

**EFAMA's REPLY TO CESR's ISSUES PAPER
CAN HEDGE FUND INDICES BE CLASSIFIED AS FINANCIAL INDICES
FOR THE PURPOSES OF UCITS?**

EFAMA¹ is grateful for the opportunity to reply to CESR's Issues Paper on the classification of Hedge Fund Indices (HFIs).

General Comments

As already stated in our prior comments to CESR's Consultations on eligible assets, we believe that HFIs should be classified as financial indices and therefore derivative instruments based on HFIs should be considered as eligible assets for UCITS.

The evaluation of HFIs should follow the same criteria as for indices with other underlying assets, as set out in the draft Commission Directive on Eligible Assets². In view of the differences among HFIs, no general a priori decision as to their classification should be made, but rather the characteristics of each index should be evaluated individually.

As long as the general criteria set by Level 2 implementing legislation are fulfilled and the high level of UCITS investor protection is thus guaranteed, investors should be able to benefit from products that allow additional diversification and keep up with financial product innovation.

Finally, EFAMA strongly believes that the assessment whether HFIs fulfil relevant criteria for eligibility should be left to the UCITS which, in case of doubt, can then refer to the competent authority. The requirement for third-party certification would represent a departure from current practice and is unwarranted.

Please see below our detailed answers to most of CESR's questions.

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

¹ EFAMA is the representative association for the European investment management industry. Through its member associations from 19 EU Member States, Liechtenstein, Norway, Switzerland and Turkey, as well as its 42 corporate members, EFAMA represents at mid-2006 about EUR 14 trillion in assets under management, of which EUR 7 trillion through about 46,000 investment funds. For more information, please visit www.efama.org.

² Draft Commission Directive implementing Council Directive 85/611/EEC 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.

Both database biases and index biases mentioned in the Issues Paper are well known and have been explored in academic studies, and we do not wish to repeat the argumentations here. Such biases are not, however, limited to HFIs but can affect in different measure also classic financial indices and indices representing style investment strategies. On the contrary, HFIs are often equally weighted, making them more representative as shown by academic studies. Some of the biases are further limited to non-investable HFIs.

Backfill bias requires special care: backfilling should be prohibited in order to avoid an upward bias to the overall database returns on a retroactive basis, and new funds should be added only going forward.

All HFI providers should have appropriate procedures for composition and rebalancing to deal with the biases in discussion, but rules for HFIS should not be different from those for the rest of the index industry.

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

No. See our reply to Q1.

Q 3: 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.

Most EFAMA members do not believe that HFIs should be subject to additional criteria other than Level 2 requirements. A flexible case-by-case evaluation of indices (traditional or HFIs) by the UCITS should be favoured, as rigid limitations would not improve the outcome and would likely prove unworkable in view of market innovation. In particular, no minimum number of constituents should be set, as this can only depend on the relevant market. One EFAMA member, however, believes that a minimum of 15 constituent funds would be helpful for broad HFIs (albeit not for narrower indices representing a specific sector or style, such as for example a Convertible Arbitrage HFI), in order to give access to a representative average return while reducing volatility.

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

EFAMA believes that HFIs should be subject to the same requirements on weighting as indices with other underlying instruments. Weighting methodology should be flexible, although HFIs tend to be equally weighted (with some corrections). What is important is the transparency of the methodology applied.

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.

Due to the dynamic nature of the Hedge Fund industry, it is impossible for any HFI to cover the entire universe of Hedge Funds. However, EFAMA believes HFIs can appropriately measure the performance of a “representative” group of underlyings and thus represent an adequate benchmark for the market to which they refer. It is crucial, however, that the index provider accurately determine the market represented and disclose it appropriately.

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

As we already stated in our answer to Q4, methodology should be flexible. A quantitative requirement does not per se improve the breadth of coverage, as the Dow Jones Index (30 constituents) shows, and therefore should not be mandatory.

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

The majority of EFAMA members believe that backfilling should be banned, as it results in a modified history, making the index an inconsistent/unstable benchmark.

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.

Yes, CESR should promote transparent guidelines on the treatment of defunct funds. Different treatment options are possible: defunct funds could be treated like a share that disappears from an equity index (at equal value), or it could be taken out of the HFI at a discount. Investable indices do not have 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.

Appropriate disclosure of the index revision methodology is sufficient on a self-regulatory basis. Classification standards recognized by the market should be acceptable just like the ones developed for equity indices.

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.

It is the duty of the UCITS to assess the revision methodology of HFIs, as it currently reviews it for other indices. With an appropriate level of methodology disclosure, the UCITS is in a position to carry out the assessment, and the involvement of an independent third party is unlikely to improve significantly the methodology. EFAMA does not believe that HFIs should be treated differently from other indices, and a third-party review would be an abnormality in index creation.

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.

Yes. Funds of hedge funds (FOHFs) follow a more active approach than HFIs in selecting their constituents, but also HFIs should be able to exercise a certain degree of judgment in the selection of constituents within the framework of publicly disclosed objective rules. Respect of Level 2 criteria is a major differentiating factor between HFIs and FOHFs. FOHFs are also likely to have less constituents. However, also equity indices (mostly style indices, but also “traditional ones” to a certain degree) also use methods for the active selection of constituents.

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, Publicly available rules and methodology are necessary.

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.

Hedge fund indices and Funds of Hedge Funds do not compete directly, as FOHFs actively manage their portfolios. However, they both provide access to the same asset class and easier access for investors to hedge fund index products via UCITS than to FOHFs could represent a competitive advantage.

At the same time, similar competing products are already available under different wrappers (i.e. structured notes, certificates, unit-linked products). This important aspect of the competition – as well as the lack of level playing field – should not be forgotten by CESR when it considers the regulatory context.

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?

Some EFAMA members believe that the investability of the underlying Hedge Funds is required to fulfil the criterion of replicability. Others, on the other hand, believe that the criterion is fulfilled if the calculation of the index can be verified.

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.

It is sufficient for the UCITS to assess the due diligence procedure of the index provider in respect to the underlyings.

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 majority of EFAMA members believes that a minimum monthly publication frequency is suitable.

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.

This decision should be left to the index provider. There is currently no such requirement for other indices, and we believe HFIs should not be subject to additional requirements. In any case, any errors in the calculation of fund NAVs would also impact the actual fund payouts for redemption purposes and therefore they would not influence the benchmarking character of the index.

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?

The majority of EFAMA members believes that full index rules should be publicly available, while other members believe that transparency should be the same as for other indices.

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.

While the majority of EFAMA members believes that HFIs should disclose at all times details of their constituents on their website, others believe that the rules should be the same as for other types of indices. Disclosure regarding constituents would help verify the correct strategy classification of the underlying hedge funds by index providers.

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.

While the majority of EFAMA members believes that the investment in derivatives based on HFIs should be disclosed in the prospectus, some members believe that the rules on disclosure should be the same as for other types of derivatives.

We hope that our comments will be of assistance and remain at your disposal for any clarification.