BG/SJ - n° 2070/Div.

Mr Fabrice Demarigny
Secretary General
Committee of European Securities Regulators (CESR)
11-13, Avenue de Friedland
75008 Paris

Paris, 18 November2005

AFG RESPONSE TO CESR SECOND CONSULTATION ON CLARIFICATION OF DEFINITIONS CONCERNING ELIGIBLE ASSETS FOR INVESTMENTS OF UCITS

Dear Mr Demarigny,

The Association Française de la Gestion financière (AFG)[1] welcomes CESR's decision to consult publicly a second time on the clarification of definitions concerning eligible assets for investments of UCITS[2]. Besides the substance of the first CESR advice, it was one of the main requests by AFG in the context of the first consultation.

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[1] The Association Française de la Gestion financière (AFG)[1] represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include around 400 management companies and investment companies. They are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing over 1800 billion euros in the field of investment management - making the French industry one of the leaders in Europe (for collective investment in particular, with more than 1100 billion euros i.e. 20% of EU investment funds assets under management) and at global level. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes funds and products such as regulated hedge funds and a significant part of private equity funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA).

[2] Acccordingly, AFG is also grateful to the European Commission for having accepted to delay the delivery of CESR's advice

AFG is also very grateful to CESR for having clearly differentiated possible Level 2 and Level 3 measures. It seemed particularly crucial for our members to take into account the potential legal consequences of the advice in the assessment of the proposed provisions.

The detailed comments and suggestions in order to improve the drafting of the advice, as synthesised by AFG from our expert members' contributions based on their day-to-day practice, are presented below.

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<u>Box 1 : Structured Financial Instruments</u>

Concerning SFIs, we are more comfortable with the new definition of liquidity, as the new text allows asset managers the necessary flexibility in the daily management of funds without compromising investor protection.

However, we wish to stress CESR's attention on the 5th bullet point of Para 1. Some securities are not freely negotiable by all investors on the capital markets: securities sold through a private placement, or only to qualified investors, or which may not be marketed to US citizens are example of such securities. As this requirement is, from our point of view, not the most important one to presume if a security is a transferable security in the context of art 19(1) (a) to (d), we ask CESR to use the following wording:

> The security must be transferable through negotiation on the capital markets, <u>registration on the register of shareholders or other equivalent means.</u>

Another important issue is Para 2 of Box 1. It reads: "*the acquisition of any transferable security must be consistent with the stated investment objectives of the UCITS.*" As it reads now, there is a (remote but existing) risk that this could be interpreted as meaning that each security, individually, must comply with the objective of the fund. We want to underline the fact that very often some UCITS invest in a particular class of assets (sometimes not consistent in themselves with the stated investment objectives) but use derivatives to gain exposure on another class of assets which are fully consistent with the stated investment objectives. The wording used by the CESR is in contradiction with this very common market practice. Therefore we propose the following wording:

> In addition, the <u>global portfolio of transferable securities and other eligible instruments including derivatives</u> must be consistent with the stated investment objectives of the UCITS.

Furthermore, with respect to the matters to be considered in the assessment of liquidity risk (Para. 6), we would suggest the following addition regarding market makers to the fourth (and last) bullet point:

> in assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security

concerned should be considered. There is however the presumption, but not a guarantee, of liquidity for transferable securities with at least one well-recognized market maker.

In Para. 5 we welcome the introduction of the presumption of liquidity for transferable securities traded on a regulated market. The second sentence in the paragraph, however, partly states the obvious ("*The presumption does not apply if the UCITS knows…that any particular security is not liquid*"), and in part it is too vague ("*The presumption does not apply if the UCITS knows or ought reasonably to know that any particular security is not liquid.*"). We would therefore suggest deleting it.

Box 2 : Other eligible transferable securities:

While broadly agreeing with the new text proposal, we believe the following modifications are necessary in Box 2:
Paragraph 1, third bullet point: it would seem to us very interesting to broaden the spectrum of data providers for the valuation of OTC derivatives and fixed income instruments. UCITS must have a similar access to valuation provided by the issuer of the security, from competent investment research or from other well known providers. We ask CESR for the following wording:

> there must be a valuation of the security available on a periodic basis which is derived from information from the issuer of the security, from competent investment research, or from any other independent providers;

Paragraph 1, 4th bullet point: we understand that it is not CESR's intention to discriminate against public and private placement. However, the current wording would exclude for example private placements. No matter if the UCITS got the information by the market or by any other manner, we believe that it would be possible for it to have access to the information, even if it is not publicly available to the market. Consequently we propose the following wording:

> there must be regular and accurate information available to the management of the UCITS on the security or, where relevant, on the portfolio of the security; and

Paragraph 1, 5th bullet point: our same concern applies here as to Box 1, and we also believe that for transferable securities under Art. 19(2) the requirements should be less strict than for transferable securities falling under 19(1)(a) to (d).

> The security must be transferable through negotiation on the capital markets, registration on the register of shareholders or other equivalent means.

Box 3 : Closed end funds:

We agree to recognize closed end funds in contractual form as eligible assets - as soon as some conditions are met. In particular, we support CESR when highlighting the necessity for the underlying funds to respect some conditions. As far as we are in favor of this specific type of funds, we are also conscious that adequate regulatory requirements are needed to ensure an appropriate investor protection safeguard.

Box 4 : Definition of money market instruments:

AFG greatly appreciates the modifications made to the text and largely agrees with CESR's consideration of the amortization method. The text allows asset managers the necessary flexibility in the daily management of funds. However, the France-based industry considers that the use of linearization method should be authorized for MMIs with short maturities (less than 3 months) only. We urge CESR to reconsider the question of UCITS investing solely in instruments (even of high quality) with a weighted average maturity of 60 days. For instance, in the context of low interest rates, this method could lead to important risks by creating a gap between the linearized value and the markt-to-market value. An increase in interest rates cannot be excluded and money markets funds using linearization for more than three months are particularly sensitive to such a market parameter.

In reference to Level 3 advice, AFG wishes to reiterate that the factors presented should not be cumulative. Furthermore, although such factors can be of help in ensuring liquidity in case of redemptions, they cannot ensure "*that UCITS will have sufficient planning … in foreseeing cash flows*". Visibility regarding cash flows depends on the type of investors (retail vs. institutional ones), and is generally not given for the asset manager.

Box 6 : Definition of money market instruments:

In reference to Para 2, 3rd indent, we find the wording unclear. Following CESR's comments at the Hearing we understand that "*independent body*" might refer to a market committee still to be created. From AFG's point of view, the use of an auditor or of a rating agency would be preferable. We therefore suggest the following modification:

- control of this information by an independent entity specializing in the verification of legal or financial documentation (such as, but not limited to, an auditor or a rating agency) and not subject to instructions from the organization they belong and from the issuers;

We also support the decision take by CESR to put at level 2 the different criteria.

Box 11 : Embedded derivatives:

This issue is particularly sensitive for the industry. Our members consider that the definition as proposed by CESR includes both the general definition of 'embedded derivatives' as proposed in IAS 39 paragraph 10 and a specific sub-case which applies only to split embedded derivatives. So we reiterate our disagreement with this definition of embedded derivatives. Such rules should not be used to define embedded derivatives, as their main objective is the implementation of mark-to-market valuations, which are already used by UCITS.

Box 11

Level 2

1. In the meaning of the UCITS Directive, a transferable security embedding a derivative element is a hybrid (combined) instrument which follows three cumulative conditions:
– the hybrid (combined) instrument includes a derivative instrument materialized by a contract with a third party, and
– the hybrid (combined) instrument includes a non derivative host contract, the economic characteristics and inherent risks of which are not modified by the characteristics and risks of the relevant derivative instrument, and
- the presence of the derivative instrument significantly affects the economic characteristics and inherent risks of the hybrid (combined) instrument.

A derivative that is attached to a financial instrument, but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative, but a separate financial instrument.

2. For the purpose of applying Art. 1(8) and 1(9) in conjunction with Article 21(3), a transferable security or money market instrument shall not be deemed to embed a derivative where it contains a component which is contractually transferable independently of the transferable security or the money market instrument. Such as component shall be deemed to be a separate financial instrument.

3. Given the three criteria developed above in paragraph 1, collateralized debt obligations (CDOs) or asset backed securities using derivatives, with or without an active management, will generally not qualify as SFIs embedding derivatives, except if:
<u>- they are leveraged, i.e. the CDOs or asset backed securities are not limited recourse vehicles and the investors' loss can be higher than their initial investment, or</u>
- they are not sufficiently diversified.

4. <u>The CDOs and asset backed securities which are limited recourse vehicles and sufficiently diversified do not qualify as embedding a derivatives. Single tranche CDOs (i.e. CDOs which only issue one tranche) qualify as embedding a derivative if this tranche is only bought by the UCITS</u>

LEVEL 3

5. In order to clarify the scope of the above definition, CESR considers appropriate to provide an illustrative and non-exhaustive list of structured financial instruments (SFIs) which could be assumed by a UCITS to embed a derivative:
- credit linked notes;
- SFIs whose performance is linked to the performance of a bond index;
- SFIs whose performance is linked to the performance of a basket of shares with or without active management;
- SFIs with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management;
- convertible bonds; and
- exchangeable bonds.

6. UCITS using SFIs embedding derivatives must respect the principles of the Directive. These include:
- Embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108/EC);
- In compliance with the third indent of Art. 21(3) of the Directive, "when a transferable security or money market instrument embeds a derivative, the latter must be taken into account when complying with the requirements of (Art. 21)". As a consequence, the UCITS must:
- employ " a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio" (Art. 21(1));
- have a global exposure relating to derivative instruments that does not exceed the total net value of its portfolio (Art. 21(3));
- comply with all the investment limits set by Art. 22 and Art. 22a: "A UCITS may invest ... in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits set laid down in Article 22" (Art. 21(3)). More specifically:
- UCITS using SFIs embedding derivatives should refer to the Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments by UCITS in order to comply with the risk spreading rules required by Art. 22 of the Directive, as this Recommendation sets out how the underlying assets of financial derivative instruments should be taken into account when assessing compliance with the risk limits set by the above-mentioned article; and
- Embedded derivatives will generally not be taken into account when calculating counterparty limits, except if these products enable the issuer of the hybrid instrument to pass the counterparty risk of underlying derivatives to the UCITS.
- Coherence must be ensured with the requirements set for financial derivative instruments, as developed below in this draft advice.

- Requirement to check compliance with the above mentioned principles will depend on the characteristics of the embedded derivative and on its impact on the risk profile and pricing of the hybrid instrument. If this impact is not significant, controls can be tailored accordingly.

We highly appreciate the effort made by CESR to try and reduce the scope of the provisions, and therefore the impact on UCITS managers (Para. 6 last paragraph, as well as Para. 102 of the explanatory text), but more clarity at Level 3 would be needed in order to estimate levels below which embedded derivatives do not need to be taken into account. Furthermore, the text is likely to lead to diverging interpretations. As a result, we doubt that CESR’s language in Para. 6 can modify the scope of Level 2 and the compliance burden for the industry is therefore likely to increase significantly.

<u>Box 13 : Financial Derivatives Instruments:</u>

From our point of view, Level 3 of this box should be deleted. There are two reasons for this request. First, such a sentence (“*Operations in derivatives may never be used to circumvent … of the Directive 2001/108/EC*”) can be appropriate as a recital for example but not as positive law. This is such a general statement, with so many potential implications, that it creates legal uncertainties, which is what the asset management wants to avoid obviously. Second, the end of this sentence (“*As a consequence, underlying of derivatives must be eligible assets*”) seems to be in contradiction with Box 14 on financial indices.

Box 14 : Financial Indices:

AFG largely agrees with CESR’s new text. However, regarding the index management process, point i) is too restrictive as far as liquidity of underlyings is concerned (“*these underlyings should be sufficiently liquid to enable users to replicate the full index, if necessary*”). We suggest the following wording instead: “*These underlyings should be sufficiently liquid to enable users to replicate a position in most underlyings, if necessary*”, as a few minor index components might be less liquid but should not compromise the possibility to use the full index as an underlying to eligible derivatives.

Concerning the index management process in general, it provides detailed criteria, defined by IOSCO, to determine an instrument’s suitability for inclusion. These criteria – transparency, rebalancing and contract design of stock index derivative products – encompass the key issues that arise in assessing the eligibility of a financial index, and are valid in order to mitigate the inherent investment risks in derivatives on financial indices. The Paper concludes by permitting commodity indices but excluding hedge fund indices.

While CESR’s reasoning – based mainly on the IOSCO conclusions – is rational, we think that the conclusions on the ineligibility of hedge funds indices are not consistent with such a reasoning:

1) UCITS investing in a hedge fund index does not have direct exposure to the funds, but to the index;

2) Distinction needs to be made between two types of hedge funds: the risky ones and the less risky ones. Hedge fund indices are generally composed of the less risky hedge funds. Moreover, major index providers have created investable indices that do not warrant the traditional criticism (underlined by CESR in Para 122 of the explanatory text) about survivor bias, selection bias, consistency, backfilling, etc…

As long as hedge fund indices meet the criteria (i) set by Art. 22a(1) of the Directive (sufficiently diversified, adequate benchmark for the market it refers to, published in an appropriate manner), (ii) comply with the diversification rules (including ratios) set by Art. 22a of the Directive, and (iii) comply with the following criteria regarding index management process, transparency and contract design as defined by the IOSCO, hedge fund indices should be considered eligible indices and no “discriminatory” exception should apply.

For example, S&P provides for four hedge funds indexes. These indexes represent *Arbitrage, Event-Driven, Directional/Tactical* strategies; the last one represents the whole alternative universe (the *Hedge Funds Index*). More than 580 daily NAVs are available for these indexes. The main index has been built with 41 hedge funds, each of them managing more than 1 378 billions $. The funds selection is realized with quantitative and qualitative studies in order to understand the investment policies, the skill of fund’s managers, the risk management process, operational capacities etc… From our point of view, these are typically indexes which can be eligible assets.

In consideration of the above, we propose the following wording for Para 2 of Box 14:

2. Indices based on hedge funds may be eligible, provided that they comply with the following criteria:
a) The index provider or his affiliates must have no role in the management or the supervision of the hedge funds that are included in the index and provide a methodology that is publicly available and appropriate to represent the investment universe.
b) The index must be sufficiently diversified.
c) The index must be investable at any time.
d) The index must be published in an appropriate manner.

If CESR's final advice doesn't take in consideration this issue, we would like that a specific consultation regarding the eligibility of hedge fund indices is put in place. This will enable the asset management industry to provide CESR with complementary information regarding each criterion developed by IOSCO.

Box 15 : OTC Derivatives:

While broadly in agreement with CESR's advice in Box 15, we have a few suggestions for text modifications.

Para 2, second indent: there is no reference in the Directive to a requirement to agree on a pricing model with the depositary. We consider that it is sufficient for the depositary to agree on the valuation process, which would include the type of methodology used for the valuation of OTC derivatives.

… If no reliable up-to-date market value is available, fair value should be based on a pricing model based on an accepted methodology.

Para 3, first indent, second sub-indent: we want CESR to take into consideration three different cases. The first one relates to the first sub-indent, when valuation is provided by the counterpart and check by a third party. The second one is the valuation done by an independent third unit in the UCITS and the last one is when the valuation is provided by the counterparty and checked by an independent unit within the UCITS. Therefore, we propose the following wording:

- Either by requiring …
- Or by requiring that the valuation be performed by an independent third unit within the UCITS, or, if the valuation is provided by the counterparty, be checked by such independent third unit within the UCITS. Independent in this context means a unit:

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If you would like to discuss the contents of this letter with us, please contact myself on 00 33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), or Stéphane Janin on 00 33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon