



FEDERATION BANCAIRE DE L'UNION EUROPEENNE

European Banking Federation

Le Secrétaire Général

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Mr Fabrice DEMARIGNY
Secretary General of CESR
CESR, 11-13 avenue de Friedland
F- 75008 PARIS
fdemarigny@cesr-eu.org

Subject: FBE's Response to CESR's draft advice to the European Commission on the eligible assets of UCITS Ref.: CESR/05-172.

Dear Mr Demarigny,

On behalf of the European Banking Federation (FBE), it is my pleasure to submit to you our response to CESR's draft advice to the European Commission on the eligible assets of UCITS Ref.: CESR/05-172.

As you may be aware the FBE is committed to supporting the short-term European paper (STEP) initiative. Concretely, the FBE will join the STEP Market Committee and participate in the technical management of the STEP Label by providing resources for the STEP Secretariat for an initial period of two years. Discussions are underway to finalise the exact details of the FBE participation. Therefore, in addition to the FBE's own response, we also support the response to this consultation submitted by STEP Task Force, prepared by a sub-group of Euribor ACI – The Financial Markets Association (ACI) with legal support from the European Financial Markets Lawyers Group (EFMLG).

I remain at your disposal for any questions you may have. You may also contact Mr Stephen Fisher, Adviser, (Stephen.Fisher@fbe.be; +32 2 508 37 45).

Yours sincerely,

Guido RAVOET

Enclosure: 1



FINAL RESPONSE

CESR's draft advice to the European Commission on the eligible assets of UCITS

Ref.: CESR/05-172

I. INTRODUCTION & EXECUTIVE SUMMARY

1. The European Banking Federation¹ (FBE) welcomes the opportunity to comment on CESR's draft advice to the European Commission on the eligible assets for UCITS. We consider the consultation to be valuable and timely, taking into account the upcoming European Commission review of the legislative framework for asset management in the EU.
2. The FBE is uniquely placed as the voice of commercial banks in Europe to present the perspective of the interests of our membership in this issue. We would like CESR to note therefore that the FBE's interests in this consultation are those of issuers (in particular of money market instruments and certificates of deposit) and of depositary banks. Naturally, the FBE's response also represents the needs of the investor in so far as banks are investors in the fund management industry, and also takes into account the more general need to bolster investor confidence in the EU markets.
3. By way of summary, the FBE highlights that:
 - We consider a forward-looking and liberalising approach necessary to harness the potential for investors and issuers alike arising out of increased innovation and liquidity in the fund market.
 - However, eligibility criteria ought to be set out in a single-place and common-to-all types of product. Where an asset is deemed to meet these criteria, then it becomes eligible for investment in a UCITS product.
 - Greater clarity is also required in the criteria CESR establishes to avoid the potential for diverging interpretations and the consequent regulatory arbitrage within the Single Market.
 - In keeping with the principle of better regulation, it would be desirable for CESR to set out in greater detail the prudential gain for investors from the measures it proposes. Where the gains are outweighed by the costs, the measures need to be revised.
 - We do not believe that it is possible to define an unacceptable risk as it is not the role of financial sector regulation to interfere with the investor's choices. Thus we

¹ Set up in 1960, the European Banking Federation (FBE) is the voice of the European banking sector. It represents the interests of over 4,500 European banks, large and small, with total assets of more than €20,000 billion and over 2.3 million employees.

consider it more relevant to state that the *caveat emptor*, or “buyer beware” principle ought to apply.

- Finally, CESR ought to make it more specific how far it envisages the draft Level 2 advice would impinge on depositary banks and what prudential gains are foreseen.

II. GENERAL REMARKS

4. We consider that the draft advice CESR sets out is, on the whole, positive. However, we would like to raise a number of general points which we urge CESR to take into consideration ahead of finalising its advice to the European Commission.
5. Firstly, we understood the objective of the exercise to be **to clarify the definition of eligible assets for the composition of UCITS products**. The FBE is supportive of this objective but we feel that the consultation raises a number of unanswered questions which undermine any intended clarifications. We feel that it is not entirely clear from the draft advice what impact it would have on the investment management industry in the EU. We look to CESR to be very clear on this issue in its final advice.
6. More specifically, the FBE is supportive of the liberalising stance the draft advice takes. However, we feel that in a number of cases highlighted in the detailed remarks below, good intentions to free up the possibility to include less traditional assets in the composition of UCITS are clouded by **vague and/or too stringent criteria**.
7. Secondly, the FBE believes that the criteria set out in Box 1² ought to be the only place where CESR sets out the criteria to decide whether an investment is eligible to be included in a UCITS product. We think that it would be more logical and ultimately clearer **to have the eligibility criteria set out at the beginning of the draft advice** rather than is currently the case with additional criteria set out throughout the paper. We therefore ask CESR to review the structure of the paper with respect to where and how the eligibility criteria are set out.
8. Aside from the specific comments on the content of the paper *per se*, the FBE would like to highlight two general but very important points related to the role of commercial banks in the investment fund industry.
9. Firstly, it is not clear how the paper caters for **the role of depositary institutions**. In a majority of European jurisdictions, the depositary bank is obliged to perform a duty of care to the investor. This implies that the draft advice CESR sets out will have a significant impact on the day-to-day running of such institutions. Therefore, we ask CESR to examine the relative merits of the impact of the proposed investor protection measures with specific regard to depositary banks.
10. Secondly, the FBE would like to draw CESR's attention to what the industry considers to be the relatively high burden that would be placed by the proposed investor protection measures on those **commercial banks participating in the investment fund business more generally**. The FBE is particularly concerned with the impact the detailed risk assessments proposed in CESR's draft advice would have on the day-to-day banking business. Therefore, we would ask CESR to set out its justification of the prudential gain it envisages from requiring detailed risk assessments of the banking and investment management industry.

² Page 11 of the Consultation Paper CESR/05-172

III. DETAILED REMARKS

Clarification of Article 1(8) (Definition of Transferable Securities)

1. Treatment of “structured financial instruments

<i>Q 1: Do you agree with the approach to the treatment of transferable securities and structured financial instruments outlined in this draft advice?</i>

11. The FBE welcomes the approach CESR has adopted with respect to the treatment of transferable securities and structured financial instruments outlined in the draft advice. We believe that the criteria CESR sets out in its draft advice are the most appropriate categories and would be acceptable as a benchmark across the industry. We would however urge CESR to ensure that the criteria and the definitions of which it sets out are sufficiently accommodating of **future developments** in the fund management industry.
12. As set out in the general remarks, the FBE sees additional value if CESR were to set out all criteria relating to eligible assets **from the outset**. We believe that the most suitable place to do this is Box 1. This way there would be added clarity of the definitions and importantly a greater deal of consistency across CESR’s proposals.

<i>Q 2: What would be the practical effect in your view if such an approach were adopted?</i>

13. Whilst the FBE is supportive of the criteria CESR has established as draft advice, the industry feels the proposed approach could raise a number of **practical problems**. We feel that such potential practical difficulties could be alleviated by CESR being more specific in the definitions of the criteria it sets out.
14. We understand the approach that CESR sets out as an overall view of the liquidity of the fund. We feel that the new approach to liquidity could be open to differing interpretation between Member States. One such area where greater clarity is needed is the expected frequency with which redemptions must take place with reference to the requirements set out in Article 37.
15. We consider the definition of valuation to be quite general and therefore of little practical use to the industry. The definition CESR sets out leaves a good deal of room for interpretation and therefore regulatory arbitrage in the Single Market.
16. We urge CESR to review each criterion and establish clear parameters with which the industry could work. We consider that it would be useful if CESR could set out a series of examples to substantiate the factors it sets out in Box 1, in lieu of more detailed guidance. We also request CESR to set out practical examples which would be relevant for the business of depositary banks in particular given the potentially far reaching impact CESR’s draft advice would have on such institutions’ day-to-day business.
17. Finally, we remind CESR to be mindful of the scope of regulatory arbitrage arising from the eligibility criteria as currently drafted vis-à-vis the objective of increasing supervisory convergence in the Single Market.

2. Closed-end funds as “transferable securities”

Q 3: Does the reference to "unacceptable risks" in the context of cross-holdings require further elaboration, and if so, how should it be elaborated?

18. We feel that it is appropriate to examine the question as to whether certain risks could be considered as unacceptable for an investor. However, ultimately we feel that “unacceptable risks” cannot be subject to an objective definition in light of differences in investors’ risk appetite, their specific investment objectives at a given point in time as well as cultural factors.
19. Whilst it may seem convenient to have a clearly defined list of unacceptable risks, we believe that a heavy-handed approach would undermine the investor’s right to make their own decisions. We do not believe that it is the role of financial sector regulation to interfere with the investor’s choices. Thus we consider it more relevant to state that the *caveat emptor*, or “buyer beware” principle ought to apply. That is, an investor has the option to invest in an investment of their choosing, assuming the investor receives full and clear information in respect of the risk and reward of investing in a given investment product. The most important advantage of this approach would be that it would allow the investors the freedom to make their own investment decisions. This approach is also consistent with the philosophy underlining other capital markets legislation adopted under the FSAP, such as MiFID, which relies on disclosure and reporting to complement a framework based on freedom of investor choice.
20. In other words, a risk only becomes “unacceptable” when the investor is not in possession of reasonably full and clear data in respect of an investment product. Furthermore, we ask CESR to be mindful of the fact that investment risk is not intrinsically undesirable, especially so given the expected directly proportionate nature of risk and reward and the fact that an efficient capital market needs investments at different levels of risk. Moreover, attempts to define what risks are unacceptable would lead to the potential stifling of dynamism in the investment fund industry and alternative possibilities for the informed investor.

Q 4: Do you consider that in order to be considered as an eligible asset for a UCITS, a listed closed end-fund should be subject to appropriate investor protection safeguards? If so, do you consider the proposed safeguards sufficient and clear enough?

21. The FBE feels that greater clarity is needed from CESR before it would be possible to state a fuller opinion. Specifically, before additional investor protection safeguards are established we consider that it would be more logical to have a single definition of a closed-end fund. As a general principle the FBE would strongly advocate that any investor protection safeguards are appropriate for and proportionate to not only the product being sold but also suitable for the potential investor.

Q 5: Further to the requirements presented in Box 2 b), CESR is considering to clarify the investor protection safeguards with the following options:

- *the UCITS should verify that the listed closed end fund is subject to appropriate restrictions on leverage (for example, through uncovered sales, lending transactions, the use of derivatives) and that it is subject to appropriate controls and regulation in its home jurisdiction; or that*
- *the UCITS should consider the extent to which the listed closed end fund can leverage (for example, through uncovered sales, lending transactions, the use of derivatives).*

22. The FBE urges CESR to set out the prudential gain it foresees from establishing further requirements for investor protection. We firmly believe that all the information necessary for an investor to make an informed choice of investment should be set out in the product prospectus as required by the Prospectus Directive of 2003. This way investors could scrutinise investment options on their merits based on the **same information** already required by European legislation to appear in a prospectus document. Therefore, the FBE would not support measures taken that would effectively render the information requirements of a UCITS product super-equivalent to that required for other financial instruments used for investment purposes.

Q 6: Should/ should not UCITS be required to invest only in such listed closed end funds, that invest in transferable securities, that would themselves be eligible under the UCITS Directive?

Regarding especially questions 5 and 6, please give your view on the possible practical impacts of the different options, based on your experience. Please give concrete examples of the impacts in terms of what kind of instruments would be actually left out/ taken aboard by the option chosen. Please give quantitative examples of the impacts in terms of the sphere of eligible instruments for UCITS, if possible.

23. UCITS ought not to be required just to invest in closed-end funds that invest in transferable securities. We consider that the fullest range of investment opportunities must be allowed to energise the investment fund industry in Europe and to allow investors to diversify to the greatest extent possible.

24. We urge CESR to review our response to questions 1 and 2 of this consultation where we call for all criteria of eligible assets for UCITS products to appear in **a single place** and to have universal application. We also ask CESR to note the practical impact of limiting UCITS investment to close-end funds, especially taking the example of limits to specific sectors, such as investment in the real estate market.

3. Other eligible transferable securities

Q 7: Are there any practical difficulties in your experience in defining the boundary between Art. 19 (1) (a) to (d) and Art. 19 (2) (a)? Do you consider the suggested approach in Box 3 as appropriate?

25. Consistent with our overall response, we believe that CESR should set out all clearly defined and forward-looking criteria in a single place in the revised advice, i.e. in Box 1. If a product meets the specific criteria, then it must be considered to be eligible for investment in a UCITS product.

Clarification of Article 1 (9) (Definition of Money Market Instruments)

2. Article 19 (1) (h)

Q 8: Do you agree with this approach and especially the proposal that one of the conditions for the eligibility of asset backed securities and synthetic asset backed securities under article 19 (1) is that they be dealt in on a regulated market under the provisions of Art. 19 (1) (a) to (d)? If not, please give practical examples of the potential impacts.

26. The FBE believes the approach CESR has adopted whereby **asset-backed securities** and **synthetic asset-backed securities** only become eligible if they are dealt on a regulated market is too restrictive. By restricting eligibility in this way we consider that

it would be difficult in practice to fulfil the liquidity requirements CESR stipulates, which is undesirable for the issuer and the investor alike.

27. We therefore encourage CESR to take account of the practical effects of applying such a restriction before finalising its advice. Furthermore, we urge CESR to clarify its intention with respect to the **eligibility of repos** which are not mentioned in the consultation paper and yet are needed for efficient portfolio management.

Embedded derivatives

28. As regards the draft Level 2 advice CESR sets out in Box 11, the FBE believes that UCITS ought not to be obliged to calculate the embedded dormant risk to an undisclosed limit. Rather, we believe that a **de minimis limit** ought to be established at 10%. We consider that the administrative burden to calculate the embedded dormant risk for over 10% of the investment in structured financial instruments would lead to a very high administrative burden for few additional advantages for the protection of the investor.

29. As regards paragraph 4 of the Draft Level 2 Advice, we consider that risk diversification for asset-backed securities ought not to be an eligibility criterion. We would ask CESR to set out its rationale for including diversification as a criterion and/or consider revising the requirement.

Other collective investment undertakings

30. In respect of the draft Level 2 advice CESR sets out in Box 12, we believe that it should be **investor protection** rather than supervision *in strictu sensu* that has to be deemed to be comparable. Whereas we support measures to foster greater convergence around supervisory standards, we believe that the factors CESR highlights in paragraph 1 ought to focus exclusively on investor protection rather than broader supervisory arrangements.

Financial derivative instruments

2. The eligibility of derivative instruments in financial indices

Q 9: In addition to the criteria developed in the draft CESR advice, CESR is considering the following options:

- only financial indices based on eligible assets should be considered as eligible underlyings for derivatives; or that

- the wording of Art. 19 (1) (g) does not require UCITS to apply a look through approach when concluding derivatives on financial indices. These financial indices should nevertheless comply with the three criteria set down by Art. 22a.

In the context of the above, and as far as derivatives on commodity financial indices are concerned, it is considered, whether

- derivatives on financial indices on financial instruments based on commodities would be considered as eligible; or whether

- derivatives on financial indices on commodities would be considered as eligible.

Please give your view on the possible practical impacts of the different alternatives, based on your experience. Please give concrete examples of the impacts in terms of what kind of

instruments would be actually left out/ taken aboard by the different alternatives. Please give quantitative examples of the impacts in terms of the sphere of eligible instruments for UCITS, if possible.

31. We seek clarification from CESR as to which underlying instruments are permitted in order to become eligible for investment in UCITS. The FBE would favour the inclusion of **alternative underlying instruments** to be permitted. We also consider that there ought to be no distinction drawn between open and closed **financial indices**. This would support the FBE's general objective of ensuring that there are sufficient investment alternatives on the market for the benefit of issuers and investors alike.

4. Credit derivatives

Q 10: What is your assessment of the risk of asymmetry of information in relation to the use of credit derivatives by UCITS? Which kind of measures should UCITS adopt in order to limit the risk of asymmetry of information? Please explain the arguments for your view.

32. The FBE is 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.

Q 11: Do you consider that the problem of a potential asymmetry of information between issuers and buyers of credit derivatives can be dealt with by limiting the nature of the issuers on which the credit risk may lie to:

- one or several sovereign issuers;
- one or several public international bodies, provided that at least one Member State is a member of the(se) public international bodi(es);
- one or several regional or local authorities of Member States;
- one or several legal entities, either issuers of bonds admitted to trading on a regulated market that have been graded at least once by a rating agency, or issuers of shares quoted on a regulated market; or
- a combination of the above?

33. The FBE does 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. The FBE is supportive of appropriate and proportionate levels of investor protection delivered in an appropriate way whereby the investor has full view of the relevant information. We believe therefore that there are very few gains from an investor protection perspective to limiting the eligibility of assets in general.

Index replicating UCITS

1. UCITS replicating the composition of a certain index

Q 12: Do you consider that the CESR advice should require UCITS to provide an estimate of the quality of the index replication? Please give practical examples of the possible impacts of using estimates in this regard.

34. We consider that CESR's advice ought not to require UCITS to provide an estimate of the quality of the index replication. The FBE believes that the additional burden such a

requirement would bring about far outweighs any potential prudential gain that could result from the requirement, notwithstanding the potentially severe legal implications for issuers in the event of the publication of an erroneous result.

Q 13: If your answer to the previous question is yes, which of the following two estimates would you consider appropriate, or would you consider both or another estimate necessary?

Option A: The tracking error of the UCITS, based on the following formula:

[see formula p41 of CP]

where :

- Rs denotes the performance error during week s between the UCITS and its reference index, based on the evolutions of the UCITS net asset value and the index value from week s-1 to week s, that is:

[see formula p41 of CP]

When appraising the quality of the index replication, the following elements should be taken into account since they may increase the tracking error:

- The index is composed of securities quoted on markets with different closing hours;*
- The quotation dates of the securities composing the index and the publication date of the UCITS net asset value do not match together;*
- The securities composing the index are mainly securities quoted in different currencies;*
- There is a time difference between the publication of the UCITS net asset value and the publication of the index value;*
- The index and the UCITS net asset values are published in two different currencies; or*
- The index replication involves the use of derivatives.*

Option B: The percentage of the index replication of the UCITS, based on the following formula:

[see formula p42 of CP]

where:

[see notes to formula p41 of CP]

Q 14: Should CESR suggest maximum thresholds as far as the estimates described above are concerned? If yes, what should these thresholds be? If you see the use of thresholds as problematic, please give practical examples of the possible impacts.

35. Please see the above response to Question 12.