requirements should be met at fund level and not by individual securities, in order to guarantee compliance with Art. 37 of the Directive.

This Association believes that Para. 2's listing of factors in BOX 1 does not fall under CESR's mandate to clarify definitions, but that it should be part of the above-mentioned conduct of business rules. Furthermore, the factors mentioned (liquidity, valuation, information and transferability), if cumulative, would unnecessarily restrict fund managers' flexibility in daily fund management operations, increase unnecessarily compliance costs and worsen the competitive position of UCITS vs. other financial products (Questions 1 and 2).

The EACB does not agree with CESR's criteria for transferability in Para. 2, which appear too restrictive and would exclude private placements from transferable securities.

Finally, CESR should clarify that shares are not considered SFIs and that, for shares, a look-through approach is not required

Based on our observations, please find below our suggestion for a new wording of Box 1:

BOX 1

Level 2

1. To be an eligible asset for a UCITS under Art. 19 (1) (a) to (d), a transferable security must fall within the definition of "transferable security" in Art. 1 (8) of the Directive. In addition, the potential loss of the UCITS in respect of holding the security must be limited to the amount paid for it.

3. When a structured financial instrument includes a derivative element, Art. 21 (3) of the Directive applies. Shares are not considered as structured financial instrument and that, for shares, a look-through approach is not required.

Level 3

2. The UCITS should take into consideration the following factors in deciding whether or not any security is a "transferable security" (as defined):

• Liquidity – The UCITS should consider, on reasonable grounds, that if the transferable security is added to its portfolio, it will continue to be able to comply with Art. 37 of the Directive. The transferable security must not compromise the overall liquidity of the UCITS. The liquidity doesn't apply to each security but applies globally to the UCITS, which has to be able to redeem its units. The management company is responsible for the control of the liquidity of the portfolio of the UCITS.
Such liquidity can be assessed for example:

- by looking at the volume in the transferable security; or
- for price-driven markets, by an analysis of bid and offer prices over a period of time; or
- by assessing the quality of secondary market activity in a transferable security; or
- by the commitments of market makers to provide liquidity.

These criteria are indicative and the investment company could use other criteria in order to assess the liquidity. Liquidity constraints should not apply to investments made according to Article 19.2 of the Directive.

• Valuation – There must be accurate, reliable and generally independent valuation systems available in relation to the instrument. Pricing in the instrument should ideally be readily available, regular and independent of the issuer. The UCITS's overall valuation must fairly and accurately reflect the value of its underlying assets.

• Information – The UCITS should assess the extent to which the issuer of the transferable security regularly makes information available to the market by providing accurate and comprehensive information on the transferable security or, where appropriate on the portfolio of the product in question.

• Transferability – The manager should assess the transferability by looking at the possibility of a security to be moved from one investor to another by registration on the register of shareholders or other equivalent means (i.e. private placements can be transferable securities).

• 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.
• The UCITS should be able to assess on an ongoing basis the risk of the transferable security and its contribution to the overall risk profile of the portfolio.

2) Closed end funds as "transferable securities"

The EACB believes that listed closed end funds fulfill the requirements of transferable securities as per Art. 1(8), and does not share CESR's opinion that they should be subject to additional requirements such as those in BOX 2 at indents (a) through (c). We believe that shares of listed closed end funds should be treated like shares of listed companies as long as the listing requirements are <u>comparable</u>. Regarding compliance with factors in Box 1 applicable to listed transferable securities, such factors would apply also to listed closed end funds, but once again only as Level 3 conduct of business rules.

No provision in the Directive implies criteria such as those at indents (a) and (b), and such considerations for investor protection should rather be part of listing requirements than of UCITS restrictions.

With regard to the question whether UCITS should be allowed to invest only in closed end funds that invest in transferable securities which would themselves be eligible assets (Question 6), the EACB does not see that restriction as warranted by the Directive.

Please find below our suggestion for a new wording of Box 2:

BOX 2

Level 3
1. The factors in Box 1 concerning listed transferable securities apply also to listed closed end funds.

3) Other eligible transferable securities

The EACB believes that the liquidity factor should not apply to securities falling under Art. 19 (2).

Please find below our suggestion for a new wording of Box 3:

BOX 3

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 the conditions respectively described in Art. 19 (1) (a) to (d).

Level 3

2. The draft advice above in Box 1 in relation to transferable securities that fall within Art. 19 (1) (a) to (d) of the Directive, will also apply, as appropriate, to such transferable securities that fall within Art. 19 (2) (a), with the exception of the liquidity factor.

CLARIFICATION OF ART. 1(9) (H) (DEFINITION OF MONEY MARKET INSTRUMENTS)

1) Box 6

The EACB suggests dropping the three requirements concerning the information memorandum, if the EU Prospectus Directive (Directive 2003/71/EC) does not require the publication of a prospectus for money market instruments.

2) Box 7

The EACB does not share CESR's advice in BOX 7, Para. 1, stating 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) 3rd indent of the Directive refers to "prudential rules *considered by the competent authorities* to be at least as stringent as those laid down by Community law", therefore putting the burden on the authorities, not on the UCITS. We consider that Para. 1 should be deleted.

Please find below our suggestion for a new wording of Box 7:

BOX 7

Level 2

1. There is a presumption by the competent authority that establishments located in the European Economic Area and G 10 countries or having investment grade rating are subject to prudential rules at least as stringent as those laid down by Community law. Measures to guarantee compliance with the requirements by the UCITS can be tailored accordingly.
2. In all other cases, these measures should be based on an in-depth analysis of issuers.

CLARIFICATION OF SCOPE OF ART. 1(8) (DEFINITION OF TRANSFERABLE SECURITIES) AND "TECHNIQUES AND INSTRUMENTS" REFERRED TO IN ART. 21

The EACB does not share the restrictive interpretation given by CESR of "techniques and instruments relating to transferable securities…used for the purpose of efficient portfolio management". Beyond Art. 21(2), the Directive does not place further restrictions to the maximum risk level deriving from such techniques and instruments, and we believe that efficient portfolio management should be interpreted broadly, in order to allow the achievement of the best results for fund investors, subject of course to an adequate risk management process and to other provisions in the Directive. The reference to an "acceptably low level of risk" should therefore be modified into "acceptable level of risk", as the risk should be in proportion to the income.

It is our understanding that the constraint of "efficient portfolio management" does not apply automatically to financial derivative instruments, which are anyway subject to Art. 19 and Art. 21(3), and we wish to have this fact reflected in Para. 5.

We believe that the sentence in Para. 3, 1st indent "This implies that they are realized in a cost-effective way" is redundant, and should be deleted.

Please find below our suggestion for a new wording of Box 10:

BOX 10

Level 2

1. Techniques and instruments relating to transferable securities and money market instruments should respect the general principle set out in Recital 13 of the Directive 2001/108/EC and may never be used to circumvent the principles and rules set out in the Directive. In particular, adequate measures should be adopted in order:

- to ensure compliance with the requirements of an adequate risk management process, in line with Art. 21 (1) of the Directive, as well as with the detailed risk spreading rules specified by Art. 22 of the Directive; and

- to avoid transactions which are not permitted by the Directive.

2. Techniques and instruments must be used for the purpose of efficient portfolio management.

Level 3

3. UCITS are considered to use efficient portfolio management if they respect all of the following requirements:

- The transactions are economically appropriate;

- The transactions are entered into for one or more of the following three specific aims:
    - the reduction of risk;
    - the reduction of cost; or
    - the generation of additional capital or income for the UCITS with an acceptable level of risk.

4. 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.

5. Regarding the coherence between Art. 19(1)(g) and Art. 21 (2), CESR notes that currently only financial derivative instruments may be subject to both articles, and that in accordance with the wording of article Art. 21 (2), financial derivative instruments used under Art. 21 (2) must comply simultaneously with the provisions of Art. 19.

6. 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

> The EACB believes that that credit linked notes, convertibles and all other structured financial instruments with a fully guaranteed nominal capital do not qualify as structured financial instruments that fall under the provisions of Art. 21 (3) of the UCITS Directive. They are simply structured products whose portfolios are not put at much greater risk by

their derivative components. Separating these financial instruments from their host contracts bears no additional benefit for the investor; there is no need or only a negligible need to further safeguard these products against risks. The overall risk limits envisaged in the UCITS Directive would suffice.

> Often the percentage of structured financial instruments in portfolios is very small or negligible. With regard to an efficient portfolio management, and given that separating a derivative from its host contract does not have any additional benefit for the investor, and that there is no further need for investor protection, the EACB recommends not to separate a derivative from its host contract provided that these structured instruments account for a minor percentage of the portfolio's total assets (these structured products must not bear any obligation to make further contributions). The EACB thinks that this percentage of structured products should not exceed 10 percent of a UCITS's assets (de minimis rule). Up to this limit of 10%, the contribution of a derivative embedded in a structured product to a portfolio's overall risk profile can be ignored.

The view expressed above is in line with the idea of total management responsibility of investment companies for portfolios (an idea recently favoured by the competent supervisory authorities) and is supported by the statutory Code of Conduct. ("Liquid financial instruments may be acquired provided they are consistent with the investment objective and the risk profile of the respective portfolio.")

> When a transferable security or money market instrument embeds a derivative, Art 21 (3) clearly mandates that the treatment of such derivative complies with the exposure requirement of **that** article (meaning Art 21 - risk exposure). No reference is made to the issuer limits of Art 22. Therefore the Directive does not mandate the splitting of structured instruments for the purpose of holding limits or counterparty limits. Box 11, Para 6, indent 3 ("comply with all the investment limits...." until "...counterparty risk of underlying derivatives over to the UCITS") should be deleted. Box 11, Para 6, indent 1 should be replaced by the correct wording of Recital 13 of Directive 2001/108/EC: "Operations in derivatives may never be used to circumvent the principles..."

> The Directive does not mandate the splitting of structured instruments and the treatment of their component parts as separate financial instruments. Therefore Box 11, Para 2 should be deleted.

OTHER COLLECTIVE INVESTMENT UNDERTAKINGS

The criteria listed in Box 12 under indents 2 to 7 and referred to as indicators of "equivalence of supervision" should really be called "equivalence of legal protection".

As provided in Art. 19 (1) (e) first indent of the UCITS Directive, it is not up to the investment company to decide on the equivalence of supervision (in contrast to the equivalence of legal protection), but this falls within the scope of responsibility of the competent authorities (*"..considered by the UCITS competent authorities to be equivalent to that laid down in Community law…")*. It does not seem practicable that the supervisory authorities should approve every single portfolio.

Financial derivative instruments

1) The eligibility of derivative instruments on financial indices

Question 9: The EACB believes that financial indices should be eligible as underlying to a derivative instrument, without requirement to look through to the constituents of those indices and to the underlying' eligibility for direct investment by the UCITS.

We do not find in the Directive any text that would justify the exclusion of financial indices based either on non-eligible assets (for example commodities, real estate and hedge funds), or on financial instruments based on such assets. Furthermore, numerous indices exist that are based on such non-eligible assets, and some of them (commodities indices for example) have been available for a considerable time and their underlyings are mostly very liquid.

2) OTC derivatives

The EACB does not believe that an estimate "by an independent third party" is necessary for OTC derivatives (BOX 15, Para. 2), since two valuations are already available (by the counterparty and by the UCITS itself), and the use of a third party would entail unnecessary costs.

Furthermore, BOX 15 (2) requires such valuation "on a daily basis", and that requirement would be very burdensome for UCITS that are allowed to be valued only every two weeks.

We also object to the introduction in Paragraph 3, 2nd indent of risk limits to be set "at least on a semestrial basis". This goes beyond the Directive's requirement that the UCITS communicate to the competent authorities information regarding the chosen risk management process, and should be removed from the text.

Please find below our suggestion for a new wording of Box 15:

BOX 15

Level 2

1. The fair value of an OTC derivative corresponds to the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Level 3

2. The valuation of the contracts by the UCITS should be made at every valuation point of the UCITS. For the sake of risk management, an indicative valuation of the contracts by the UCITS should be made as often as required to monitor the risks.
3. The definition of the fair value of an OTC derivative combined with the general requirements set by Art. 21 (1) of the Directive on risk management imply that an adequate risk-management process for OTC derivatives has the following characteristics:

- the UCITS must have taken reasonable care to determine that, throughout the life of the derivative, it will be able to value the investment concerned with reasonable accuracy at its fair value, on the basis of the pricing model which has been agreed between the UCITS and the depositary, or on some other reliable basis reflecting an up-to-date market value which has been so agreed. When doing so, reference should be made to an accepted methodology; and
- the UCITS should have the organization and the means to allow for a risk analysis realized by a department independent from commercial and operational units.

3) Credit derivatives

The EACB believes that credit derivatives should be treated like any other derivative. Regarding Paragraph 2, 4th indent please see our comments about OTC derivatives, both as far as the valuation and as far as the reference to risk limits to be set at least on a semestrial basis which should be deleted.

Question 10: We are supportive of initiatives to increase transparency of asymmetric risks. However, from a practical standpoint, the industry considers that it would be extremely difficult to get hold of the information necessary to make a meaningful assessment of risk asymmetry. Therefore, we consider that CESR's proposals in this area to be unrealistic having taken into account the scarcity of [third party] information required to produce meaningful data for risk asymmetry measurement. We consider also that credit derivative instrument should not be singled out as to risk asymmetry.

Question 11: We do not consider that the potential problem of asymmetry of information between issuers and buyers of credit derivatives can be dealt with by limiting the nature of issuers to specific or a combination of the categories CESR sets out. We are supportive of appropriate and proportionate levels of investor protection delivered in an appropriate way whereby the investor has full view of the relevant information.

Please find below our suggestion for a new wording of Box 16:

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:

   - The credit derivative complies with the conditions of eligibility of derivative instruments;

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

Level 3

- The UCITS has taken adequate measures in order to limit risks of asymmetry of information, especially when dealing with related parties;

- A UCITS investing in credit derivatives can demonstrate that it has the organization

and the means to allow for:

- the valuation of the contracts by the UCITS at every valuation point of the UCITS. For the sake of risk management, an indicative valuation of the contracts by the UCITS should be made as often as required to monitor the risks;

- a risk analysis realized by a department independent from commercial and operational units; and

- an internal control independent from the operational units.

- Coherence is ensured with the requirements set for OTC derivative instruments including the requirements on valuation, as developed above in Box 15 of this draft advice.

INDEX REPLICATING UCITS

Index characteristics (Box 18)

The EACB disagrees with CESR´s extension of risk dispersion rules in Art 22a (applying to UCITS investments) to indices, in order to determine their eligibility. In order for an index to be deemed "sufficiently diversified", it should be sufficient that the index in question adequately represent the reference market, even if that results into few index components".

5. Conclusions

The EACB trusts that its comments will be taken in due account by the CESR. For further information or questions on the paper, please do not hesitate to contact:

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