



Mr M Glibbery  
Financial Services Authority  
25 The North Colonnade  
Canary Wharf  
London  
E14 5HS

5 December 2007

Dear Mark

**Quarterly Consultation Paper 07/18 – Chapter 7**

The Depository and Trustee Association (DATA) promote the role of trustees and depositaries in providing consumer protection to investors in authorised collective investment schemes (unit trusts and OEICs) in the UK.

Please find attached our response to chapter 7 of the CP on the proposed amendments to the COLL sourcebook.

We look forward to discussing these issues with you in due course.

Yours sincerely

John Cargill

DATA Chairman

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## Questions from Chapters 7 of FSA's CP18/07

### **Q14: Do you agree that our general approach to implementing the EAD and the CESR guidelines is appropriate?**

DATA agrees with the FSA's approach to implementation and appreciates that because the FSA are implementing a Directive there is little room for flexibility. We do believe the FSA should consider renumbering COLL 5.2 and providing a derivation and destination table to make the new rules easier to follow. Finally there are areas of the rules which are incorrectly referenced which we will highlight below.

### **Q15: Do you agree with our proposed rules and guidance in relation to transferable securities?**

We agree with most of your proposed rules however, we have some issues which need to be addressed:

- 5.2.7 C R(2) stipulates that a closed end fund under the law of contract must be (a) 'subject to corporate governance mechanisms equivalent to those applied to companies' and (b) 'it is managed by a person who is subject to national regulation for the purpose of investor protection'. We believe that there should be an additional rule (c), stipulating that 'the AFM should provide evidence of (a) and (b) to the Depository' on request. This should also be added to chapter 6.
- Under 5.2.7 D G (2) we believe that the term "unitholders" should be replaced with 'its investors' to differentiate between the unitholders of the investing fund and the investors of the closed end fund. This is also the case for (3).
- Under 5.2.7E R (2) there is an incorrect reference to COLL 5.3.19R (3A). This should be 5.2.19R (3A).
- Under COLL 5.2.8 R (4) it should refer to (3) not (1) as 1 has been deleted.

### **Q16: Do you agree with our proposed rules and guidance in relation to money market instruments?**

DATA believes that rule 5.2.7H R should also include a cross reference to the CESR guidance with respect to Article 4 (2), which provides clarification of the principles of accurately determined value in respect of a money market instrument and UCITS Money Market Funds.

Chapter 7.24 of the policy statement represents that the FSA will not allow money market instruments that are not dealt on a regulated market due to 'unlawful sub-delegation of powers to another competent authority'. Whilst this may be your view, the EAD applies equivalence rules to collective investment schemes which are regulated by other 'competent regulators' outside of the EU. DATA would not expect that an AFM should have to seek a rule waiver to allow a scheme to invest in securitisation vehicles since these are eligible assets permitted under Article 19 (1)(h) of the Directive.

### **Q17: Do you agree with our proposed rules and guidance in relation to derivatives and efficient portfolio management?**

As EPM is still an integral part of many fund managers' investment techniques, we welcome the re-introduction of EPM into the glossary.

In order to ensure consistency throughout the COLL source book, 5.4.2 G (1) which relates to EPM should read:

'This section covers techniques relating to transferable securities and money-market instruments ***permitted by COLL 5.2.7F*** .....

We also welcome the step FSA has taken by widening the Risk Management Process beyond the sole use of derivatives. We would, however, appreciate clarification from FSA that there was no

intention to extend the Depository's responsibilities in relation to the risk management process beyond its remit of oversight.

COLL 6.3.6 G 2 (2)(k) is drafted to ensure that the valuation of an OTC derivative is compliant with methods as agreed with the Depository. As these methods must comply with COLL 5.2.23R, we believe that it would be helpful if there was a cross- reference to this rule.

**Q18: Do you agree with our proposals in relation to index-replicating funds and collective investment schemes? Are there any other matters we should consider in relation to the EAD or the CESR guidelines?**

Clarification is required on how the spread of risk rules for index replicators interacts with the 5/10/40 rule for securities schemes generally. Is the 5/10/40 rule disapplied for index replicators?

We believe that the FSA should relax the rules on the equivalence of collective investment schemes. Whilst the FSA limit the provision to NURS with equivalent investment and borrowing powers to UCITS, EEA funds equivalent to UCITS and s.270 funds, many other member states allow regulated territories outside of s.270 which puts the UK at a competitive disadvantage. To expand the provision, a principles-based rule should be applied where the outcome is dependent upon investor protection equivalent to that of a UCITS scheme. This would remove the need for a prescriptive list of accepted territories which would require constant maintenance by the FSA. A rule should be introduced that would allow the depository to obtain evidence of investor protection equivalent to that of a UCITS scheme from the AFM on request.

**Q19: Do you agree we should permit investment in covered bonds by a UCITS scheme up to the maximum permitted by the Directive?**

DATA welcome the proposals to align UK funds with other EU members. We do recommend that 5.2.11 (10A) should include a reference to the Covered Bond limit for consistency, as follows:

'The limits provided for in (3) to (7) may not be combined, and thus investments in transferable securities, including covered bonds, or approved money-market instruments issued by the same body or in deposits or transactions in derivatives made with this body carried out in accordance.....'

**Q20: Do you agree we should not impose a global limit on investment in covered bonds in a non-UCITS retail scheme?**

Whilst we agree with your proposals, draft rule 5.6.7 R (3A) still includes the clause limiting exposure to 80%, which we believe is unintentional and would actually impose the global limit as currently drafted. DATA recommends that all text is deleted after '.....property in respect of covered bonds.....'.

**Q21: Do you agree with our proposals for modifying our rules in relation to guarantees and indemnities?**

Article 41 of the UCITS Directive relates to the granting of loans and acting as a guarantor on behalf of third parties. The proposed addition of restrictions on indemnities goes beyond what was intended in the Directive and is super-equivalent. It is unduly burdensome on firms and the proposed restriction should therefore be removed.

**Q22: Do you agree with our proposal to allow indemnities to be given to third parties in respect of immovable property?**

In relation to NURS the same position as that in Q21 should be adopted so as to maintain a level playing field.

CONTINUED BELOW

**Q23: Do you agree with our proposed rules and guidance in relation to liens?**

The general restriction referred to in paragraph 7.46 of the CP is not present in the Directive.

In a letter dated 2 May from DATA to the FSA we set out various legal devices to be found in

typical custody agreements. DATA contend that the presence of these various legal mechanisms in the custody agreement allows the custodian to extend services which benefit the fund and its unitholders (principally borrowing and contractual settlement facilities). DATA's letter sets out the typical legal mechanisms which are found in custody agreements namely:

- Lien (which is a right of retention)
- Charge (whether fixed or floating)
- Power of sale
- Right to assign or transfer
- Right to withhold delivery

It appears that mortgages are not typical in custody agreements. Our primary contention is that there is no basis under the Directive for retaining Rule 5.5.7R (3) of COLL namely "The [scheme property](#) must not be mortgaged". This rule goes beyond what was intended in the Directive and is super-equivalent.

If the FSA is nevertheless determined that it wishes to introduce rules and guidance on this point then the current draft needs to be reviewed. We believe that guidance 5.5.7A G (2) should include the words "*contractual* entitlement", with 'and not to enable any party to make a profit' being deleted as all fees include an element of profit. In relation to the guidance (5.5.7A G (1)) again this is a drafting point but the current drafting appears to imply that the rights referred to in the second sentence are sub-categories of a charge. It might be preferable to list those rights which are permissible.

In respect of 5.5.7 R (3) (a), then issue concerning a delegation agreement authorising a mortgage or pledge is unlikely to arise as the real issue is in respect of a delegate taking a lien or a charge over any of the scheme property

The FSA should be concerned about liens and suggest that the rule is changed to only effect their concerns in that area.

COLL 5.6.22A G states that the Depositary should consider whether the terms of the guarantee should be 'normal' commercial terms. We believe that the word 'normal' could potentially inhibit innovation and therefore 'appropriate should be used' This is also applicable to COLL 5.5.7A(2)(a).

**Q24: Do you have any comments on our other proposals for changes to COLL?**

With regards to the guidance on financial indices, we believe that the wording of 5.2.20B G (1) is confusing and should read as follows:

'An index based on derivatives, on commodities or a property index.....'. This will clarify the two types of indices as described by CESR

COLL 5.6.13 R (1) (b) has been amended to include COLL 5.6.5 R (2). As 5.6.13(1) applies to the exposure/spread limits of the underlying asset of the derivative, we see no need to include 5.6.5 R (2) which discusses the eligibility of assets. We therefore recommend this reference is deleted.

Article 10 (2) of the UCITS Directive stipulates that the Depositary *and* AFM must act solely in the interest of the unit holder. The COLL rules only mention that the Depositary must act in this manner. As you have already proposed amendments in COLL to align with the UCITS Directive, we believe that this difference should be rectified.

**Q25: Do you agree with our analysis of the costs and benefits of these proposals?**

DATA agrees with FSA's cost/benefit analysis.

