

CESR's Issues Paper

Can hedge fund indices be classified as financial indices for the purpose of UCITS?

The Irish Funds Industry Association (IFIA) is the representative body of the international investment fund community, representing the custodian banks, administrators, managers, transfer agents and professional advisory firms involved in the international fund services industry in Ireland. Given that as at end of October 2006 there were 3,948 Irish domiciled funds, including sub-funds, with a Net Asset Value of €686 billion, (2,275 Irish domiciled UCITS funds, including sub-funds with a Net Asset Value of €547 billion), all developments in the European investment funds arena are of particular interest and relevance to the Irish industry.

The Industry in Ireland is involved in the domicile and administration of investment funds and while not in a position to comment on the detailed individual technical questions, we would like to contribute to this debate/process in support of the inclusion of hedge fund indices as financial indices for the purposes of UCITS and believe that the Directive already permits the use of hedge fund indices for UCITS.

We would submit that the wording of Article 19 (1)(g) does not require a UCITS fund to apply a look through approach with respect to investment in derivatives on financial indices. As noted in previous consultations, Article 21(3) allows that a UCITS may, in relation to index-based financial derivatives, benefit from an exemption in relation to application of investment restrictions which might otherwise apply. It would be inconsistent with this approach to the application of the UCITS investment restrictions to require, in the case of investment in derivative instruments on financial indices, that there should be a look through to the underlying assets. In a previous consultation paper, CESR notes that a fund may not invest directly in commodities; however, this would not preclude a fund from investment in transferable securities of an issuer which derived its value from activities related to commodities.

The question, therefore, is whether a UCITS fund may invest in derivatives on financial indices on commodities, notwithstanding that direct investment in commodities would be unacceptable. The UCITS directive does not take a sectoral approach to risk. For example, it is possible for a UCITS fund to invest in transferable securities issued by a company engaged in any type of commercial activity and in any part of the world. It is up to the UCITS fund to determine the level of risk which it will assume and to ensure that there is adequate disclosure of that level of risk. Accordingly, a UCITS fund may invest in emerging market debt or in securities issued by companies of emerging markets. A UCITS fund may not acquire precious metals; however, a UCITS fund may acquire equity or debt securities of a company which derives all of its value from holdings of precious metals and from activities related to precious metals such as mining and distribution. It is arguable that the conclusion which should therefore be drawn is that the primary concern of the UCITS directive is in relation to the particular instrument which the UCITS is allowed to acquire rather than the economic risk related to the particular asset class. Accordingly,

if the asset to be acquired by the UCITS meets the requisite criteria in terms of transferability, liquidity, settlement and custody, it should be an acceptable asset for a UCITS fund. Accordingly, we would submit that it should be possible for a UCITS fund to invest in derivatives on financial indices on financial instruments based on commodities and in derivatives on financial indices on commodities.

The issue of the correct interpretation of the Directive on the question of whether Financial indices have to be based on eligible assets in order to be considered as eligible underlying for derivatives was specifically considered by Gerard Hogan an Irish Senior Counsel and below follows the relevant extract from his opinion.

“Summing up, therefore, my principal conclusions are as follows:

- A. The language, structure and syntax of Article 19(1)(g) clearly envisages that the underlying may consist of a number of disjunctive possibilities, including financial indices. There is accordingly no textual basis for the argument that the financial indices referred to are governed by the words “instruments referred to in this paragraph” (i.e., Article 19(1). If the Community legislator wished to circumscribe what was envisaged thereby by financial indices, more circumscribed language might have been used, such as is the case with the use of the words “certain stock or debt securities index” in Article 22A.
- B. While it is true that teleological principles of interpretation play a large role in the interpretation of Community legislation, such principles cannot be at the expense of doing violence to the actual language used. This would be doing violence to the actual language of Article 19 (1)(g), since, obviously, if the financial indices, currencies etc. were to be governed by the reference to the instruments referred to elsewhere in Article 19(1), the language actually used would have been very different indeed.
- C. So far as the purposive argument is concerned, one must first note that Recital 11 expressly recognizes the use of derivatives to set financial targets. In any event, there is no question here of circumventing the financial principles set out in the Directive...”

Irish Funds Industry Association
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