

**MEMO# 18683**

March 24, 2005

## **COMMITTEE OF EUROPEAN SECURITIES REGULATORS ISSUES DRAFT ADVICE ON DEFINITIONS OF ELIGIBLE INVESTMENTS FOR UCITS**

[18683] March 24, 2005 TO: INTERNATIONAL COMMITTEE No. 5-05 RE: COMMITTEE OF EUROPEAN SECURITIES REGULATORS ISSUES DRAFT ADVICE ON DEFINITIONS OF ELIGIBLE INVESTMENTS FOR UCITS The Committee of European Securities Regulators (CESR) has published for comment its draft advice to the European Commission on the definitions of eligible investments for UCITS funds. A public hearing is scheduled for May 9, 2005, and written comments are due to CESR by June 10, 2005. A copy of the consultation paper is attached. The Institute is considering whether or not to submit comments to CESR. If you have particular concerns on which the Institute should comment, please contact us at [jchoi@ici.org](mailto:jchoi@ici.org) or (202) 326-5810 immediately. CESR's consultation paper covers the following areas: (1) definition of transferable securities; (2) definition of money market instruments; (3) clarification of conditions under which instruments would be techniques and instruments relating to transferable securities and money market instruments; (4) embedded derivatives; (5) other collective investment undertakings; (6) financial derivative instruments; and (7) index-replicating UCITS. This memorandum briefly highlights CESR's advice. Definition of Transferable Securities CESR provides a list of factors for UCITS<sup>1</sup> to consider in determining whether financial instruments whose underlying involves products of varying degrees of liquidity and/or which may not be directly eligible for investment by a UCITS would qualify as "transferable securities" for purposes of the Directive. In addition to the requirement that the instrument be admitted to trading (or is dealt in) on a regulated market, CESR believes a UCITS should consider the following factors: (1) liquidity; (2) valuation; (3) information; (4) transferability; (5) consistency with the stated investment objectives of the UCITS and with the requirements of the UCITS Directive; and (6) ability of the UCITS to assess the risk of the transferable security and its contribution to the overall risk profile of the portfolio. UCITS also should apply these factors to listed closed-end funds. In addition, if a listed closed-end fund takes the form of a transferable security, the UCITS should: (1) consider whether the transferable security may be engaging in cross-holdings in other closed-end funds, 1 As used in the consultation paper, UCITS refers to the investment company if the UCITS is self-managed and to the management company if the UCITS is not self-managed or if the UCITS is in a contractual form. 2 creating unacceptable risks for the listed closed-end fund and for the UCITS; (2) ensure that the asset management activity of the listed closed-end fund is subject to appropriate investor protection safeguards; and (3) not make investments in listed closed-end funds for the purpose of circumventing the

investment limits provided for UCITS by the UCITS Directive. The list of factors for a “transferable security” also is essential for determining whether a security that is not dealt in on a regulated market falls within the scope of “other transferable securities,” which can make up 10% of the investment of a UCITS. CESR is of the view that unlisted closed-end funds are highly unlikely to meet these factors. Money Market Instruments CESR takes the position that for an instrument to be considered an eligible money market instrument under the UCITS Directive, the instrument must: (1) be liquid (i.e., must be able to repurchase, redeem, or sell the instrument in a short period (7 days) at limited cost, in terms of low fees, narrow bid/offer spread, and with a very short settlement delay; (2) have a value that can be accurately determined at any time; and (3) have either a low interest risk where it has a maximum residual maturity of one year or regular yield adjustments in line with money market conditions at least every 12 months. CESR states that, although a UCITS must ensure that the money market instrument meets the liquidity criteria, the fact that a money market instrument is admitted to trading on a regulated market creates a presumption that it complies with the condition of “liquidity” and “accurate valuation.” For money market instruments that are not dealt in on a regulated market, it is the responsibility of the UCITS to determine whether a particular instrument is an eligible asset. CESR notes several key areas that a UCITS should consider in assessing the eligibility of a money market instrument. These areas include: (1) whether an information memorandum providing information on the issue and legal and financial situation of the issuer is available prior to the issue of the money market instrument; (2) whether this information memorandum is regularly updated; (3) whether this information memorandum is subject to control by an independent authority; (4) whether each issuance has a minimum amount of EUR 150,000 or the equivalent in other currencies; and (5) whether free transferability and electronic settlement in book-entry form are possible. Finally, for money market instruments dealt in on a regulated market outside the EU, UCITS have the responsibility to check that the requirement that prudential rules are at least as stringent as those laid down by Community law is met. CESR is of the view that there is a presumption that establishments located in the European Economic Area and G10 countries or having investment grade rating are subject to prudential rules at least as stringent as those laid down by Community law. Techniques and Instruments Relating to Transferable Securities and Money Market Instruments Techniques and instruments relating to transferable securities and money market instruments must be used for the purpose of efficient portfolio management. According to 3 CESR, UCITS are considered to use efficient portfolio management if the transactions are (1) economically appropriate (conducted in a cost-effective way) and (2) entered for the reduction of risk, the reduction of cost, or the generation of additional capital or income with an acceptably low level of risk. CESR is of the view that techniques and instruments that satisfy these criteria include financial collateral arrangements, repurchase agreements, guarantees received, and securities lending. Embedded Derivatives CESR clarifies the factors for determining whether and under what conditions certain instruments would be considered transferable securities embedding a derivative element. CESR also provides a non-exhaustive list of structured financial instruments embedding a derivative. Other Collective Investment Undertakings A UCITS can invest up to 30% of its assets in investment funds domiciled outside the EU if the funds are subject to equivalent supervision and the level of protection for unit-holders in a non-UCITS fund is equivalent to that provided for unit-holders in a UCITS. CESR is of the view that the following factors could be used to determine whether a non-EU collective investment undertaking is subject to equivalent supervision. These factors include: (1) Memorandum of Understanding (bilateral or multilateral) and membership by the non-EU jurisdiction in an international organization of regulators, such as IOSCO, to ensure satisfactory cooperation among authorities; (2) rules guaranteeing the autonomy of the

management of the collective investment undertaking and management in the exclusive interest of unit holders; (3) the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision; (4) availability of pricing information and reporting requirements; (5) redemption facilities and frequency; (6) restrictions in relation to dealings by related parties; (7) the management company of the target collective investment undertaking, its rules and choice of depositary have been approved by its regulator; and (8) registration of the collective investment undertaking in an OECD country. To determine whether the level of protection of unit holders of the other collective investment undertaking is equivalent to those provided for unit holders in a UCITS, CESR believes that the following factors should be considered. These factors include the extent of asset segregation and the local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the collective investment undertaking. Financial Derivative Instruments CESR proposes advice regarding the factors to be used to determine whether and under what conditions a derivative financial instrument would be an eligible asset under the Directive. CESR provides advice on the eligibility of derivative instruments on financial indices, OTC derivatives, and credit derivatives. 4 Index Replicating UCITS According to CESR, a UCITS is deemed to be replicating the composition of a certain index if it has the aim to replicate the composition of its underlying assets. A UCITS can replicate an index through the use of derivatives or other portfolio management techniques. CESR also clarifies the three conditions for determining whether a specified index would be eligible for replication by a UCITS. Jennifer S. Choi Associate Counsel Attachment (in .pdf format)

---

**Source URL:** <https://icinew-stage.ici.org/memo-18683>

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.