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BG/SJ – Div.

AFG's response to CESR consultation on Hedge Fund Indices

Dear Mr. Demarigny,

In response to your consultation please find below the Association Française de la Gestion Financière (AFG) answers on the above topic.

The Association Française de la Gestion financière (AFG) represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include management companies and investment companies. Some are entrepreneurial ones; others belong to French or foreign banking, insurance or asset management groups. AFG members are in charge of the management of over 2200 billion euros - making the French industry the leader in Europe for collective investment management in particular (with more than 20% of EU investment funds assets under management) and the second at global level after the US, in terms of financial management location (wherever the funds are domiciled). In the field of collective investment, our industry includes – beside UCITS – a significant part of products such as hedge funds, real estate funds and private equity funds. We are of course an active member of the European Fund and Asset Management Association (EFAMA).

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General comments

A. There cannot be a single answer about eligibility or non-eligibility of Hedge Fund indices

The CESR consultation is named “can hedge fund indices be classified as financial indices for the purpose of UCITS?”. This title raises in itself many issues.

The draft Commission Directive on eligible assets¹ (hereafter the “Commission Directive”) makes no distinction between indices based on components that would be classified as acceptable and components that would not be classified as acceptable. On the contrary, the Commission Directive states that an index may be eligible as an underlying of derivatives, even if it is made of assets which are not directly eligible.

Hedge Fund indices are extremely diverse and it is therefore not appropriate to try to put them in a single group of instruments that would be or would not be considered as eligible according to the UCITS Directive. Some indices are investable, some are not; some indices are built up from ‘managed account platforms’ and some are not. A lot of research is also currently going on and it is probable that methodologies will improve and that new types of Hedge Fund indices will even emerge.

Our view is therefore that there should not be any a priori and general decision as to whether Hedge Funds indices should or should not be considered as financial indices. Each of them should be assessed on its own merit in order to determine if it respects the requirements of the Commission Directive. If CESR wishes to provide added guidelines, they should detail some specific requirements of the Commission Directive. They should not propose specific requirements that would apply solely to Hedge Fund indices.

If CESR wishes however to provide specific guidelines to Hedge Fund indices, they could refer to some specific indices and some specific issues, but they should not close the door generally to any type of Hedge Fund indices. **CESR should leave the door open to any index provider that can reasonably argue that it fulfils the requirements of the Commission Directive.**

B. CESR should not be more demanding for Hedge Fund indices than for Equity (or commodity) indices

When examining whether Hedge Fund indices fulfil the three criteria articulated by the Commission Directive (diversification, adequate benchmark and publication), CESR should not demand a higher degree of compliance than what is usually asked from Equity indices. Reading CESR paper, we get the feeling that Hedge Funds

¹ Draft Commission Directive implementing Council Directive 85/611/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions

indices would have to bear a higher level of compliance with financial indices principles than classical Equity or commodity indices.

C. CESR should propose grand-fathering provisions for UCITS that already exist and use Hedge Fund indices

We believe that current investors in UCITS and asset managers should not suffer from any new interpretations of regulators. UCITS that entered into derivatives on Hedge Fund indices prior to the publication of this consultation should be allowed to continue to use the same derivatives if such derivatives are essential to the respect of their investment purpose, even if they do not comply with the new vision of CESR. Such grand-fathering clause should extend at minimum to 5 years.

D. Can Hedge Fund Indices comply with Article 9 of Commission Directive?

According to the Commission Directive, Hedge Fund indices are financial indices complying with the UCITS Directive if they fulfil the following criteria:

(i) Diversification

Text of Commission Directive:

“(a) they are sufficiently diversified, in that the following criteria are fulfilled:

(i) the index is composed in such a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index;

(ii) where the index is composed of assets referred to in Article 19(1) of Directive 85/611/EEC, its composition is at least diversified in accordance with Article 22a(1) of that Directive;

(iii) where the index is composed of assets other than those referred to in Article 19(1) of Directive 85/611/EEC, it is diversified in a way which is equivalent to that provided for Article 22a(1) of that Directive; “

The criterion of Article 22a(1) of the UCITS Directive is the criterion that each component must represent less than 20% of the total composition of the index. One component can represent more than 20%, up to 35%.

We believe that there would be no rationale to require a higher level of diversification than this level, which is accepted for Equity Indices. All Hedge Fund indices we know respect this diversification requirement.

In fact, Hedge Fund indices are in general much more diversified than equity indices, especially sector indices. A study made by the Edhec Risk and Asset Management Research Centre² concludes that “if hedge fund indices typically have a relatively low

² Edhec Risk and Asset Management Research Centre : « A Reply to the CESR Recommendation on the Eligibility of Hedge Fund Indices for investments of UCITS » available on: http://www.edhec-risk.com/latest_news/Alternative%20Investments/RISKArticle.2006-09-21.4924/attachments/csr%20amenc%20goltz.pdf

number of components, the same can be said of sector or style indices in the equity universe”. Also, having looked at the better non correlation of the components, the research concludes that “the components of hedge fund strategy indices appear to offer at least as much diversification as securities that make up equity indices”.

(ii) Adequate Benchmark

Text of Commission Directive:

“(b) they represent an adequate benchmark for the market to which they refer, in that the following criteria are fulfilled:

(i) the index measures the performance of a representative group of underlyings in a relevant and appropriate way;

(ii) the index is revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available;

(iii) the underlyings are sufficiently liquid which allows users to replicate the index; “

Condition (iii) is fulfilled by investable indices.

Condition (ii) is fulfilled by some Hedge Fund indices that have a publicly available methodology. If an example is needed, this is the case of the investable index that is named “MSCI Hedge Invest Index”. Methodology is publicly available on MSCI website³.

Condition (i) is a more scientific question that can be answered only by the academical world. The research made by Edhec Research Centre⁴ makes a very interesting comparison between equity style indices representativity and hedge fund strategy indices. The research concludes that Hedge Fund strategy indices are not less representative than Equity style indices. They conclude that current methodologies could be improved to increase their representativeness and the author of the research proposes some new methods.

We therefore suggest that the representativeness of each index should be judged on its own merit. Index providers should be allowed to reasonably demonstrate the appropriateness of their methodology in this respect without predetermined views from regulators.

(iii) Publication

Text of Commission Directive:

“(c) they are published in an appropriate manner, in that the following criteria are fulfilled:

³ See: http://www.msccibarra.com/resources/pdfs/HII_Methodology.pdf

⁴ Edhec Risk and Asset Management Research Centre : « A Reply to the CESR Recommendation on the Eligibility of Hedge Fun Indices for investments of UCITS » available on: http://www.edhec-risk.com/latest_news/Alternative%20Investments/RISKArticle.2006-09-21.4924/attachments/cesr%20amenc%20goltz.pdf

- (i) their publication process relies on sound procedures to collect prices and to calculate and to subsequently publish the index value, including pricing-procedures for components where a market price is not available;*
- (ii) material information on matters such as index calculation and rebalancing methodologies, index changes or information relating to any operational difficulties in providing timely or accurate information is provided on a wide and timely basis.”*

This criterion is obviously fulfilled by several existing Hedge Fund indices. The MSCI Hedge Invest Index is only one example.

E. Conclusion

We strongly support the eligibility of HFIs for UCITS III funds. As we already say, HFIs are extremely diverse and it is therefore not appropriate to close the door to any type of HFIs. From our point of view there is no need to build another regulation or other constraints for the sole case of HFIs.

Even if it is possible that the existing indices are not, for the time being, fully compliant with UCITS directive, it is not a reason to prevent improvements from being made in the next years (or months) which would lead then to their eligibility under the current provisions of the directive.

Finally, we want to highlight that if HFIs would be eligible under the current provisions of the directive, it would drive to a huge growth of competition in database and indices providers. This surge in competition will undoubtedly increase the quality of data and methodologies used to build non skewed HFIs.

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Annexe I : Detail comments on the specific questions raised by CESR

Q1: What are your views on the potential biases described in this section and on how they can affect HFIs? Please explain your comments.

Some biases mentioned (defunct funds) refer to non-investable indices. Others (sample bias and classification bias) exist to a certain extent with any index as they are inherent to their construction. There is no proof that they are particularly important with Hedge Fund indices. On the contrary, Hedge Fund indices are often equally weighted, which is an advantage in terms of representativity, as has been shown by academic literature.

Moreover, competition between data providers is driving to a concentration period (such as the LIPPER M&A). Obviously, this concentration in providers will conduct to more representative databases.

Q2: Are there any other material sources of bias affecting HFIs that CESR should consider?

None, as regards investable indices.

Q3: Should an HFI have to meet certain additional quantitative criteria other than level 2 requirements, or should compliance with the level 2 requirement of sufficient diversification be left to the UCITS to assess? Please explain precisely the grounds underlying your comments.

We believe that there is no reason to treat them differently from Equity or commodity indices. See our comments above.

Q4: What requirements on weighting should HFIs have to fulfil to qualify as financial indices? Please explain precisely the grounds underlying your comments.

Methodology should be flexible in this respect. For a long time, the view was that indices should be based on market capitalisation. New research seems to show that equally weighted indices are more appropriate. Hedge Fund indices tend to be equally weighted, with some corrections.

In any case, the Commission Directive does not provide for any regulation concerning weighting, except diversification.

Q5: Is the definition of the representative group of underlyings made by the index provider sufficient to satisfy the criterion of “adequate benchmark” ? Please provide comments.

See answer above.

Q6: Is there a role for any quantitative assessment of the 'breadth' of coverage of the HFI? If so, how would this work?

See answer above.

Q7: Should backfilling be banned for HFIs to qualify as financial indices? If not, why not? Please explain precisely the grounds underlying your comments.

Investable indices do not face such a problem.

Q8: Should CESR set criteria for the treatment of defunct funds by HFIs for them to qualify as financial indices? If so, what should they be? Please explain precisely the grounds underlying your comments.

Defunct funds should be treated as when a share disappears in an equity index. The defunct fund should be replaced by another one and the methodology should insure that this happens at equal value.

Again, investable indices do not have such an issue of treatment of defunct funds.

Q9: Is disclosure of the index revision methodology sufficient or should controls be placed on the frequency, method or amount of due diligence the index provider must

carry out regarding ongoing constituent classification? If so, what should they be? Please explain precisely the grounds underlying your comments.

There are already classification standards in the market. These changes of classification happen also in the equity universe. They should be treated in the same way.

Q10: Can the UCITS assess the revision methodology of the HFI adequately or should an independent third party be required to review the HFI's methodology? If the latter, how would this work? Please explain precisely the grounds underlying your comments.

Again, we do not see any reason to treat Hedge Fund indices in a specific way. The methodology is an essential part of an index. UCITS managers should look at it just as they look at equity indices methodology.

Q11: Is passive versus active selection of constituents the key difference between an HFI and a fund of hedge funds respectively? What could be the other differences? Please explain precisely the grounds underlying your comments.

Statistical methods allow active selection of constituents provided this is made in an unbiased way. For example, the quota method is often used to achieve representativity while selecting constituents.

Some equity indices, like style indices, also use some selection methods. Again Hedge Fund indices should not be treated differently.

Q12: Should only HFIs where constituent selection depends solely on publicly available objective rules qualify as financial indices? If not, why not? What sort of subjective judgments could be used to select underlying constituents? Please explain precisely the grounds underlying your comments.

We believe that publicly available methodology and rules are important.

Q13: Are there any competition aspects CESR should consider in the context of hedge fund indices compared to funds of hedge funds? Please explain precisely the grounds underlying your comments.

Yes in theory, but in practice there will not be any forthcoming European legislation for funds of hedge funds – and we deeply regret it. It could also be argued that UCITS indexed on equity indices compete with actively managed UCITS.

Q14: Do respondents agree that the ability to verify the value of the index given price data and the HFI methodology satisfies the replicability criterion? If not, why not?

Criteria should be the same as for equity indices.

Q15: Should CESR set requirements for verification of NAV calculation and independent custody arrangements/robust governance structures for the underlying constituents of HFIs to qualify as financial indices; or as an alternative, should the

UCITS be required to assess the due diligence procedures of the index provider in respect of the underlyings in this regard? Please explain precisely the grounds underlying your comments.

A general answer is not possible, due to the very diverse nature of Hedge Fund indices.

We believe that the above requirements may be too stringent. The methodology document should provide for some credible way to compute the index so that regulators are sufficiently comfortable that the index provider can calculate the index in an objective, rule-based way.

Q16: Should a minimum monthly publication frequency be a requirement for HFIs to qualify as financial indices? If not, why not, and what frequency would be suitable?

As a minimum, a monthly or weekly publication frequency seems to us as an appropriate requirement.

Q17: Should CESR require an independent audit of the calculation of HFIs to qualify as financial indices, or should the market be left to decide whether this would be an attractive option for an index provider to put in place? Please explain precisely the grounds underlying your comments.

Equity indices do not have to follow a complex procedure through which each index would have to be validated by an independent audit. We believe this audit should be left to asset managers themselves.

Q18: Should it be a requirement for an HFI to qualify as a financial index that its full rules are publicly available (rather than just material rules)? If not, why not?

Standards should be the same as in the Equity universe.

Q19: To qualify as financial indices, should HFIs be required to disclose at all times details of their constituents (eg list of underlyings, their classification, and the weight applying to them, if appropriate)? Is there other information about the HFI that should be disclosed? Would this be done via the index provider's website? Please explain precisely the grounds underlying your comments.

Standards should be the same as in the Equity universe.

Q20: Should a UCITS which intends to invest in derivatives based on HFIs have to disclose this fact in its prospectus or other documents? What degree of information should a UCITS which intends to invest in derivatives based on HFIs have to disclose in its prospectus? Please explain precisely the grounds underlying your comments.

General regulations concerning derivatives seem to us as appropriate.

Q21: Do you have any other comments relating to hedge fund indices that CESR should consider? What are they?

See above comments

Q22: From the regulatory and retail investors' point of views, how do you assess the situation of competition between funds investing in derivatives based on HFIs and funds of hedge funds? Please explain precisely the grounds underlying your comments.

Hedge Fund investable indices are rather new. They represent and will continue to represent a small size of the market for the foreseeable future. The Hedge Funds world will stay very different, for some time, from the Equity universe where indexing represents a very significant share of the market.

However, Hedge Fund indices are more and more important in the sense that they provide some benchmarks to alternative asset management that may be, at least in some instances, more appropriate than pure no-risk returns. They measure and they improve the visibility of Hedge Funds risks; they therefore contribute to the understanding of Hedge Fund risks, which is of utmost importance for regulators and for the public at large.

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If you wish to discuss the content of this response with us, please contact myself at 00 33 1 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), our Head of International Affairs Stéphane Janin at 00 33 1 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or our Senior Adviser Bertrand Gibeau at 00 33 1 44 94 94 31 (e-mail: b.gibeau@afg.asso.fr).

Yours sincerely,

(signed)

Pierre Bollon