Association of the Luxembourg Fund Industry
Association Luxembourgeoise des Fonds d'Investissement

POSITION PAPER ON CESR's CONSULTATION PAPER

"Clarification of the definitions concerning eligible assets for investment by UCITS: can hedge fund indices be classified as financial indices for the purpose of UCITS?"

16 April 2007

Foreword :

The Association of the Luxembourg Fund Industry, the ALFI, welcomes the opportunity to comment on CESR's consultation paper on the classification of hedge funds indices as eligible assets under UCITS.

As already indicated in the position paper issued by the ALFI at the occasion of CESR issue paper on the same subject, the ALFI is favourable to consider hedge funds indices as eligible assets under UCITS. Indeed hedge funds indices can be regarded as constituting financial indices within the meaning of the UCITS Directive.

As a result, ALFI takes the view that hedge funds indices should to the extent possible be treated as other financial indices and should therefore not be more regulated than such other financial indices.

The ALFI also remarks that due to the lack of homogeneity in the market in relation to hedge funds indices and substantial differences from one hedge funds index to another or one index provider to another, it does not seem appropriate to excessively regulate all details in relation to hedge funds indices but rather refer, where possible, to general principles applicable to UCITS.

Answers to CESR's questions :

Question 1 : If you believe that there should be additional guidelines relating to diversification for HFIs, please explain what they should be and why the requirements for HFIs should be higher than those for traditional' indices in this respect ?

No, because hedge fund indices are financial indices as any other indices and neither Level 1 nor Level 2 regulation impose any obligation to treat hedge fund indices differently.

Question 2: Should the definition of what the index is trying to represent be available to the public as a whole, just to the UCITS, or to UCITS investors as well? Is there a need for a guideline to state that the information should be available free-of-charge to UCITS investors? Do you have any comments on how the information would be made available in practice (e.g. the index provider's website)?

Information in relation to the index should be made available by the index provider to the UCITS as it is the responsibility of the management of the UCITS to determine whether the HFI in which it contemplates to invest is in line with (i) the investment objective and policy of the UCITS, (ii) the risk profile of the UCITS, (iii) and the investment restrictions to be complied with by the UCITS.

Such information should be made publicly available by means for example of a publication on the index provider's website.

Question 3: Do you have any other comments on these proposed level 3 guidelines?

We have no particular comments.

Question 4: Respondents are invited to provide their comments on the above, taking into account that the UCITS always needs to properly value its portfolio and assess the risks therein.

Providing information on the estimated monetary value of the assets of the index components on an aggregate basis would be helpful. It does not seem necessary to have this information for each index component.

Question 5: Please provide your comments on these proposed level 3 guidelines.

The requirement for using pre-determined rules on the basis of objective criteria is not appropriate for the selection of index components. Indeed, strategies adopted by hedge funds cannot easily be classified on the basis of objective criteria which would not be subject to discussion. Hence, Level 3 guidelines proposed in Box 1 seems sufficient in this respect.

Box 3, point 1 proposes to make interesting information available to the market such as weighting and treatment of defunct components. Objective criteria for the selection of index components are however difficult unless they are limited to criteria such as, e.g., size and liquidity.

Blackfilling should not be permitted unless, obviously, based on an error in the valuation of one of the index components

Question 6: Respondents are invited to provide their comments on the above.

Any payment by hedge funds to index providers for the mere selection of the hedge fund as a component of the index could result in a selection bias and does not seem appropriate. Index providers are normally remunerated by the users of the relevant indices.

Questions 7 and 8 : Do index providers currently carry out the type of annual audit described, or would the eligibility of many current HFIs be negatively impacted by such a requirement? If so, please give an estimate of the cost of introducing such an audit procedure. Is the scope of disclosure of the audit (full opinion or summary, to the UCITS/UCITS investor/the public) appropriate? Please provide your comments on this proposed level 3 guideline.

Index providers are usually not submitted to external independent audit procedures.

The index provider should demonstrate that sound procedures are in place as required by Level 2 provisions, which do not expressly require an independent audit by either a third party or an internal audit committee. An independent audit could be one of the components of a sound procedure but only one of them and therefore should not be expressly required.

Question 9: Please provide your comments on these proposed level 3 guidelines.

For transparency purposes, the information provided in Box 5 should be made available to the UCITS.

Question 10: Please provide your comments on this proposed level 3 guideline.

UCITS have to be satisfied that the valuation process of their assets including positions in derivatives in financial indices including hedge fund indices is adequate. In this respect, UCITS necessarily have to understand the valuation mechanisms of underlying hedge fund indices. Box 6 suggests that UCITS expressly confirm that the index provider carries out due diligence on the net assets value calculation procedures. An express confirmation in this respect does not seem necessary since UCITS anyway have to understand and be comfortable with the valuation mechanisms of underlying financial indices in order to ensure that they can meet their obligation to valuate their assets correctly.

Questions 11 and 12 : Please provide comments as to the suitable minimum frequency of index publication. Do any hedge fund strategies require a different frequency of index publication? If so, which are they, why do they need a different frequency, and what should that frequency be?Does the frequency of publication of index values affect the UCITS ability to value its assets?

The UCITS requirement to value assets twice a month and to redeem shares or units at such minimum frequency has as a result that the UCITS should be able to unwind positions in derivatives on hedge fund indices, twice a month, in particular where the UCITS is fully invested in the relevant hedge funds indices. The key question therefore relates to the price at which positions can be unwound. It would however not seem adequate to impose any minimum frequency on index valuations.

However, UCITS will, as a result of their obligation concerning NAV calculations, have to ensure, before investing in derivatives on a hedge fund index that they can, given the characteristics of the index, adequately calculate their NAV and redeem their shares or units. This question obviously is also impacted by the overall exposure the UCITS will have in relation to the relevant index.

Question 13 : Should CESR carry out further work on this issue?

Disclosure requirements are guided by general principles of law and the relevant provisions the UCITS directive. Imposing specific requirements concerning disclosure on UCITS intending to invest in derivatives based on hedge fund indices does not seem appropriate.

Question 14 : Do the level 3 guidelines proposed in this paper adequately address the position of HFIs based on managed account platforms, or are additional guidelines necessary? If so, what are they and why?

It should as a general rule be irrelevant whether the alternative investment strategies are implemented in relation to the assets owned by a hedge fund or in relation to assets on managed accounts platforms. For technical reasons, index providers usually select hedge funds rather than managed account platforms. Transparency requirements and requirements in relation to investability should however be met with difficulties only in relation to managed accounts.

Question 15 : Do you have any other comments about, or suggestions for, level 3 guidelines?

We have no further comments.