

Comments from Raiffeisen Capital Management (RCM) on CESR's Issues Paper "Can hedge fund indices be classified as financial indices for the purpose of UCITS?"

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1. Preface

Raiffeisen Capital Management („RCM“) appreciates the opportunity to be able to provide comments on CESR's Issues Paper "Can hedge fund indices be classified as financial indices for the purpose of UCITS?" This document examines important ideas for the future of the investment fund industry and for the question of possible eligible assets of an UCITS.

RCM has a positive approach to allow hedge fund indices (HFI) as an eligible underlying for derivatives under the conditions set up pursuant to Art. 19 (1) (g) of the UCITS-Directive. According to our point of view HFI are not a wholly new asset-class by its own, but rather a derivative investment universe of an established asset class. Therefore it is not appropriate to speak of a new risk category for investors of HFI since they represent a similar risk repackaged in a similar form. Allowing HFI for UCITS (through derivatives) would rather facilitate to implement certain investment strategies that are currently only possible through a detour. Furthermore it would – without changing the existing UCITS-Directive – be a suitable instrument to keep pace with the innovative tolls of the financial industry, especially regarding other comparable retail saving products. Keeping a high standard of the investment fund industry and maintaining a high level of investor protection should stay a prime goal.

2. Answers

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

“Database biases” and “index biases” are indeed discussable issues with some intrinsic problems. It is nevertheless important to emphasize that these are not limited for HFI, but affect the whole index-industry. Biases should therefore be treated with the same standards for all indices. Especially “index biases” reflect a problem of the whole index-industry, since every index is based on subjective criteria (e.g. market capitalization, industry-structure) and these provide only limited valuable information about the profitability of the investment.

A special case of biases, namely “backfill biases”, poses certain difficulties. Backfill biases pretend a nonfactual index-history and thereby provide an artificial picture that has little explanatory power. Backfill biases should therefore be handled with special care, and backfilling should be prohibited due to misguidance.

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

As mentioned above it is difficult to detect and ascertain special biases that affect HFI only, since these are features of the entire index-industry.

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

The requirements of level 2 are sufficient and provide appropriate criteria to fulfil the diversification requirement of a HFI. It leaves a flexible and case-by-case approach that would not be improved with rigid limitations (like minimum number of constituents or a particular weighting). The individual market and the special market conditions (e.g. Nokia in Finland) should be always favoured vis-à-vis pre-defined constraints.

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.

Yes, this definition is sufficient. Crucial should only be that the index provider has to accurately determine what “market” exactly is represented and to disclose this in an appropriate way.

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

No, this should not be an issue. A quantitative requirement does not per se improve the “breadth” of coverage, as for example the Dow Jones Index with only 30 constituents shows. The criterion to “represent an adequate benchmark” is a sufficient requirement for due coverage.

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, this option should be considered. As noted above backfilling can lead to a falsified picture since it pretends a nonfactual index-history.

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.

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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.

Due disclosure and transparency of the revision methodology is sufficient on a self-regulatory basis. It would otherwise be an unequal treatment vis-à-vis “traditional” indices that are not subject to any form of

control. It is furthermore doubtful if a third party control would lead to an improvement of the revision methodology.

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.

With the according transparency, as noted under Q9, the UCITS will be able to assess this methodology. The requirement of a third party within this process would only mean administrative and costly burden without improving the situation.

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.

Every index, the “traditional” ones as well as HFI, are subject to a certain degree of active selection of constituents, as can be observed on many established indices, like the S&P 500 or Dow Jones. Obviously funds of hedge funds follow a more active approach on the selection of its constituents, as it is main part the “value creation” process. HFI should nevertheless have - in numbers - more constituents than funds of hedge funds since the latter regularly comprises between 15 and 30 (sub-hedgefunds). This number typically and normally is not sufficient for an index to be representative for a market to which it refers.

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.

Yes. In order to fulfill the necessary transparency requirement the constituent selection should be based on open and objective rules.

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.

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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?

It should be sufficient if the data of the index are disclosed, can be verified and are therefore replicable.

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.

Within its assessment process of the HFI/ index provider it should be left to the UCITS to decide if the requirement of the NAV calculation is sufficient or not.

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?

A monthly interval for publication is an adequate minimum frequency for a HFI.

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.

No additional burden should be established for HFI, especially if they do not exist for other indices. The market and its mechanism can appropriately decide on that.

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?

As stated above, full transparency is an important precondition that HFI are accepted as financial indices and therefore the full rules should be openly available.

Q19: To qualify as financial indices, should HFIs be required to disclose at all times details of their constituents (e.g. 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.

See answer to Q18

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.

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

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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.

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