

CONSULTATION CESR « CAN HEDGE FUND INDICES BE CLASSIFIED AS FINANCIAL INDICES FOR THE PURPOSE OF UCITS »

FBF'S RESPONSE

GENERAL COMMENTS

1. The French Banking Federation (FBF) is the professional body representing over 500 commercial, cooperative and mutual banks operating in France. It includes both French and foreign-based organizations.

As universal banks, the FBF member are highly interested by the development of the hedge funds, since these markets are an alternative for investment strategies of investors, especially when the equity markets drawdown and the performance of debt instruments are low.

Indeed, hedge funds can offer high yields and an adequate covering of risk.

2. The huge importance of the Hedge funds. The FBF would like to tackle the problem with a statement about the development of hedge funds. Both economists, professional of asset management, investment bankers and distributors consider that the hedge funds will undoubtedly know a huge growth in the new few years, since they can offer an alternative strategy for investors to get high levels of performances and/or coverings.

Thus the main message the FBF wishes to bring to CESR is that the eligibility of hedge funds indices as assets for the purpose of the UCITS cannot find an answer only by analysing the actual situation but must be considered from a global point of view and with a sight of the near future.

The best way to ensure that the expansion of the hedge fund industry will profit to every investor is to remove any barrier to the possibility of the actors to promote these funds, provided these funds comply with precise rules.

3. The existing scepticism of some financial regulators. The main critics expressed by some regulators find a synthesis in the study published in September 2006, on the demand of the French AMF and called "*Les indices de hedge funds doivent-ils être éligibles ou non aux fonds grand public?*"¹ seem to be the following:

- *The underlying of these indices is not eligible for the purpose of UCITS;*
- *The OTC nature of the hedge fund markets is an obstacle to the creation of representative and transparent indices;*
- *While there are more than 20 hedge fund indices, no one has taken a "leadership" and no one has become a global reference recognised by the actors;*

¹ AMF, Cahiers Scientifiques – n°2, septembre 2006, François-Serge Lhabitant (HEC Lausanne, membre du Comité scientifique de l'AMF).

- *Since the hedge fund indices must be representative, regarding the around 8 000 existing hedge funds, it seems very difficult to reach such representativeness, considering the opacity of the markets;;*
- *The most mature hedge funds have no need for more liquidity; thus they are not interested to disclose their performance; on the other hand, the less liquid and mature hedge funds need such information: thus it is undisputable that hedge funds have very different strategies and very different performances which explain the lack of transparency and the lack of representativeness of the hedge fund indices.*

The FBF considers that these critics are based on the overview of the actual hedge funds indices and cannot be considered as definitive since the hedge funds markets is quite young and is moving.

These arguments therefore shall not be used as a justification of a refusal of the eligibility of hedge funds indices as financial indices for the purpose of UCITS.

Furthermore, the FBF considers that the question is not really to know whether the hedge funds indices are financial indices, especially because many of these indices are not comparable, but to help the industry to meet the criterion defined in the directive for the financial indices.

4. The FBF supports the eligibility of Hedge Funds Indices as assets for the purpose of the UCITS Directive.

First, the hedge funds indices shall be considered as financial indices and therefore be eligible to the UCITS provided they comply with some criteria defined by the UCITS Directive; the eligibility of hedge funds indices will certainly involve an evolution of these indices in a way that some of them will be build to comply with the criterion defined in the Directive.

Second, the fact that the hedge are not eligible to the UCITS has no consequence since it is broadly admitted that non-financial underlyings are subject to financial indices (real estate, commodities). The draft Commission Directive on eligible assets² makes no distinction on indices based on underlyings that would be classified as acceptable and underlyings 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.

Third, a clear distinction must be made between the investable hedge funds and the non-investable hedge funds. Non-investable indices used to predominate in the hedge fund industry over the last decade; investable indices have been introduced more recently. It is clear that most of the biases that are correctly underlined in pages 7-8 of the consultation apply mostly to the former ones. According to us, it is clear that such indices should not be considered as valuable candidates for indices as they do not satisfy minimum requirements for being eligible: transparent, reliable and, above all, investable (open to new investors). These indices track performances which are unreachable for most investors as they involve closed funds, mitigate or, at times, ignore the draw downs induced by funds going bankrupt or poorly performing. The investable indices are more accurate measures of performances.

² 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

5. The FBF underlines that there cannot be a single answer about eligibility or non-eligibility of Hedge Fund indices.

Since Hedge Fund indices are extremely diverse, it is not relevant to try to put them in the same group of instruments that would be or would not be considered as financial indices according to the UCITS Directive. Some indices are investable, some are not; some indices are based on managed account platforms and some are not. A lot of research is also currently going on and it is probable that new types of Hedge Fund indices will emerge.

The FBF's considers that there should not be any definitive decision about the qualification of hedge fund indices 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. From FBF's point of view, CESR should not propose specific requirements which would apply only to Hedge Fund indices.

6. The FBF also estimates that CESR should not be more demanding from Hedge Fund indices than from Equity (or commodity) indices.

The FBF notices that the consultation could be interpreted in a way that Hedge Funds indices would have to bear a higher level of compliance with financial indices principles than classical Equity or commodity indices.

When examining whether Hedge Fund indices fulfil the three criteria articulated by the Commission Directive (diversification, adequate benchmark/representativeness and publication), the FBF nonetheless considers that CESR should not demand a higher degree of compliance than are usually asked from Equity indices.

7. The FBF believes that it would be useful to propose a grand-fathering clause 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.

8. The Criteria the Hedge funds indices would have to comply with.

The FBF estimates that the three criteria which define in the UCITS Directive the financial indices have to be considered as is:

① Diversification

The Directive states:

"(a) [the indices] 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 criteria of Article 22a (1) of the UCITS Directive is the criteria that each underlying must represent less than 20% of the total underlying of the index. One underlying can represent more than 20%, up to 35%.

The FBF considers that it would not be relevant to require a higher level of diversification than this level which is accepted for Equity Indices. All Hedge Fund indices respect this diversification requirement.

In fact, Hedge Fund indices are in general much more diversified than equity indices, especially sector indices. A recent study published by the Edhec Risk and Asset Management Research Centre³ concludes that *“if hedge fund indices typically have a relatively low 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 underlyings, 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”*.

② Adequate Benchmark/ Representativeness

The Directive states:

“(b) [the indices] 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; “*

The condition (iii) is fulfilled by investable indices. The 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 website.

The condition (i) is a more scientific question that can be answered only by the academic world. The research made by Edhec Research Centre makes a very interesting comparison between equity style indices representativeness 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.

Thus the FBF suggests that the representativeness of each index should be appreciated 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.

③ Publication

The Directive States:

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

- (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;*

³ Edhec Risk and Asset Management Research Centre : « A Reply to the CESR Recommendation on the Eligibility of Hedge Fun Indices for investments of UCITS », N. Amenc et F. Goltz.

(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.

9. The market forces shall inevitably lead to the eligibility of some Hedge fund indices.

Considering the existing situation and the evolution seen on the hedge fund industry, some indices will probably, in the near future, be able to be classified as financial indices.

That's why the FBF states that the criteria defined by the Directive are sufficient and that the "monitoring" of the hedge fund indices by the industry will generate the conditions which are asked by the actual legal framework.

Thus there is no need, from FBF's point of view, to add new criteria⁴ or to modify the existing ones.

⁴ The Study published in October 2006 in the "Cahiers Scientifiques" of the French AMF proposes some new criteria, such as : simplicity, component's transparency, suitability, audit, measurement, passive management, ultimate value of index, stability of the performance, weighting.

QUESTIONNAIRE

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

The FBF agrees on the existence of the biases, but estimates that some of them (defunct fund) refer to non investable indices, not to investable ones. Others (sample bias and classification bias) exist to a certain extent with any index. They are inherent to the construction of any index but there is no proof that they are more important with Hedge Fund indices. On the contrary, Hedge Fund indices are often equally weighted, which is an advantage in terms of representativeness, as has been shown by academic literature.

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

As regards investable indices, the FBF considers there are no other material sources of bias.

Nevertheless, for the sake of clarity, it might be relevant to harmonise the presentation of performances in terms of fees as some are gross while others are net. Investing through Managed Accounts allows harmonising the fees paid on all strategies.

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.

As it is states in the General Comments, the FBF firmly believes there is no reason to treat the hedge funds indices differently than Equity or Commodity indices. Moreover, the experience has shown that index providers are aware of the actual “weaknesses” of the indices regarding the representativeness and the diversification; thus the regulation on this issue is useless.

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.

Moreover, the 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.

No, it is not. The FBgf underlines that an adequate benchmark should be investable either directly or through (almost) perfect replication.

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

From FBF's point of view, Investable indices should present a strong correlation (75% or more) with the non-investable indices. Even if, it was said above that non-investable indices are not good candidate for being HFI, the FBF considers that while their performances are affected by biases, these biases are only affecting average returns and not their variability or their correlation with other assets. With a number of funds above 3000 or so, non-investable indices have more chances than investable indices which are based on 50 or 100 funds to capture exposures to other markets or risk factors.

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

Yes they should be banned. Investable indices do not have such 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.

The FBF believes that 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 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.

The FBF estimates that 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, the FBF does not see any reason to treat Hedge Fund indices in a different way. The methodology is an essential part of an index. UCITS 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.

In some sense, HFI based on platforms are also performing active selection of funds. Active selection is not limited to fund picking, though. In particular, it is plausible that FoF will more and more pay attention to allocation between strategies (top-down views). As for any

underlying asset, active management aims to outperform passive strategies thanks to management process and abilities.

The FBF also estimates that other differences between funds of funds and HFI deserve attention:

- Funds of funds are offering capacity to some funds which will never be registered on platforms as it is too much constraining for them.
- Funds of funds are acting as liquidity providers and are thus exposed to liquidity squeezes. In particular, they have to manage gap of liquidities. On the contrary, there is homogeneity of liquidity on platforms.
- Fees are more transparent for hedge funds indices based on platforms where again homogeneity is observed.

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.

The FBF believes that all quantitative rules should be publicly disclosed. Due diligence should be the sole qualitative rule. In this case, while details and methodology should be disclosed, human judgment which is prevailing in the end can not so clear. The parallel with rating agencies is meaningful here: their analysis is based on criteria which are publicly exposed but the process is not purely mechanical.

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.

There are two ways to answer this question:

- First, by saying that UCITS indexed on equity indices compete with actively managed UCITS;
- Second, in comparing the advantages of hedge funds indices (liquidity, transparency and fees) and those of funds of funds (capacity to invest in “famous” funds, tactical allocation, due diligence expertise).

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. Some index providers do not publish all data for free and this does not disqualify them as index providers.

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 at least for investable indices. 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?

The FBF considers that at minimum monthly seems an appropriate requirement: most strategies are able to publish reliable values at higher frequency and larger weight of institutional investors should favour this evolution.

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. The fbf thus believes that CESR should let the market do as it is aware of the biases.

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.

The FBF considers that the standards of disclosure 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.

The FBF estimates that the general regulations concerning derivatives seem appropriate.

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

Please refer to the General 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.