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Response to 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?"

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April 2007

Summary Comments

To date, we have seen extensive background research from a variety of sources regarding the treatment of Alternative Investments in general, and Hedge Funds/Hedge Fund Indices (HFIs) in particular. In addition to this research and background work, CESR has published extensive guidelines concerning eligible assets for investments by UCITS (March 2007) that propose a series of level 3 guidelines designed to protect the integrity of the financial markets and the interests of investors. Finally, regional European supervisory authorities (such as BAFIN) provide another level of oversight and supervision for local registrants.

It is our opinion that, together, these various bodies represent sufficient oversight to ensure the sound functioning of the marketplace. Furthermore, the market itself must be considered as a sound judge of the qualities of its constituents; history has clearly shown that the market is, at times, the harshest critic of inefficient business practices. Add to this the asset class under discussion, Hedge Funds, and the additional scrutiny to which they are subject by the public, the media, and the securities regulators: the rules we make today must reflect investment reality and the future of the investment industry. What is viewed as "Alternative" today will be "traditional" tomorrow and the rules must allow for further innovation and increased market efficiency.

Our opinion reflects that of the majority of respondents: that HFIs are an important tool for the efficient development of the financial markets; that the CESR consultation process is a necessary part of this development; but that HFIs should be treated in an equitable manner and should not be subject to any rules or oversight over and above what is required for "traditional" financial indices.

We believe that HFIs should be constructed in such a manner so as to maximize transparency and efficiency for investors, end users (UCITS), and regulators. This means that there must be an effort to maximize transparency and ease of reporting so as to minimize both the level and frequency of potentially complex independent verification by end users of the HFIs. The goal of the HFI provider should be the creation of a relevant and representative tool that does not create inefficiencies for the end user. Furthermore, we believe that the market will reward those HFI providers that act in an efficient manner and will punish those that do not; investors & UCITS will "vote with their wallets" and undue oversight by regulators will only detract from the efficiency and attractiveness of the market segment.

Given the extensive discussion that has preceded the most recent Consultation Paper, our comments will be relatively brief and will focus on the areas that we feel are of greatest importance to the discussion. One of these areas is the use of the words "benchmark" and "index". While there are clearly instances when these words may be used interchangeably, there are times when they may not and when doing so can be misleading and confusing. We feel that the phrase/criterion "representing an adequate benchmark" may be, at times, inaccurate or unnecessary and that further thought should be given to the specific wording of the underlying premise.

Responses

Q1: 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?

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Q2: 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)?

The purpose of any given index should be easily definable and readily available both to current and potential investors. Clear and accurate communication and transparency will benefit not only the end investor but the index provider as well. Providing such information should be an integral part of the HFI provider's mandate.

Q3: Do you have any other comments on these proposed level 3 guidelines?

First and foremost, the level of independent verification required of a UCITS should be kept to a level that is reasonable and consistent with that required for investment in traditional indices.

The fact that a HFI is compliant with existing rules and guidelines (CESR or otherwise) should, to some extent, presuppose its usefulness as the basis for investment. Whether any given HFI also represents an "adequate benchmark" may or may not be at issue, depending on the goals of the specific fund. Take, for example, an index fund whose objective is to match the performance of the S&P 500 index. In this case, the index is the benchmark and any "assessment of the methodology of the index construction" by the manager, investor, or regulator, is of purely academic interest. In other cases, the index may represent a very small portion of the UCITS, and not be included in the fund's benchmark (if, indeed, it employs one).

Clearly, it will not always be the case that an underlying HFI will also fully represent the UCITS´ benchmark, and undue independent analysis and assessment should not be a requirement of the UCITS. As such, we oppose any mandated assessment, objective or otherwise, that may subject UCITS to unnecessary review activity on an ongoing basis.

Please see response to Question 5.

Q4: 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.

As a rule, when it comes to the construction and ongoing use of indices, more transparency is generally preferable to less. In the case of HFIs "representativeness", the ability to provide relevant and timely quantitative data will generally be viewed as a positive feature of a HFI and the provider that is able and willing to provide such information will be rewarded by the market. This may not, however, always be the case and there may be instances when it is neither possible nor desirable to provide this background data. In particular, as with any quantitative measure (ex. VaR), providing incomplete &/or inaccurate data, even when accompanied by suitable explanation of the data's shortcomings, can lead to misunderstanding, misuse, or undue reliance on the data by the end user (especially if they are unsophisticated investors). An investor, faced with requisite disclosures will tend to assume that these are full and complete; in cases where the data is neither, the UCITS should be left to decide what disclosure is necessary, relevant, or suitable given its individual circumstances.

Q5: Please provide your comments on these proposed level 3 guidelines

As previously discussed, whenever possible, requirements for independent assessment, independent analysis, and independent verification should be kept to a minimum. To this list we would add the pre-requisite for independent (subjective) verification of "objective criteria".

Confirmation of the existence of publicly available information regarding index construction, etc. seems entirely reasonable. On the other hand, the verification and accompanying due diligence necessary to ensure that the HFI provider's methodology does not allow backfilling (or any other forbidden practice) can easily become overwhelming.

These and other requirements recommended by CESR could be integrated into one concise HFI reporting guideline that could be satisfied on a monthly/quarterly/annual basis through reference to the HFI provider's web site or other central reporting system. This would allow the UCITS an efficient method for HFI oversight and regulatory reporting.

The regulation might require disclosure by the HFI provider of the following information on a regular basis (monthly, quarterly, etc. as required) which would satisfy several UCITS verification requirements at one time (from CESR/07-045):

- The definition and public explanation of what the index is trying to represent, including a narrative description (Box 1.)

- The methodology of selection of index components (Box 2.)

- The full methodology of the index, including weighting, the treatment of defunct components, and where applicable, the classification of components (Box 3.)

- Whether the HFI is investable or non-investable and the details of the index component for each calculation point (Box 5.)

This type of reporting is already accessible online, and includes reporting of such factors as index methodology and construction, investability, lists of index constituents, frequency of reporting, etc. Examples of such reporting can be found at the following websites :

- https://www.hedgefundresearch.com/index.php?fuse=indices-faq&1176296981
- http://www.hedgeindex.com/hedgeindex/en/invxmethodology.aspx?cy=USD
- http://www.mscibarra.com/products/indices/hf/methodology.jsp
- http://cisdm.som.umass.edu/indices/hedge/hedgefundweighted.asp

Q6: Respondents are invited to provide their comments on the above.

Fee sharing arrangements between hedge funds and HFI could be seen as detrimental to the integrity of the HFI and, by inference, the UCITS which invests in the HFI. If CESR feels that such arrangements could jeopardize the stability of UCITS or have an undue influence on the efficacy of HFIs as underlyings, it seems an easy enough task to prevent or restrict such payments.

Q7: 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?
Q8: Please provide your comments on this proposed level 3 guideline.

Again, this point raises the question of additional verification requirements for UCITS, as well as requirements for HFIs that are over and above those applicable to traditional indices. We are generally opposed to any and all regulation that would place any given asset class or group at a regulatory disadvantage.

Q9: Please provide your comments on these proposed level 3 guidelines.

Please see response to Question 5.

Q10: Please provide your comments on this proposed level 3 guideline.

Since we disagree with the premise of questions 7 & 8 (or, more specifically, with the suggestion that HFIs be subject to audits over and above requirements for traditional indices), we must question the ease with which the UCITS will be able to supervise the NAV calculation of the HFI provider.

Q11: 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?
Q12: Does the frequency of publication of index values affect the UCITS ability to value its assets?

UCITS investing in HFIs face a challenge to liquidity. Given an illiquid underlying security, the ability to provide liquidity (especially in the case of declining markets) will create operational risk for the UCITS. Ideally, a HFI would be able to offer daily liquidity with a NAV that offered a realistic representation of the value of the underlying assets. In reality, this may prove difficult in the short term. As such, CESR should recommend a minimum reporting frequency of one month, and recommend that more frequent reporting be provided when & where possible. In addition, CESR may wish to recommend additional disclosure for UCITS that invest in illiquid HFIs.

It is our opinion that increased competition and other developments (of which this process is a part) will lead to the increased efficiency of this portion of the market. This will, in time, lead to increased liquidity of the underlying assets and, eventually, daily reporting will be the norm for HFIs. As will quickly become apparent, HFIs that can report daily, thus allowing the UCITS to provide daily liquidity will be at a distinct advantage to their less liquid competition.

Q13: Should CESR carry out further work on this issue?

Notwithstanding our response to Questions 11 & 12, the extent to which a UCITS will be subject to disclosure requirements under existing guidelines, the various risks faced by financial institutions (including but not limited to reputational risk), as well as the market's current focus on derivatives, leads us to suggest that the market should, where possible, be given the responsibility for oversight. As previously discussed, transparency is a positive feature for HFIS that many investors & regulators will demand, especially concerning the use of derivative securities. Additional requirements regarding transparency may only lead to further levels of undecipherable "boilerplate".

Q14: Do the level 3 guidelines proposed in this paper adequately address the position of HFISs based on managed account platforms, or are additional guidelines necessary? If so, what are they and why?

Managed account platforms are a natural evolution of the traditional relationship between investor/fund and broker/prime broker. The accounts are not revolutionary and the guidelines already established for UCITS to invest in HFIs should be suitable given various administrative platforms. As such, no further requirements should be necessary.

Q15: Do you have any other comments about, or suggestions for, level 3 guidelines?

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This opinion was issued on April 12, 2007. For further information please contact:

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