

CESR's Issues Paper – “Can hedge fund indices be classified as financial indices for the purpose of UCITS?”

The Alternative Investment Association Austria (VAI) is representing national and international alternative investment houses totalling more than €75bn Assets under Management with more than €5bn exposure to the Austrian Alternative Investment market. Members of the association are institutions under the authority of FMA or their national financial market authority.

The goal of the Alternative Investment Association Austria (VAI) is to enable members to offer products that comply with the Directive which is applied in a flexible manner so as product innovation is not inhibited and at the same time all investments are consistent with the investor protection principles.

Austria has a vibrant alternative investment community with history going back to 1989/90 and investors are well educated about the merits of absolute return products independent of benchmarks. Therefore we welcome the opportunity to respond to the efforts of CESR and the commission to establish a unified regime for the operation and promotion of regulated open ended collective investment undertakings throughout the European Union.

We agree to the utmost importance to ensure that UCITS do follow strict guidelines on investment diversification, fund liquidity and disclosure to ensure that retail investors in UCITS are adequately protected. At the same time we also must point out that discrimination of certain investment instruments and techniques is not a good way to ensure this goal.

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

We hope and in fact are sure that CESR is aware of the fact that all indices including traditional indices – as prominent as the Dow Jones Industrial, the DAX 30, etc. - are affected to at least some degree by one or more of the listed biases. We fully agree that “backward adjustments” – i.e. changing the history of an index – are a potential concern and that a case can be made for precluding such adjustments. Apart from the outright alteration of an indexes history, however, the listed biases may best be treated by a call for transparency in the calculation method and purpose of the particular index (i.e. which part of the market is represented by the index in question). Explicit legal restrictions e.g. on technicalities of index construction (e.g. index weighting schemes) tend to give excessive

preference to particular, narrowly defined – but often well contested – viewpoints restricting investor choice and hence giving rise to deadweight costs.

We, thus, strongly feel that the purpose of investor protection is best served by transparency of method – allowing for informed investor choice and competition as watchdog against excesses.

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

No.

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.

We feel that the diversification requirements as outlined in the UCITS directives already imply a minimum number of index constituents and, hence, no further explicit minimum requirement is necessary. Limiting the index construction to a certain pre-specified weighting scheme – certainly in opposition to current practice in equity index construction – would only serve to limit investor choice as outlined above and hence seems excessive.

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

Reiterating our stance that unduly restrictive regulation merely serves to reduce investor choice and create economic deadweight losses we do not feel that any additional restrictions on weighting schemes are warranted. Furthermore, allowing for flexibility in the construction of indices allows for incorporation of expertise of the index provider as well as the results of up to date (academic) research as to how to best represent market (-segment).

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.

We agree that the definition of what is to be represented by an index has to be provided to investors by way of transparency of index construction method. Further requirements are not necessary as is illustrated very well by existing equity indices.

As an example we wish to point out that the Dow Jones Industrial Average Index with only its 30 constituents is a representative for the US Stock market as a whole.

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

‘Breadth’ being interpreted as a minimum number of index constituents: please see answer to Q3
‘Breadth’ being interpreted as the universe which it is said to represent: to avoid abuse it is obviously necessary to rule out index-universes consisting of very narrowly defined However, since the

diversification requirements implicitly already take care of a broader definition of the underlying universe already – e.g. by ruling out the admissibility single fund universes represented by an index - we feel that it is unnecessary to introduce an additional quantitative measure for ‘breadth’ on top of the implicit requirements of the diversification requirement.

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

We agree that the practice of backfilling is not serving a positive purpose and in fact is diametrically opposed to the criterion of investibility and hence may be restricted.

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.

Since admissible hedge fund indices need to – at least in principle – be investible treatment of “defunct funds” is implicitly given by current regulation. Therefore, no further guidance is required.

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.

The index framework establishes the grounds for the constituent classification. E.g. a simple correlation study is able to identify classification issues.

More generally, it seems prudent to require that the index provider validates the adequacy of the index on a regular basis – e.g. quarterly to annualy – to ensure the representativity and existence of an underlying market.

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.

Since UCITS fund managers are competent investment mangers and do have comparable experience in assessing traditional index methodologies we agree that the UCITS fund manager is fully capable of assessing the hedge fund index methodology.

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.

We agree that rule based management of the index components should serve as the primary distinction between Hedge Fund indices and Fund of Hedge Funds.

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.

We agree that constituent selection should be rule based with public transparency serving as watchdog against abuse alleviating the need for explicit legal regulation.

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.

We strongly feel that aspects of competition between only superficially related assets does serve no purpose in assessing the eligibility of hedge fund indices.

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?

Due to intellectual property rights replicability with the actual securities and weights to bypass any licensing agreement is critical. Therefore replicability as described in your question shall be sufficient.

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.

We strongly feel that UCITS fund managers are capable of assessing the procedures followed by an index provider. Even more so, as the selection of an index is no different than selecting a suitable more traditional security (e.g. shares) for investment purposes. From an economic point of view then the combined due diligence fund managers perform on any given index eligible for inclusion in their portfolios certainly gives rise to superior supervision without introducing deadweight cost.

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?

Minimum monthly is fine.

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.

Again, from the viewpoint of maximum investor choice it is to be preferred that “the market” – defined as the aggregate of investors choice - is left to decide.

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?

Again, from the viewpoint of maximum investor choice it is to be preferred that “the market” – defined as the aggregate of investors choice - is left to decide. As UCITS fund managers are required to fully understand their investments anyway no further requirements are necessary.

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.

Generally, we feel it is sufficient for an index provider to define its underlying universe as well as the index construction methodology. Disclosing constituents might run counter to trademark and intellectual property rights. Furthermore, transparency on position level is not even required from more “traditional” indices (conf. Lehman Brothers Bond Index Family) and hence, by way of equal treatment, should not be demanded from hedge fund indices.

Alternatively, disclosure can be handled as with traditional indices, i.e through the - subscription based - website of the provider.

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.

We assume that a UCITS investing in derivatives will describe the investment policy in the prospectus. Therefore the investor is thoroughly informed.

Q21: Do you have any other comments relating to hedge fund indices that CESR should consider? What are they?

CESR is trying to protect the retail investor. But as a matter of fact the retail investor is perfectly protected since there is no derivative counterparty who will sell a derivative on a financial index without being hedged. So, by induction, if hedging by the counterparty can be done, then it must by definition be a replicable instrument with fair pricing. CESR is not able to protect the retail investor from performance risk and as a fact of life hedge funds did protect wealth in the aftermath of the burst of the New Economy bubble whereas traditional funds did not.

Q22: From the regulatory and retail investors' point of views, how do you assess the situation of competition between funds investing in derivatives based on HFIs and funds of hedge funds? Please explain precisely the grounds underlying your comments.

We strongly feel that aspects of competition between only superficially related assets does serve no purpose in assessing the eligibility of hedge fund indices.

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