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Submission on a Revision of the Directive on Undertakings for Collective Investments in Transferable Securities (UCITS)

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Contact: **WEED – World Economy, Ecology and Development**
Markus Henn
Eldenaer Str. 60
D-10243 Berlin
Phone 0049-30-27582249
Email markus.henn@weed-online.org

Interest Representative Register ID number: 96427979956-77

About WEED

WEED – World Economy, Ecology & Development is a Berlin based specialist think tank and advocacy organization that has worked on global finance issues for about 20 years. It has outstanding expertise on the development impact of the international financial system. WEED regularly testifies to the German parliament on financial market issues and is engaged in dialogue with German civil servants from the finance and other ministries. WEED has been part of several EU funded projects on international financial markets, currently implementing one called "Towards a Global Finance System at the Service of Sustainable Development". For more information please see www.weed-online.org.

ELIGIBLE ASSETS (Box 1)

(1) Do you consider there is a need to review the scope of assets and exposures that are deemed eligible for a UCITS fund?

We would rather restrict than extend the scope of assets. We think that UCITS funds are intended as retail funds that do not invest in risky or opaque assets. Any further extension of the asset scope would go against this intention. This is particularly true for commodity (derivative) investments which are risky and should not be opened up to UCITS funds.

Furthermore, allowing for commodity assets would further contribute to the financialisation of commodity markets. While there is no unanimous view on the effects of this financialisation, there is a lot of evidence from academics, analysts and public institutions that massive investments of investors into commodity markets have contributed to negative effects such as rising prices, price peaks and divergence of futures and physical markets[1] which deteriorated the global hunger situation and was harmful to hedgers.

Of particular importance would be to keep the prohibition of direct investments into commodities. Such investments would lead to hoarding effects with even stronger price impact than in the case of derivatives. An example is the current plan by US bank JP Morgan to create physically backed copper ETFs. These ETFs are even strongly being opposed by copper users who are "warning they would have a "devastating" effect on prices and supply."[2]

(2) Do you consider that all investment strategies current observed in the marketplace are in line with what investors expect of a product regulated by UCITS?

No, we think that many UCITS funds in fact do not do what is expected of a transparent low-risk retail fund. Particularly since the UCITS III revision, there are more and more special UCITS commodity funds that are designed to cope with the directive and still invest in commodities. As the Financial Times put it, "A growing number of Ucits funds are getting around rules barring investment in some assets, such as commodity futures, simply by having a total return swap based on an offshore hedge fund that does hold such positions."[3]

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[1] See the list here: http://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf.

[2] "U.S. copper users lodge last appeal against "devastating" ETFs", Reuters, 28.9.2012, http://www.reuters.com/article/2012/09/28/us-etf-copper-jpm-idUSBRE88R10L20120928

[3] Johnson, Steve (2011): "Swaps tactic threatens UCITS brand", Financial Times, 13.11.2011, http://www.ft.com/intl/cms/s/0/e0d0e01e-0b84-11e1-9a61-00144feabdc0.html#axzz29YQh5XuC.

Investment companies such as Castlestone[4], MAN[5] or Blackrock[6] set up ever larger such funds. The difference between alternative investment funds (regulated by the AIFM directive) and UCITS funds is thus getting increasingly blurred and UCITS funds become alternative and risky investments[7]. Recent attempts by ESMA to reduce the complexity of current UCITS funds are obviously not sufficient as the financial industry openly admits.[8]

(5) Do you consider there is a need to further refine rules on exposure to non-eligible assets?

Yes, there is a need. As demonstrated above, the UCITS standard has been dangerously weakened if it has not already been lost. We thus think that UCITS funds should not be allowed at all to have any direct or indirect (derivative) investment into non-eligible assets in any way. Any circumvention of the non-eligibility of certain assets will either mean that investors have to face risks that they should actually be protected against, or at least that the funds get opaque and hard to assess in their riskiness. Both effects are undesirable.

What would be the consequences of the following measures for all stakeholders involved:

- Preventing exposure to certain non-eligible assets (e.g. by adopting a "look through" approach for transferable securities, investments in financial indices, or closed ended funds).

We think that such a provision would be the right way to go. By applying a “look through” approach, no UCITS funds would be allowed to channel money into assets that are actually non-eligible.

In the case of commodities, this would also prevent the contribution of the synthetic commodity funds to the financialisation of commodity markets with the above described negative impact. Such funds have been growing massively in the last years.[9]

Furthermore, investors could again be sure to know what they are finally investing in. Currently, it is not possible to finally assess where the money goes. We have experienced this in the course of a case study of Deutsche Bank commodity funds that we commissioned. For the European funds, it was not possible to finally assess where the money ends up – only Deutsche Bank knows.

- Defining specific exposure limits and risk spreading rules (e.g. diversification) at the level of the underlying assets.

In case there is no prohibition of indirect investments in non-eligible assets, we would be in favour of such a limit.

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[4] http://www.castlestonemanagement.com/non-ucits/fund-summary.aspx?fundId=15.

[5] http://www.mangroupplc.com/media/news-from-man/2012/press-release-13mar2012.jsf.

[6] https://www2.blackrock.com/webcore/litService/search/getDocument.seam?venue=PUB_IND&source=GLOBAL&contentId=1111125006.

[7] See for example: http://www.ucitshedgefunds.com/issue/201007/images/ucits-hedge-conference-2010.pdf.

[8] Flood, Chris (2012) “EU rules will not kill complex Ucits”, Financial Times, 26.08.2012, http://www.ft.com/intl/cms/s/0/09725aae-ec74-11e1-8e4a-00144feab49a.html#axzz29YQh5XuC.

[9] Ramaswamy, Srichander (2011): "Market structures and systemic risks of exchange-traded funds", BIS Working Papers No 343, www.bis.org/publ/work343.pdf, page 2.

(6) Do you see merit in distinguishing or limiting the scope of eligible derivatives based on the payoff of the derivative (e.g. plain vanilla vs. exotic derivatives)? If yes, what would be the consequences of introducing such a distinction? Do you see a need for other distinctions?

We think that limiting the scope is a minimum requirement. An approach based on the payoff would be useful in some respects, e.g. regarding risks. However, we would also recommend a distinction based on the underlying. For example, we would keep the prohibition of the use of commodity derivatives as it is included now and even extend this to OTC derivatives such as (index) swaps.

3. EFFICIENT PORTFOLIO MANAGEMENT (EPM) (Box 2)

(6) Do you think that there is a need to define criteria on the eligibility, liquidity, diversification and re-use of received collateral? If yes, what should such criteria be?

We think that collateral should not be allowed to be re-used, for example for lending to other investors. The idea of collateral basically is to have it available as a secure protection against defaults. Any deviation from this will only risk the very sense of collateral.

The 2011 bankruptcy of major US commodity broker MF Global and its abuse of collateral[10] have highlighted the need for strong rules on the use of collateral.

4. OTC DERIVATIVES (Box 3)

(1) When assessing counterparty risk, do you see merit in clarifying the treatment of OTC derivatives cleared through central counterparties? If so, what would be the appropriate approach?

Yes, we see a merit. Central counterparty (CCP) clearing in its broad application to almost all OTC derivatives has not yet demonstrated to be risk-free. The fact that the US in the meanwhile have declared the first clearing houses as too big too fail indicates that there might be a new systemic risk with the CCP clearing houses.

(2) For OTC derivatives not cleared through central counterparties, do you think that collateral requirements should be consistent between the requirements for OTC and EPM transactions?

Yes, of course they should be consistent to prevent regulatory arbitrage.

6. DEPOSITARY PASSPORT (Box 5)

(5) Are there specific issues to address for the supervision of a UCITS where the depositary is not located in the same jurisdiction?

We think that there is a particular need to address the problem of secrecy jurisdictions (tax havens). UCITS rules should ensure that such jurisdictions are not allowed as depositary

[10] "MF Global Didn't Segregate Client Collateral, CME Group Says", Businessweek, 08.11.2011, http://www.businessweek.com/news/2011-11-08/mf-global-didn-t-segregate-client-collateral-cme-group-says.html.

locations. The fact that even countries such as Gibraltar have become UCITS compatible[11] is worrisome. Gibraltar had a secrecy score of 78 in the 2011 Financial Secrecy Index[12] of the Tax Justice Network which places it towards the top end of the secrecy scale. However, also Luxemburg as a major UCITS funds location must be seen with caution given its tax haven quality which was highlighted by the role these funds played in relation to the Madoff scandal.[13]

7. MONEY MARKET FUNDS (Box 6)

(5) Do you agree that MMFs, individually or collectively, may represent a source of systemic risk ('runs' by investors, contagion, etc…) due to their central role in the short term funding market? Please explain.

We do not state to have a strong opinion on this issue. However, our general experience with the financial crisis and the risks stemming from the interbank markets suggest that there is a considerable risk. This risk should be addressed by limiting any intra-player exposure in the financial markets. Higher self-reliance of all players without the need of permanent short-term refinancing generally seems a prudent way to go.

8. LONG-TERM INVESTMENTS (Box 10)

(1) What options do retail investors currently have when wishing to invest in long-term assets? Do retail investors have an appetite for long-term investments? Do fund managers have an appetite for developing funds that enable retail investors to make long-term investments?

While we are generally in favour of long-term investments compared to speculative short-term investments, we think that the listed long-term investments are not in the interest of society as a whole and developing countries particularly. This relates to all long-term investments in monopolistic services of general interest, such as water, energy, transport, health care, education, infrastructure, to name the most important.

The privatisation of such services, fuelled by funds investments, does often deteriorate the service quality and price level, and thus is not to the benefit of users and the public. There is now extensive evidence of such negative effects (or missing positive ones) for all kinds of sectors[14], including water[15], health care[16], electricity[17], and infrastructure[18]. The financial

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[11] See http://www.gibraltarfinance.com/pdf/GIF-feb-apr-2012.pdf

[12] See the ranking at http://www.financialsecrecyindex.com/2011results.html and the country report at http://www.secrecyjurisdictions.com/PDF/Gibraltar.pdf.

[13] http://investments.lawyers.com/blogs/archives/526-Role-of-the-depositary-in-a-Luxembourg-UCITS-fund-a-general-overview-as-a-result-of-the-Madoff-case-i.e.-Luxalfpha,-Herald,-Norvest,-etc..html.

[14] For all sectors see the *Public Services International Research Unit* at the University of Greenwich, www.psiru.org. For Germany in general see *Gemeingut in BürgerInnenhand*, www.gemeingut.org.

[15] See for example Bel, Germà / Fageda, Xavier / Warner, Mildred E. (2012): “Is Private Production of Public Services Cheaper than Public Production? A meta-regression analysis of solid waste and water services,” Journal of Policy Analysis and Management, 29(3): 553-577. http://onlinelibrary.wiley.com/doi/10.1002/pam.20509/abstract. Corporate Accountability (2012): "Shutting the Spigot on Private Water. The case for the World Bank to divest”, http://www.stopcorporateabuse.org/resource/shutting-spigot-private-water-case-world-bank-divest. Further evidence is the wave of remunicipalisation such as in Paris, Berlin and many other cities, or also the nation-wide referendum in Italy which clearly voted against water privatisation and which was recently approved by the constitutional court, see http://www.fame2012.org/en/2012/07/20/constitutional-court-water/.

[16] See for example Lethbridge, Jane (2012): “A Parallel Approach to Analysis of Costs/benefits and Efficiency changes resulting from Privatisation of Health Services”. PSIRU, University of Greenwich, http://www.psiru.org/reports/parallel-approach-analysis-costsbenefits-and-efficiency-changes-resulting-privatisation-heal.

benefit of "private finance" for public services has also been questioned in a recent report by the UK's House of Commons.[19]

Huge problems are also related to any direct investments in land, often referred to as "land grabbing". As has been demonstrated in many cases, land investments normally lead to the eviction of smallholders and can even put the local food supply at risk.[20]

(2) Do you see a need to create a common framework dedicated to long-term investments for retail investors? Would targeted modifications of UCITS rules or a stand-alone initiative be more appropriate?

Yes. There should be a clear framework that any long-term investment has to meet strong sustainibility criteria, at least along the lines of the Equator Principles or even stronger proposals by NGOs.[21]

(3) Do you agree with the above list of possible eligible assets? What other type of asset should be included? Please provide definitions and characteristics for each type of asset.

As said before, we are not at all in favour of opening up the funds' eligibility for these assets.

(7) Should the use of leverage or financial derivative instruments be banned? If not, what specific constraints on their use might be considered?

Yes. Given the extremely negative experience in the financial crisis with leverage and derivatives, UCITS funds should not engage in these types of business. Their best protection against financial risks and losses is not leverage and derivatives but the opposite: long term investments in shares and bonds. This would be also helpful for the economy as a whole. At least, restrictions on the use should be envisaged, for example a clear leverage ratio as it has been decided for banks with Basel III (but much stricter than this ratio). For derivatives, the use should be, at least, clearly restricted to hedging activities. However, given the blurred line between hedging and speculation, a ban would be a clear and sustainable solution.

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[17] See for example Hall, David / Thomas, Stephen / Corral, Violeta (2009): "Global experience with electricity liberalisation", PSIRU, University of Greenwich, http://www.psiru.org/reports/global-experience-electricity-liberalisation.

[18] See for example a recent stop of a bridge-building PPP project in Frankfurt: "PPP – Brückenprojekte in Frankfurt am Main stehen vor dem Aus", 15.05.2012, http://blog.gemeingut.org/2012/05/ppp-bruckenprojekte-in-frankfurt-am-main-stehen-vor-dem-aus/

[19] House of Commons, Treasury Committee (2012): "Private Finance Initiative, Seventeenth Report of Session 2010–12", http://www.publications.parliament.uk/pa/cm201012/cmselect/cmtreasy/1146/114602.htm.

[20] For an overview see http://farmlandgrab.org/, http://www.grain.org, and http://www.oxfam.org/en/grow/issues/land-grabs.

[21] See for example Friends of the Earth (2011): „How to integrate sustainability criteria in banking regulation?" March 2011. http://www.foeeurope.org/finance/sustainableCRD-2011.pdf.