

Can Hedge Fund Indices be classified as Financial Indices for the purpose of UCITS?
Comments Submitted by Dechert LLP
In respect of CESR's Issues Paper of October 2006

Dechert LLP is an international law firm with a particular specialisation in the investment management sector. The following comments are made in general terms with reference to our experiences of the global investment management industry.

While this submission refers to the CESR Issues Paper of October 2006, our comments are of a relatively general nature, and we have not sought to respond to all the CESR questions individually.

1 The Desirability of allowing UCITS to invest in HFIs

Our most fundamental point is that there still appears to be some question as to whether hedge fund indices ("HFIs") should be permitted as eligible assets at all. UCITS III has dramatically extended the classes of eligible asset available for investment by UCITS funds. In particular, it allows UCITS funds to invest in derivatives with widely differing underlyings, levels of operational transparency, and risk exposure. In this context we can see no valid reason why derivatives in the form of hedge fund indices should alone be singled out for exclusion.

Hedge fund products represent an important and growing asset class, which is increasingly available to the retail market by means, usually less transparent, other than UCITS, or which lack the quality control element provided by interposing a UCITS manager in between the product provider and the investor. It is desirable that the UCITS regime should not exclude its investors from participation in the HFI aspect of this important market.

2 Setting the HFI Criteria

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

One issue which is expressed as a concern in paragraph 1.1 is the impossibility of capturing the entire hedge fund market. We agree that this is not possible, but question why this should be desired in the first place, since it would be equivalent to seeking to construct an equity index incorporating every security, listed and unlisted, currently in issue in the world economy.

In our understanding an index operates in respect of a defined "universe", whether that happens to be a particular exchange or other factor. It is the responsibility of the HFI operator to define what hedge fund universe it's HFI

is seeking to capture. The HFI may be based on themes such as a particular investment style, asset class, or investment sector. Provided the resulting HFI meets general principles of objectivity, representativeness and transparency, and does not operate as a covert fund of funds, it should not be necessary or desirable to try to second-guess or pre-prescribe its composition at the legislative level. The indexes which work best will attract the most volume.

3 Level of Regulatory Prescription

Questions 3-9 and passim

The Issues Paper raises a number of questions as to how HFIs should operate, potential problem areas, and the extent to which CESR should intervene to prescribe the basis on which HFIs should operate. These raise a series of technical issues on which we do not have specific views. Generally, however, we consider that HFIs, like other indices, have evolved in response to market forces rather than regulation, and that it is those market forces which are most appropriate to their future development. We therefore favour an approach based on the application of a set of general principles of the sort outlined in the level 2 diversification requirements, coupled with clear disclosure and ultimately, the placing of responsibility on the UCITS manager to decide if the HFI product is an appropriate one, and on the index operator to produce an index which product providers want to use and UCITS managers want to buy. For example, if the positive aspects of an index are materially over-stated due to back filling and defunct fund bias, it is unlikely that product providers will be prepared to use it as a basis for providing index products, because of the difficulty of obtaining an adequate hedge.

There may be some limited cases where the imposition of explicit prescription may be effective as a confirmation of what investors and the industry expect anyway. This may well be the case with the proposed prohibition of back-filling (question 7). On the other hand the treatment of defunct funds (question 8), while undoubtedly an issue, does not lend itself to the same simplistic treatment and additional criteria should not be specified unless there is wide industry agreement as to what those criteria should be.

It would be desirable for CESR to monitor the operation of HFIs once they are actually being used by UCITS funds, to see how relevant its current theories actually prove to be in practice, and whether any new considerations have emerged.

4 Integrity of fund information/fund governance

Q15. Should CESR set requirements for verification of NAV calculation and independent custody arrangements/robust governance structure

While we do not think it is desirable or practical for CESR to be prescriptive in the area of fund governance, the integrity of underlying hedge fund components of HFIs is in practice a major issue for hedge fund investors.

We would expect similar principles to be born in mind at the HFI level, though it would be up to the Index operator to what extent it incorporated them into its HFI criteria. Key tests for the integrity of the NAV calculation and fund governance generally include:

- The appointment of an independent professional administrator;
- The appointment of an independent professional auditor;
- Board independence;
- The appointment of an independent custodian or prime broker where relevant;
- The listing of the fund on a regulated market such as the Irish, Luxembourg or Malta Stock Exchange.

Of these the single most important factor is probably the appointment of an independent professional administrator to calculate NAV. For example, though it is always difficult to generalise, in our experience professional administrators such as Bisys and CITCO do not suddenly stop calculating and reporting the NAV just because the fund is being wound up.

The appointment of a custodian or prime broker is desirable for securities-based hedge funds, but will not generally be possible for derivatives portfolios, and encouraging the appointment of a custodian for purely cosmetic purposes should be avoided. Board independence, while of increasing importance, is also very subjective, and it may be noted that many funds, including UCITS funds, would not generally be able to meet this requirement.

It would thus be possible to base an index on one or more of these governance factors, which meet the general requirements for publicly disclosed, objectively determined passive criteria. An HFI index based on all the hedge funds listed on a particular regulated market or series of regulated markets, for example, would seem a very natural development.

5 Other comments

Q16 Should a minimum monthly publication frequency be a requirement for HFIs to qualify as financial indices? If not why not?

Monthly liquidity is the norm for most hedge funds. But for certain less liquid assets classes, such as real estate, a longer valuation period – three monthly or even six monthly - is more appropriate. This in itself should not be a ground for excluding the relevant asset class. There may be situations where the inclusion of funds with similar investment objectives but different valuation periods could have a distortive effect, but this is a question for the index operator to determine on the facts of its particular situation.

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?.

The level of disclosure should be the same as for other derivatives products.

On general international standards we would consider it good practice for a manager who expected HFIs to be a significant part of its investment strategy to make disclosure of this. However it would be difficult to reduce this to a regulatory obligation other than in the form of a formally prescribed statement, and there seems little reason for singling HFIs out for this sort of treatment when no equivalent requirements exist for other derivative products. We also note that the approach taken by the UICITS regime to disclosure, as for example in the concept of the simplified prospectus, is relatively minimalist and that detailed disclosure in respect of one particular type of eligible asset would be inconsistent with this.

Dechert LLP
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