Response to CESR: Clarification regarding hedge fund indices and classification as financial indices for purposes of UCITS

On behalf of Greenwich Alternative Investments, thank you for hosting the recent hearing and giving all concerned the opportunity to provide a further response. The common message throughout the hearing was that the same standards be applied to hedge fund indices as are applied to traditional indices.

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?

If the hedge fund index follows the same diversification standard as required of other financial indices, there should be no further requirements specific to HFIs.

Box 1. In respect of a hedge fund index, the criterion of "representing an adequate benchmark" will not be met unless the UCITS:
1. verifies that the index provider clearly defines, and makes publicly available, an explanation of what the index is trying to represent. This definition should include a narrative description of what the index is
2. assesses whether the methodology of the index construction means the representativeness for the market to which it refers is likely to be achieved.

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)?

Again, drawing from common industry practice regarding traditional indices, the public should have access to a clearly stated description of what the index is trying to track. However, in light of competitive issues, there should be no requirement for disclosure of constituents. Such disclosure, in practice will be part of the due diligence responsibility of the UCITS and would not benefit the ultimate UCITS investor.

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

Again, the premise that HFIs be held to the same standard as are applied to traditional indices should be the guiding principle such that no level 3 guidelines are imposed that put HFIs at a disadvantage to traditional indices.

31. Regarding the quantitative assessment of the coverage of the HFI, respondents' views were mixed. Some thought that it was not necessary due to diversification requirements; others were of the opinion that quantitative measures may help determine the appropriate number of index constituents and the representativeness of the index, but that these measures should not be mandatory. In CESR's view, although it may be helpful for a statistical measure to reflect the "breadth" of coverage of the HFI, the difficulty of mandating an appropriate measure must be acknowledged. An ideal figure might be the percentage of the "total" defined market constituted by the HFIs underlyings; although in the context of hedge funds, calculating the total size of the whole market is problematic.

32. However, at each index calculation point the index provider could simply be required to also publish the total disclosed or estimated monetary value of the assets of (each of) the index

components. This figure would at least allow the UCITS to make a judgment about how representative an HFI was, compared to estimated figures for the total market assets for particular hedge fund strategies, for example.

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.

Traditional indices are not required to use asset weighting (ie market capitalization weighting) for index construction, therefore, neither should HFIs. It is well recognized that size is not guaranteed to be an indication of representability. The UCITS, as part of their due diligence, would be in position to judge the level of representability of the HFI and would most likely draw upon industry standard published broad benchmarks and databases as the guide for defining the hedge fund universe, various strategies, etc that the index in question is supposed to represent. This is a very important point specific to HFIs, as unlike an equity market of listed stocks, there is no central, comprehensive listing of all hedge funds. This contrasts to traditional indices such as equity indices that can more precisely define the market they are designed to track. Ultimately, the UCITS will judge representability of the HFI.

Box 2. In respect of a hedge fund index, the criterion of "representing an adequate benchmark" will not be met unless the UCITS verifies that the methodology of the index requires the selection of index components to be made using pre-determined rules, on the basis of objective criteria.

Box 3. In respect of a hedge fund index, the criterion of "publication in an appropriate manner" will not be met unless the UCITS: 1. confirms that the index provider makes publicly available the full methodology of the index, including weighting, the treatment of defunct components, and where applicable, the classification of components; 2. verifies that the methodology of the index does not allow retrospective changes to previously published index values ("backfilling").

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

Assuming the UCITS is responsible for making public availability of the full methodology rather than the underlying constituents, we are in agreement.

39. Stemming from some respondents' views and after reflecting upon the issue, CESR has concerns about the conflicts of interest that could arise if hedge funds are making payments ("fee-sharing") to HFI providers to be selected as index components. This could result in selection bias of the index components. An index constructed in such a way would not seem to represent an adequate benchmark for the market to which it refers, and so would be unacceptable from the point of view of eligible assets regulation.

40. There are different views as to whether there should be an explicit intervention from CESR in this respect. CESR could propose a level 3 guideline which had the practical effect of preventing UCITS from gaining exposure to HFIs which receive payments from hedge funds. In particular, this may depend on the circumstances in which payments are made by hedge funds to index providers including their level and structure).

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

The prevention of fee sharing seemed to be met with full support by those that attended the Paris hearing. Fee sharing, by its nature, would conflict with index methodology for both HFI and traditional indices.

Box 4. In respect of a hedge fund index, the criterion of "publication in an appropriate manner" will not be met unless the UCITS verifies that the index will be subject to an independent audit at least annually. The audit can be conducted by either a third party, or an internal unit within the index provider (e.g. an "audit committee") which is independent of the department in charge of managing the index. The summary audit opinion must be available to the UCITS on request. As a minimum, the audit should: a. consider whether the index's published methodology has been respected during the period in question (including, where applicable, for the treatment of defunct components and classification of components); b. validate that, for a sample of index calculation points, the index value was calculated consistently with the disclosed methodology.

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?

In our opinion, the UCITS should decide whether an audit is required. HFIs should be held to the same standard as traditional financial indices.

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

See above.

Box 5.
In respect of a hedge fund index, the criterion of "representing an adequate benchmark" will not be met unless the UCITS:
1. verifies that the index provider makes available to the UCITS details of whether each index component is investable or non-investable;
2. verifies that the index provider makes available to the UCITS details of the index components (including a list of components and their prices and weight in the index) for each index calculation point.
Q9: Please provide your comments on these proposed level 3 guidelines.

In our opinion, part 1 adds no value.

Box 6.
In respect of a hedge fund index, the criterion "publication in an appropriate manner" will not be met unless the UCITS confirms that the index provider carries out due diligence on the net asset value calculation procedures used by each index component. The audit referred to in Box 4 above should confirm the adequacy of this due diligence and that it is being appropriately carried out.

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

The UCITS due diligence on the HFI provider should be sufficient to ensure the index provider applies professional standards in their own due diligence of the index constituents, including analyzing the NAV calculation procedures.

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?

Standard industry practice for index publication is monthly or better.

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

No. Independent of the official publication of index values, it is common practice to provide estimated values on a more frequent basis. The frequency of official index publication does not therefore, affect the UCITS' ability to value its assets.

53. CESR was also concerned about the disclosure to the UCITS investor that should take place about investment in derivatives based on HFIs. In that regard, CESR asked market participants whether UCITS intending to invest in derivatives based on HFI had to disclose this fact in the prospectus and to what degree of information would have to be disclosed. Most respondents were in favor of disclosure, although views were mixed regarding the extent of that disclosure. Having considered this matter carefully, CESR considers setting out level 3 guidelines on this issue is outside the scope of the current question of whether HFIs can be considered to be financial indices. Nevertheless, CESR considers it important that there is appropriate disclosure not only to the UCITS allowing it to carry out its due diligence but also to the retail investor about their fund gaining exposure to HFIs, and may consider this issue further.

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

No. The current requirement for UCITS disclosure is sufficient.

Q14: 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?

Yes. However, the use of managed account platforms must not involve fee sharing between the index provider and the constituent funds.

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

No.

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