THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-045

CESR Consultation Paper

Clarification of the definitions concerning eligible assets for investment by UCITS: can hedge fund indices be classified as financial indices for the purpose of UCITS?

February 2007

11-13 avenue de Friedland - 75008 PARIS - FRANCE - Tel.: 33.(0).1.58.36.43.21 - Fax: 33.(0).1.58.36.43.30
Web site: www.cesr.eu

INDEX

INTRODUCTION

Background

1. In order to finalise its work on eligible assets for investments by UCITS, CESR published an issues paper[1] seeking the views of market participants on questions concerning the ability of hedge fund indices ("HFIs") to fall within the definition of "financial indices" contained in the UCITS Directive.

2. The issues paper was written in a non-directive way, with the aim of allowing CESR to obtain, and then consider, detailed comments from a wide range of interested parties. This would allow CESR to come to an informed view on the position of HFIs.

Purpose of this paper

3. The purpose of this consultation paper is to describe CESR's conclusions on HFIs, and to propose draft measures.

4. The measures proposed will be adopted by CESR at "level 3". At level 1, the UCITS Directive governs the overall framework for the operation of EU-harmonised collective investment undertakings. A level 2 implementing Directive on eligible assets [2] clarifies certain definitions in the UCITS Directive that are related to eligible assets, including financial indices. Level 3 measures concern strengthened co-operation between (national) regulators to ensure consistent and equivalent application of level 1 and level 2 legislation.

Consultation

5. Readers are asked to consider the questions in this consultation paper and send their response via CESR's website (www.cesr.eu) under the section "Consultations". The consultation closes on **16 April 2007**.

6. CESR will hold an open hearing at its offices in Paris on **2nd April 2007**, for interested parties to attend and give their views. Further information and registration details will be made available on CESR's website shortly.

Next steps

7. CESR will publish a feedback statement and final level 3 text, in the second quarter of this year.

[1] CESR/06-530 (October 2006), available at www.cesr.eu.
[2] The level 2 implementing Directive is expected to be published in March 2007.

DEFINITIONS

8. References in this paper to the "UCITS Directive" mean 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.

9. References in this paper to the "implementing Directive" mean the level 2 Directive clarifying certain definitions concerning eligible assets.

10. References in this paper to terms defined in the UCITS Directive shall have the meaning given to them in that Directive, or in the implementing Directive as applicable, unless the context requires otherwise.

11. 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 or unit trust form.

FINANCIAL INDICES - LEGISLATIVE BACKGROUND

12. CESR's issues paper sets out the background to the UCITS eligible assets work, which readers may find helpful in understanding the context of this consultation. Since the issues paper was published, the text of the implementing Directive has been finalised.

13. *Level 1.* Article 19(1)(g) of the UCITS Directive provides that financial derivative instruments are eligible investments for UCITS, provided that their underlying - among other things – is a financial index. Article 21(3) provides 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."

14. *Level 2.* Article 9 of the implementing Directive sets out criteria that must be met by indices for them to be considered financial indices for the purposes of the UCITS Directive. The text of the implementing Directive, which will be published shortly, has changed slightly from the version quoted in the issues paper:

"*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 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 in Article 22a of that Directive;

(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, if necessary;

(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*".

15. *Level 3.* As part of its general eligible assets work, CESR has agreed on some level 3 guidelines relevant to financial indices, concerning the diversification requirements referred to in paragraphs (a)(ii) and (a)(iii)[3]. As with the level 2 measures, these criteria apply to all indices eligible to be considered financial indices, not just HFIs:

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
a)(ii)	If the composition of the index is not at least as diversified under the ratios of Article 22a of Directive 85/611/EEC, its underlying assets have to be combined with the other assets of the UCITS according to Article 21(3) and Article 22 of Directive 85/611/EEC in order to avoid undue concentration.
a)(iii)	Where derivatives on an index composed of non-eligible assets are used to track or gain high-exposure to the index, in order to avoid undue concentration the index should be at least as diversified as set out under the diversification ratios according to Article 22a of Directive 85/611/EEC. If derivatives on the index are used for risk-diversification purposes, provided that the exposure of the UCITS to the individual indices complies with the 5/10/40% ratios, there is no need to look at the underlying components of the individual indices to ensure that they are sufficiently diversified.

[3] CESR/07-044 (which will be published at the same time as the implementing Directive, expected to be March 2007).

PROPOSED LEVEL 3 MEASURES

General

16. In the issues paper, CESR asked questions in order to i) gather further information about HFIs and ii) to seek views on proposed conditions that could apply to HFIs for them to be considered as financial indices.

17. Twenty-two responses were received to the issues paper, from organisations including national asset management and banking associations, alternative investment trade bodies, and index providers. We are grateful to those who took the time to respond. The non-confidential responses (21) can be viewed on CESR's website.

18. This section of the consultation paper sets out CESR's preliminary conclusions and proposals for level 3 guidelines regarding HFIs. It does not include a detailed summary of responses to the issues paper[4].

19. Many respondents argued that CESR should not seek to impose any additional guidelines for HFIs over and above the level 2 criteria that apply to all financial indices. CESR however considers that at present HFIs are at an early stage of development and there is concern - even amongst market participants - about whether exposure to them is suitable for retail investment through a UCITS portfolio. Indeed, the report of the European Commission Expert Group[5] recommended that "… *the Group recognises the validity of concerns regarding the reliability and functioning of hedge fund indices. It recommends that UCITS investment in derivatives based on such indices be deferred until concerns regarding the structure and performance of hedge fund indices are resolved.*"

20. CESR believes that its proposed level 3 guidelines will help to address these issues, and so allow derivatives based on some HFIs to be purchased by UCITS at the current time with an adequate level of investor protection. Index methodology and standards will develop over time, and CESR will monitor the evolution of the market to consider which measures might be necessary to cope with market developments.

21. Taking this into account, CESR requests that respondents to this paper engage directly with the consultation questions and do not only assert that no additional level 3 guidelines should be applied to HFIs.

22. Reflecting the application of the UCITS Directive, the criteria themselves apply to the UCITS and not directly to index providers. CESR believes that it is important that the senior management of the UCITS take responsibility for ensuring compliance with the guidelines. In devising the guidelines, CESR has been aware of the need for a proportionate regulatory response. Exposure to HFIs may form either a small or significant part of the total investment portfolio of any particular UCITS, inviting CESR to take a balanced and cautious position.

[4] A separate feedback statement will be published covering in detail the responses to both the issues paper and consultation paper together.
[5] Recommendation 3 of the "Report of the Alternative Investment Expert Group – managing, servicing and marketing hedge funds in Europe" (July 2006), available at http://ec.europa.eu/internal_market/securities/docs/ucits/reports/hedgefunds_en.pdf.

23. CESR's Investment Management Expert Group's Consultative Group[6] were given the opportunity to comment on a draft of this consultation paper. Among the points made were:

- whether there was demand for investment in HFIs as opposed to making funds of hedge funds more widely available. On this issue, CESR notes that its mandate in this case is to consider the issue of clarifying definitions related to eligible assets only, such as the meaning of "financial indices";

- that as investors may gain exposure to HFIs by other means, a degree of protection is provided by that exposure being through the regulated structure of a UCITS; and

- UCITS represents a "gold standard" internationally, so it is important that the characteristic elements of the UCITS be preserved (eg appropriate investment rules that make it a suitable product for the retail sector), considering also that the development of EU regulation of eligible assets may influence the choices of non-EU regulators.

Assessment of hedge fund indices against level 2 criteria for financial indices

24. The issues paper considered HFIs in the light of the three level 2 criteria for financial indices – that is, sufficient diversification, representing an adequate benchmark, and publication in an appropriate manner. This paper follows the order of questions in the issues paper where possible. When looked at in detail, some of the proposed level 3 guidelines are relevant to more than one of the level 2 criteria. In order to help readers, however, each of the proposed guidelines has been listed under the level 2 criterion that appears to be most relevant.

Sufficient diversification

25. CESR asked whether HFIs should have to meet additional quantitative conditions in addition to those set out at level 2 on diversification, and whether there should be requirements concerning how the index is weighted[7].

26. Regarding the imposition of additional quantitative conditions, respondents' general view was that the UCITS Directive criteria were already sufficient and that HFIs should not be treated differently from other financial indices. A minority of respondents thought, however, that level 3 should set out a minimum number of index constituents. Taking into account that the diversification requirement set out in the UCITS Directive requires the index to have at least five underlyings, CESR considers there is no need for additional level 3 guidelines. It must be noted though, that whereas five constituents might be a suitable number for a narrow sectoral index, it would likely be insufficient in other cases. In this respect, CESR believes that the level 2 criteria apply and provide for adequate regulation with regard to index construction.

27. On the issue of whether and/or how an index is weighted, the majority of respondents said that it was not necessary to impose any additional requirements and that transparency of methodology should be sufficient to allow the UCITS to decide whether

[6] See http://www.cesr.eu/template.php?page=contenu_groups&id=28&keymore=1&BoxId=2 for details of the Consultative Group.

[7] Questions 3 and 4 in the issues paper.

a particular weighting scheme is appropriate. According to CESR's proposals, the UCITS will be able to assess the methodology of the index in this regard, as the proposed level 3 guidelines will require its rules to be available (in particular, see Box 3 below).

> *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?*

Representing an adequate benchmark and publication in an appropriate manner

28. CESR asked whether the index provider's own definition of the group of underlyings it was trying to represent would satisfy the level 2 "adequate benchmark" criterion, and whether there was a role for a quantitative assessment of the coverage of the HFI[8].

29. A large majority of respondents thought that the index definition given by the index provider should be sufficient, although some respondents were of the opinion that due to the non public nature of hedge funds, often the explanation of the definition of what the index is trying to represent is not explicit enough. Therefore, CESR proposes the following level 3 guidelines:

> 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 trying to track and not merely list underlyings;
>
> 2. assesses whether the methodology of the index construction means the representativeness for the market to which it refers is likely to be achieved.

30. The question arises of the scope and method of the disclosure required by paragraph 1 of Box 1. As an alternative to the proposed wording, the definition of the index could be made available only to the UCITS, or to UCITS investors (possibly on an "on request" basis).

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

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

[8] Questions 5 and 6 in the issues paper.

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 HFI's 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.*

33. The issues paper next asked questions about index methodology, in particular areas such as backfilling, fund classification, the treatment of defunct funds, and the objectivity of rules for the selection of index components[9].

34. Regarding backfilling, CESR asked whether an HFI that allowed backfilling should be considered not eligible to be a financial index. There was almost unanimous agreement with this view.

35. Respondents suggested that the issue of defunct funds was not specific to HFIs but applied to underlyings in other indices (i.e. insolvent companies in equity indices). Although different options to treat defunct funds were expressed, the majority of respondents thought that there was not a role for regulators to enforce guidelines. In that respect, most respondents thought that it was up to the index provider to decide on the treatment of defunct funds.

36. Regarding fund classification, CESR asked whether additional controls other than disclosure should be enforced. The majority of respondents argued that self-regulation through disclosure should be acceptable and that there were already classification standards in the market place. However, a few other respondents suggested that additional controls (i.e. due diligence, independent audit) could be considered.

37. As far as the selection of index components is concerned, CESR asked whether an HFI should make its full rules publicly available (rather than just material rules). Respondents to this question favoured full transparency – as with equity indices - but were divided as to how it should be enforced (i.e. self-regulation or mandatory). In CESR's view, full publicity could help ensure that the selection of underlyings depends on pre-determined rules.

38. Taking account of respondents' comments, CESR proposes the following level 3 guidelines:

[9] Questions 7, 8, 9, 12 and 18 of the issues paper.

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.

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.

41. CESR asked about the necessity of an independent third party review of the HFI's methodology and calculation[10]. Many respondents questioned the need for this on the grounds of cost and of unequal treatment in relation to equity indices. According to most respondents, the UCITS should be fully capable of carrying out the assessment of the index methodology. However, CESR believes such an independent assessment could provide valuable support to a UCITS in assessing the construction standards of a particular HFI, so increasing investor protection. Taking account of the concerns expressed by respondents, CESR proposes the following level 3 guideline:

[10] Questions 10 and 17 of the issues paper.

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?

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

42. A further factor to be considered by the audit is set out in Box 6 below.

43. Regarding the issue of investability and taking into account that in the case of HFIs it is possible that some underlying components of the index may be closed to new investment, CESR considered whether it was necessary for all HFI components to be investable, and whether an index with only investable components could be considered as representative of the market to which it referred. It must be clarified that the issues paper asked about investability in the context of the level 2 requirement of replicability[11]. In that respect, CESR asked whether the replicability criterion would be fulfilled if the value of the index could be verified, given price data and the HFI's methodology.

44. The majority of respondents agreed that the ability to verify the index value was sufficient to satisfy the replicability criterion. Some respondents noted that only including investable hedge funds in the index might reduce the representativeness of the HFI. On the other hand, some respondents thought that including non-investable hedge funds in the index might not fulfil the level 2 condition.

45. Taking into account the reality of the hedge funds market, CESR believes that HFIs including non-investable components should be eligible to be considered financial indices, provided that their characteristics are clearly disclosed.

46. In fact, since the issues paper was published, the drafting of the level 2 condition on replicability has changed slightly, with the inclusion of an "if necessary" in the adequate benchmark condition (see article 9, letter (b)(iii)). CESR believes that full transparency provides an important safeguard, and so believes that a combination of level 3 guidelines should allow replication of the calculation of the value of the index.

[11] Question 14 (and also relevant to question 19) of the issues paper.

47. CESR proposes the following level 3 guidelines, with disclosure being to the UCITS rather than the public as a whole. In conjunction with paragraph 1 of Box 3, this should allow replication of the calculation of the index value:

> 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.

48. CESR asked whether guidelines should be set for the underlying components of HFIs (in particular, regarding net asset value calculation and custody arrangements)[12] or, alternatively, whether the UCITS should be required to assess the due diligence of the index provider in respect of ensuring certain characteristics of the underlyings.

49. A large majority of respondents opposed CESR imposing any minimum standards for the underlying components, instead favouring the view that the UCITS should monitor the due diligence of the index provider. Taking those remarks into account, the following level 3 guideline is proposed:

> 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.

50. The issues paper asked about a minimum monthly frequency of index value publication[13]. A large majority of respondents commented that this matched current industry practice. However, certain CESR members are concerned that mandating this frequency might hinder more frequent index publication from developing. On the other hand, not mandating a minimum frequency might allow HFIs to be promoted with less frequent publication. Finally, setting a frequency for calculation greater than

[12] Question 15 of the issues paper.
[13] Question 16 of the issues paper.

monthly might lead to selection bias by limiting the potential index components, or be inappropriate for HFIs seeking to replicate certain hedge fund strategies.

51. Article 34 of the UCITS Directive requires UCITS to make public in an appropriate manner the price of its units at least twice a month[14]. The question arises of whether operational risk for the UCITS (in terms of its ability to frequently calculate the price) is impacted by infrequent (less than one month) publication of the index value.

52. There are different views as to whether CESR should recommend a minimum frequency of the index value publication and what would be a suitable timeframe.

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?

Q12: Does the frequency of publication of index values 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[15]. 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 what degree of information would have to be disclosed. Most respondents were in favour 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?

<u>Managed account platforms</u>

54. Some respondents commented about HFIs constructed using managed account platforms, on issues such as diversification, selection bias, and potential issues relating to fees charged and rebates from hedge funds to the index provider. Managed account platforms are an important part of the hedge fund marketplace and CESR does not wish to stifle market innovation.

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?

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

---

[14] The competent authorities of a member state may permit this frequency to be reduced to once per month provided that this does not prejudice the interests of unitholders.
[15] Question 20 of the issues paper.

Annex A List of respondents to Issues paper – "Can hedge fund indices be classified as financial indices for the purpose of UCITS?" (CESR/06-530)

Nº	Name	Activity
1	Credit Suisse	Banking
2	European Banking Federation	Banking
3	French Banking Federation	Banking
4	Austrian Federal Economic Chamber	Government regulatory & enforcement
5	Alternative Investment Management Association	Insurance, pension & asset management
6	Alternative Investments Association Austria (VAI)	Insurance, pension & asset management
7	Association Française de la Gestion Financière (AFG)	Insurance, pension & asset management
8	Association of the Luxembourg Fund Industry	Insurance, pension & asset management
9	Assogestioni	Insurance, pension & asset management
10	Belgian Asset Managers Association (BEAMA)	Insurance, pension & asset management
11	DEXIA	Insurance, pension & asset management
12	EFAMA	Insurance, pension & asset management
13	Greenwich Alternative Investments	Insurance, pension & asset management
14	Irish Funds Industry Association (IFIA)	Insurance, pension & asset management
15	Raiffeisen Capital Management, Austria	Insurance, pension & asset management
16	Dechert LLP	Legal & accountancy
17	Association of Foreign Banks	Others
18	Bundesverband Alternative Investments e.V.	Others
19	EDHEC Business School	Others
20	FTSE Group	Others
21	MSCI Barra	Others

Annex B Indicative CESR workplan on the Consultation Paper "Clarification of the definitions concerning eligible assets for investment by UCITS: can hedge fund indices be classified as financial indices for the purpose of UCITS?"