THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CESR's Issues Paper

Can hedge fund indices be classified as financial indices for the purpose of UCITS?

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INTRODUCTION

Background

1. When CESR published its final advice to the European Commission on clarification of the definition concerning eligible assets for investments by UCITS[1], one matter was left outstanding. This short paper seeks views from market participants on issues related to that matter – whether hedge fund indices (HFIs) can fall within the definition of "financial indices" contained in the UCITS Directive.

2. The answer to this question will determine whether derivatives whose underlying is an HFI will be an eligible investment for UCITS, and also the extent to which such investments would have to comply with some of the investment limits set out in the Directive.

3. During the two rounds of public consultation on its eligible assets advice, CESR received many comments arguing that HFIs should be considered by CESR as an eligible underlying for derivatives. However CESR concluded that it wished to monitor the issue further, because the impact of such derivatives raised questions about the risk profile of the UCITS and the risk that retail investors might not be able to assess the impact. This paper meets CESR's commitment to re-consider its position by October 2006[2].

4. In drawing up this paper CESR has benefited from submissions provided by:

- an industry body (the Alternative Investment Management Association) and a number of hedge fund index providers (CSFB/Tremont Index LLC and MSCI Barra);
- contributions from some members of the CESR Investment Management Expert Group's Consultative Working Group;
- Francois-Serge Lhabitant, professor of finance at the HEC University of Lausanne, including a paper entitled "Hedge fund indices for retail investors: UCITS eligible or not eligible?"[3].

Purpose

5. This CESR paper is only an "issues" paper aimed at gathering relevant and precise views from all interested parties. It will not seek to put forward views, even on a preliminary basis, of CESR. Instead this paper is to set out issues for discussion in an open and non-directive manner. It will help CESR by bringing together a broad range of views since at this stage CESR's possible preliminary positions could only have been based on very few contributions. Accordingly, by publishing this paper, CESR wants to take the opportunity for additional inputs to its debate and to have a chance to consider reactions from all market participants before exposing a position.

Consultation Period

[1] CESR/06-005 (January 2006), available at www.cesr.eu.
[2] See paragraph 2 of Box 14 (page 56) of CESR/06-005.
[3] This paper is available at http://www.cob.fr/documents/general/7369_1.pdf

6. Readers are asked to consider the questions[1] set out in this issues paper and send their responses via CESR's website (www.cesr.eu) under the section "Consultations". The consultation closes on **30 November 2006.**

7. Respondents are also welcome to make any relevant points which they do not think are covered directly by the questions.

Next steps

8. The European Commission is currently preparing a legislative text based on CESR's final advice on eligible assets[2]. That text, which is a "level 2" implementing measure, will be supplemented by "level 3" measures adopted by CESR[3]. If any measures are thought to be necessary on HFIs, following this consultation, they will also be adopted at level 3.

9. Depending on CESR's consideration of responses to this paper, CESR will publish in February 2007 a short consultation paper presenting CESR's view in relation to hedge fund indices. The consultation will take account of responses to this paper, the concerns of some CESR members, and will include any draft level 3 measures for comment.

[1] See annex A for a consolidated list of questions.
[2] Working document ESC/43/2006, available at http://ec.europa.eu/internal_market/securities/ucits/index_en.htm.
[3] "Level 3" measures concern strengthened co-operation between (national) regulators to ensure consistent and equivalent transposition of level 1 and level 2 legislation.

DEFINITIONS

10. References in this paper to the "Directive" mean, unless the context requires otherwise, Directive 85/611/EEC of the Council of 20 December 1985 on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as subsequently amended.

11. References in this paper to terms defined in the Directive shall have the meaning given to them in the Directive unless the context requires otherwise.

12. In this paper, the general term "UCITS" refers:

- to the investment company, if the UCITS is self-managed; and
- to the management company, if the UCITS is not self-managed, or if the UCITS is set up in a contractual form or unit trust form.

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HEDGE FUND INDICES (HFIs)

Background

13. CESR's final advice on eligible assets set out in detail its views on the criteria that should be met by a financial index for derivatives on such an index to be an eligible investment. Readers of this paper may find it helpful to study that section of the final advice before proceeding further[1].

14. This section of the issues paper sets out the current legislative background and discusses some of the biases commonly thought to arise with HFIs. The next section goes on to discuss the assessment of HFIs as financial indices.

15. All interested parties are invited to respond to this paper in line with the arrangements set out in paragraphs 6 and 7.

Legislative background

16. Article 19(1)(g) of the Directive provides that financial derivative instruments are eligible investments for UCITS, provided that their underlying, among other things, is a financial index.

17. Article 21(3) of the Directive states that Member States may allow that, "when a UCITS invests in index-based financial derivative instruments, these investments do not have to be combined to the limits laid down in Article 22."

18. In its final advice to the European Commission, CESR laid down criteria that an index would have to meet to be considered a "financial index" in the context of Article 19(1)(g), based on the conditions set out for indices in Article 22(a)(1).

19. The text of the European Commission's current level 2 implementing measure, which would implement CESR's final advice in this area, is set out below:

> The reference in point (g) of Article 19(1) of Directive 85/611/EEC to financial indices shall be understood as a reference to indices which fulfil the following criteria:
>
> (a) they are sufficiently diversified, in that the following criteria are fulfilled:
>
> (i) the index is composed in such a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index;
>
> (ii) where the index is composed of assets referred to in Article 19(1) of Directive 85/611/EEC, its composition is at least diversified in accordance with Article 22a(1)of that Directive;
>
> (iii) where the index is composed of assets other than those referred to in Article 19(1) of Directive 85/611/EEC, it is diversified in a way which is equivalent to that provided for Article 22a(1) of that Directive;
>
> (b) they represent an adequate benchmark for the market to which they refer, in that the following criteria are fulfilled:

[1] See paragraphs 154 – 171 and Box 14 of CESR/06-005.

(i) the index measures the performance of a representative group of underlyings in a relevant and appropriate way;

(ii) the index is revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available;

(iii) the underlyings are sufficiently liquid which allows users to replicate the index;

(c) they are published in an appropriate manner, in that the following criteria are fulfilled:

(i) their publication process relies on sound procedures to collect prices and to calculate and to subsequently publish the index value, including pricing-procedures for components where a market price is not available;

(ii) material information on matters such as index calculation and rebalancing methodologies, index changes or information relating to any operational difficulties in providing timely or accurate information is provided on a wide and timely basis.

20. Subject to changes in the final wording of this text, these criteria would therefore have to be met by any HFI, for derivatives with the HFI as an underlying to be an eligible investment for a UCITS.

1 *Potential biases with hedge fund indices*

21. This section of the issues paper briefly describes some of the material biases thought to affect hedge fund indices. CESR notes that several of these issues can also affect "traditional" indices. Further background and detailed information on HFI providers and their indices can notably be found in Professor Lhabitant's paper.

1.1 *Overview of database biases*

22. The purpose of an index is to concentrate and distil the information from the underlying constituents. This suggests that, to construct an index, information must be available on all possible relevant constituents to allow a proper selection for the particular index to take place.

23. For an HFI this information may be taken by index providers from a commercial or proprietary database. However, because hedge funds are in the main "private" vehicles which are not required to report publicly, any database will only contain a partial selection of funds. This is also the case because there is no universally accepted definition of what a "hedge fund" actually is. Academic research seems to indicate that the net effect of this bias on performance is difficult to measure.

24. These facts can result in *self-reporting bias*. Only hedge funds that choose to report data will be included in a database. This could mean that poorly-performing funds, and/or hedge funds that are closed to new investment, neither of which have an incentive to report their data, will simply choose not to – so an index drawn from the database may not be properly representative.

25. There may also be *database selection bias*, if the database itself has minimum inclusion criteria (even for funds that choose to report) – e.g. a minimum asset base, length of fund track record or specific strategies.

26. Databases may also suffer from *survivorship* and *backfill bias*. *Survivorship bias* refers to the situation where, at any particular point in time, the analysis of a database may only

include the funds that are still in existence at that point, and not those who have failed or ceased to report in the meantime. *Backfill bias* refers to the instant addition by a fund manager of historical data on a fund that has newly chosen to report to a database.

1.2 Overview of index biases

27. Each particular HFI will have its own construction rules decided by the index provider. This methodology will determine on an ongoing basis how constituent hedge funds are selected and how the index is calculated. Some biases that can affect HFIs are described below:

28. *Sample bias.* An HFI provider will need to determine how to select constituent funds so that its index is representative of the particular market it seeks to represent – e.g. the "breadth" of coverage. This might include the selection of only investable underlyings, for example. If this is done through a managed account structure, this will limit the available underlyings that can be selected. More generally, depending on the amount and type of due diligence that the HFI provider chooses to carry out on potential underlyings, there is a possibility that constituent selection comes to resemble an active – rather than passively rules-based selection of underlying funds. This may explain why index providers use significantly different samples to build their index.

29. *Defunct fund bias.* This bias raises the issue of the way that the HFI provider decides to treat a hedge fund which becomes bankrupt or stops reporting data for some reason. The HFI provider's decision will affect the calculation of the index, especially if the HFI provider decides to remove defunct funds going backward.

30. *Classification bias.* An HFI may claim to track the performance of a particular hedge fund strategy, which means the index provider will have to develop a methodology to classify potential underlyings both initially and on an ongoing basis (in case of "style drift"). This could involve a passive acceptance of self-classification by the manager of the underlying fund, or a degree of due diligence by the index provider which may be questionable in terms of passive selection of underlyings.

31. *Index weighting.* Many different forms of index weighting can be chosen (equal weights, weights by the assets under management of the underlyings, with or without capping, etc.)

32. Of course, the construction rules of the index generally will be vital to whether it can be considered to qualify as a "financial index", and so the next section of this paper seeks respondents' views on this assessment, given the detail set out above.

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.

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

2 Can hedge fund indices qualify as "financial indices"?

33. Taking into account the legislative background and potential biases affecting HFIs set out in the last section, this section of the paper seeks views from market participants about the ability of HFIs to be considered financial indices.

34. The relevant issues are discussed below, based around each of the level 2 requirements that would apply to such an assessment.

2.1 Sufficient diversification

The reference in point (g) of Article 19(1) of Directive 85/611/EEC to financial indices shall be understood as a reference to indices which fulfil the following criteria:

(a) they are sufficiently diversified, in that the following criteria are fulfilled:

(i) the index is composed in such a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index;

(ii) where the index is composed of assets referred to in Article 19(1) of Directive 85/611/EEC, its composition is at least diversified in accordance with Article 22a(1)of that Directive;

(iii) where the index is composed of assets other than those referred to in Article 19(1) of Directive 85/611/EEC, it is diversified in a way which is equivalent to that provided for Article 22a(1) of that Directive;

35. CESR could consider setting level 3 requirements under the "sufficient diversification" requirement, which could help to address sample bias and index weighting issues, for example:

- a minimum number of index constituents for an HFI; or
- a particular weighting scheme that should be used by the index.

<u>Questions:</u>

Q3: 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.

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

2.2 Represent an adequate benchmark

The reference in point (g) of Article 19(1) of Directive 85/611/EEC to financial indices shall be understood as a reference to indices which fulfil the following criteria:

…

(b) they represent an adequate benchmark for the market to which they refer, in that the following criteria are fulfilled:

(i) the index measures the performance of a representative group of underlyings in a relevant and appropriate way;

(ii) the index is revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers following criteria which are publicly available;

(iii) the underlyings are sufficiently liquid which allows users to replicate the index;

36. The first criterion of this requirement is that the index measures the performance of a "representative" group of underlyings in a relevant and appropriate way. This seems key to the issue of sample bias. Whether something is representative depends on the definition of

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what is trying to be measured by the index. While no HFI is actually able to be representative of the whole universe of hedge funds, this condition suggests that the index provider must precisely and comprehensively define and disclose what the HFI is attempting to measure (perhaps by providing information on the breadth of its sample). Accordingly, the UCITS can assess whether this criterion is met.

Questions:

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

37. A number of issues arise from the second criterion: that the index is "revised or rebalanced periodically to ensure that it continues to reflect the market to which it refers following criteria which are publicly available":

- *backfilling and defunct funds.* These treatments can both affect the index calculation going backward. Backfilling occurs when historical data from a new index constituent is allowed to change previously published index values, whereas the treatment of defunct funds will also affect the index calculation going forwards;

- *sample bias.* In order to address the issue raised by this bias, each change in composition of the HFI could be announced, explained and documented by the HFI provider;

- *classification bias.* In view of the problems of classification bias, requirements could be placed on the index provider's methodology in this regard;

- *funds of hedge funds.* It has been suggested that some HFIs are funds of hedge funds in another guise. One way to distinguish between the two would be based on active/passive selection of the constituents; that is, whether selection of constituents depends on some degree of judgment or solely on publicly disclosed objective rules.

Questions:

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

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.

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.

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.

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.

38. The final criterion of the requirement refers to underlyings being sufficiently liquid to allow users to replicate the index. In the context of HFIs it may not be possible to invest in all the underlying index components because some of the hedge funds in question may be closed to new investment; rather "replication" could mean that if supplied with price data for the underlying constituents, users of the index should be able to replicate and so verify the calculation of the index value using the publicly available rules of the HFI.

Questions:

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?

2.3 Published in an appropriate manner

The reference in point (g) of Article 19(1) of Directive 85/611/EEC to financial indices shall be understood as a reference to indices which fulfil the following criteria:

…

(c) they are published in an appropriate manner, in that the following criteria are fulfilled:

(i) their publication process relies on sound procedures to collect prices and to calculate and to subsequently publish the index value, including pricing-procedures for components where a market price is not available;

(ii) material information on matters such as index calculation and rebalancing methodologies, index changes or information relating to any operational difficulties in providing timely or accurate information is provided on a wide and timely basis.

39. In respect of the first criterion of the appropriate publication requirement, that there should be "sound procedures to collect prices and to calculate and to subsequently publish the index value", concern has been expressed about the adequacy of the index provider relying on reported net asset values (NAVs) from the underlying hedge funds, and the adequacy of their custody arrangements. These issues could be addressed either at the level of the UCITS or at the level of the index provider.

40. Calculation of the index will depend on when NAVs become available for the underlying funds. Frequently hedge funds may only publish formal values once a month, with estimates between formal valuations.

41. Finally, an independent audit of the calculation of the value of the HFI could be considered as an option, particularly given the discussion in paragraph 39 above.

Questions:

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.

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?

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.

42. The second criterion of this requirement refers to material information on the methodology of the HFI being provided on a wide and timely basis. This could be addressed by demanding both transparency of index construction and of index constituents.

Questions:

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?

Q19: To qualify as financial indices, should HFIs be required to disclose at all times details of their constituents (e.g. 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.

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.

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

43. As mentioned in paragraph 37, funds investing in derivatives based on HFI and funds of hedge funds could be considered as alternative financial products from retail investors'

point of view - but their characteristics can entail different consequences from a regulatory point of view.

Questions:

> *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.*

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ANNEXES TO THE ISSUES PAPER

ANNEX A

Consolidated list of 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.*

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

Q3: *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.*

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

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.*

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

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

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.*

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.*

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.*

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.*

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.*

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.*

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?*

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.*

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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.*

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

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.*

ANNEX B

Indicative CESR work plan on the Issues Paper “Can hedge fund indices be classified as financial indices for the purpose of UCITS?”