



**CESR's guidelines concerning eligible assets for investment  
by UCITS**

**The classification of hedge fund indices as financial  
indices**

**Feedback Statement**

**July 2007**



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## Overview

### Introduction

1. The UCITS Directive lays down a set of rules concerning what financial instruments a UCITS can invest in. Article 1 of the Directive defines these, at a high level, as being “transferable securities and... other liquid financial assets”. Other articles, in particular Article 19, set out the rules in more detail.
2. Article 53a of the Directive provides that technical amendments may be made to the Directive to clarify definitions “in order to ensure uniform application of [the] Directive throughout the Community”.
3. In October 2004 the Commission issued a mandate to CESR requesting its technical advice – in its capacity as an independent advisory group – regarding clarification of definitions relating to eligible assets<sup>1</sup>
4. In order to fulfil the mandate, CESR undertook two rounds of public consultation<sup>2</sup>, and delivered its final advice to the Commission in January 2006<sup>3</sup>. The advice set out suggested measures that could be adopted at “level 2” and “level 3”<sup>4</sup>.
5. An implementing Directive was published in the Official Journal in March 2007<sup>5</sup>, and at the same time CESR published its accompanying level 3 guidelines<sup>6</sup>.
6. In that paper CESR noted that one eligible assets issue remained outstanding – whether hedge fund indices could be properly classified as “financial indices” for the purposes of the UCITS Directive.

### Hedge fund indices: consultation process

7. The classification of hedge fund indices was addressed briefly in CESR’s two original eligible assets consultations. Due to the complexity of the topic and the relatively new nature of such indices, CESR decided further in-depth consultation was needed to reach a conclusion.
8. As part of this process, two documents were published (available on CESR’s website):
  - CESR’s Issues Paper – Can hedge fund indices be classified as financial indices for the purpose of UCITS? (CESR/06-530, October 2006); and

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<sup>1</sup> Available at [http://ec.europa.eu/internal\\_market/securities/docs/cesr/final-mandate-clarification\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/cesr/final-mandate-clarification_en.pdf).

<sup>2</sup> See CESR/05-064b (March 2005) and CESR/05-490b (October 2005), available at <http://www.cesr.eu>.

<sup>3</sup> "CESR's advice to the European Commission on clarification of definitions concerning eligible assets for investments of UCITS" (CESR/06-005).

<sup>4</sup> Under the “Lamfalussy” process, a four-level procedure is applied to financial services legislation. Level 1 constitutes framework legislation; level 2 covers implementing measures for level 1 legislation; level 3 consists of supervisory committees facilitating the convergence of regulatory practice; level 4 concerns enforcement of EU measures.

<sup>5</sup> Directive 2007/16/EC.

<sup>6</sup> “CESR’s guidelines concerning eligible assets for investment by UCITS” (CESR/07-044, March 2007).



- 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? (CESR/07-045, February 2007).
9. An open hearing was held in Paris in April 2007 on the consultation paper. In addition, CESR had the benefit of discussions with index providers, academics and CESR's Consultative Working Group on Investment Management.

Next steps

10. This paper contains feedback to the CESR's level 3 guidelines on hedge fund indices, which relate to Article 9 of the implementing Directive. It also contains feedback on the two papers relating to hedge fund indices mentioned above.
11. CESR members will effect the implementing Directive and all level 3 guidelines as a single package of measures. This will be by March 2008 at the latest.



## Definitions

12. 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.
13. References in this paper to the “implementing Directive” mean Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the co-ordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards the clarification of certain definitions.
14. 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.
15. 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.



## The guidelines

16. As outlined in the overview section of this paper, CESR has carried out a thorough consultation exercise regarding hedge fund indices. Detailed feedback on each of the questions asked in the issues paper and consultation paper can be found in Annexes A and B respectively.
17. The proposed level 3 guidelines contained in the consultation paper set out a series of prescriptive criteria that a hedge fund index would need to meet in order to be classified as a “financial index”, but placed the onus on ensuring these criteria were met on the UCITS.
18. Having reflected upon all the comments received, CESR believes that the following three points are particularly relevant:
  - the UCITS Directive and implementing Directive already contain requirements for financial indices, so it is necessary to justify why additional criteria should be imposed in the case of hedge fund indices;
  - a UCITS would gain exposure to a hedge fund index by means of a derivative, so there is a third party – the derivative provider – between the UCITS and the index provider. Investments by means of over-the-counter (OTC) derivatives are subject to a number of safeguards in the UCITS Directive and implementing Directive; and
  - the scope of CESR’s current work is limited to issuing level 3 guidelines implementing the existing legislative framework in accordance with the mandate received on eligible assets.
19. Taking these points into account, CESR has decided to amend its level 3 guidelines accordingly. The revised guidelines are both based either on existing requirements from the Directives, or the guidelines and discussion from the consultation paper. No new issues have been introduced so CESR does not believe further consultation is necessary.
20. Annex C contains a consolidated list of the final guidelines.

### Final level 3 guidelines

21. The level 3 guidelines on hedge fund indices relate to Article 9(1) of the implementing Directive (“Financial Indices”).
22. New Boxes 1 to 6 below represent the standards that must be complied with if a UCITS is to gain exposure to a hedge fund index.

#### **New Box 1**

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, to fall under the classification of a “financial index”, a hedge fund index must comply with the conditions laid down in Article 9 of Directive 2007/16/EC.

CESR has published level 3 guidelines to accompany Article 9 (see CESR/07-044).



23. **Explanation.** This guideline, while not included in the consultation paper, does not impose any new requirements on UCITS. It merely recalls the existing level 2 and 3 provisions which are of relevance to financial indices, including the requirements for any index to be sufficiently diversified, to represent an adequate benchmark and to be published in an appropriate manner.

#### New Box 2

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, a hedge fund index will not fall under the classification of a “financial index” unless the methodology of the index provides for the selection and the re-balancing of components on the basis of pre-determined rules and objective criteria.

24. **Explanation.** CESR believes that the objective selection of components using pre-determined rules is a key distinction between a hedge fund index and a fund of hedge funds. This guideline reflects Box 2 from the consultation paper.

#### New Box 3

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, a hedge fund index will not fall under the classification of a “financial index” if the index provider accepts payments from potential index components for the purpose of being included in the index.

25. **Explanation.** This issue was discussed in paragraphs 39 and 40, and question 6, of the consultation paper. Feedback on question 6 can be found in Annex B of this paper. CESR believes it is appropriate to issue a guideline as the practice of making payments to a provider for inclusion in an index is contrary to the principles of objective component selection and the index being an adequate benchmark.

#### New Box 4

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, a hedge fund index will not fall under the classification of a “financial index” if the methodology of the index allows retrospective changes to previously published index values (“backfilling”).

26. **Explanation.** This guideline reflects Box 3(2) from the consultation paper. There has been widespread acceptance that backfilling is not an acceptable practice in respect of a hedge fund index.

#### New Box 5

When gaining exposure to a hedge fund index by means of an OTC derivative, a UCITS must comply with the relevant requirements laid down in Directives 85/611/EEC and 2007/16/EC.

These include:

- requirements about counterparties (Article 19(1)(g) of Directive 85/611/EEC);
- requirements about valuation and the ability to close a position (Article 19(1)(g) of Directive 85/611/EEC and Article 8 of Directive 2007/16/EC);



- requirements about risk management and valuation processes (Article 21(1) of Directive 85/611/EEC); and
- requirements about risk exposure (Article 22 of Directive 85/611/EEC).

CESR has published level 3 guidelines to accompany Article 8 of Directive 2007/16/EC (see CESR/07-044).

27. **Explanation.** During the consultation several respondents argued that CESR had underestimated the degree of assurance to be gained by a UCITS from the fact that it would gain exposure to a hedge fund index via a counterparty providing an OTC derivative. CESR therefore believes it is useful to include a guideline recalling some of the relevant requirements for such derivatives in the Directives. Although not included in the consultation paper, this does not impose any new requirements on UCITS.

#### New Box 6

When gaining exposure to a hedge fund index, a UCITS must carry out appropriate due diligence. This includes consideration by the UCITS of the “quality” of the index.

In assessing the quality of the index, the UCITS must take into account at least the following factors. The UCITS must keep a record of its assessment.

(a) the comprehensiveness of the index methodology, including

- whether the methodology contains an adequate explanation of subjects such as the weighting and classification of components (eg on the basis of the investment strategy of the selected hedge funds), and the treatment of defunct components;
- whether the index represents an adequate benchmark for the kind of hedge funds to which it refers;

(b) the availability of information about the index, including

- whether there is a clear narrative description of what the index is trying to represent;
- whether the index is subject to an independent audit and the scope of the audit (eg that the index methodology has been followed, that the index has been calculated correctly);
- how frequently the index is published and whether this will affect the ability of the UCITS to accurately calculate its net asset value (NAV);

(c) matters relating to the treatment of index components, including

- the procedures by which the index provider carries out any due diligence on the NAV calculation procedures of index components;
- what level of detail about the index components and their NAVs are made available (including whether they are investable or non-investable);
- whether the number of components in the index achieves sufficient diversification.

28. **Explanation.** A UCITS should of course carry out appropriate due diligence on any investment it proposes to make. New Box 6 above contains a list of factors specifically related to hedge fund indices that a UCITS must at least consider before it makes a relevant investment.





30. For the avoidance of doubt, “due diligence” in this context means that the UCITS must make an overall assessment of the quality of the particular hedge fund index based on the criteria set out above, and any additional criteria the UCITS feels is relevant. The UCITS is responsible for this decision and will need in practice to be able to justify its assessment.
  
31. For example, it might be the case that a hedge fund index publishes a very detailed methodology and comprehensive information about index components, but is not subject to an independent audit. The UCITS will need to assess whether, considering all the factors listed, gaining exposure to the index would be consistent with its investment objectives and risk profile.



**Annex A      Feedback on CESR/06-530 (“Can hedge fund indices be classified as financial indices for the purposes of UCITS?”)**

Twenty-two responses were received to the issues paper (CESR/06-530). The 21 non-confidential responses can be viewed on CESR’s website. This Annex summarises the responses to each question asked in the issues paper.

*General comments*

Respondents argued that hedge fund indices were eligible assets under the existing Directive requirements, and that CESR should take into account the competition UCITS faced from less regulated structures which already allowed investors to gain exposure to hedge funds.

It was noted that hedge fund indices would develop over time in a similar way to traditional indices, and market innovation meant that a UCITS should consider possible investments, including hedge fund indices, on a case-by-case basis.

An investment management trade association drew attention to the conclusions of the European Commission’s Expert Group on Alternative Investment Funds, which were that there were current concerns with the reliability and functioning of hedge fund indices, and argued that more research was needed to resolve these issues before hedge fund indices became eligible for investment by UCITS.

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

Respondents noted that many of the biases described mainly affected only non-investable hedge fund indices; but that they also applied to “traditional” equity indices. Mitigants to the biases included transparent and objective index methodologies.

Sample bias was said to be greater for indices based on managed accounts, although another respondent argued that hedge funds were asked to open a managed account only after they had fulfilled the index selection criteria.

An index provider would need to have sufficient monitoring arrangements to deal with constituent classification, which should be independent of the hedge fund’s own classification.

Differences were expressed over whether asset-weighted or equal-weighted indices resulted in greater representativity.

One respondent noted that no-one would write a derivative on an index whose methodology allowed backfilling, as they would suffer the tracking error from retrospective index changes.

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

A respondent argued that the use of managed accounts to address issues of investability introduced the risk of default of the managed account provider; and could also led to fee bias and tracking error.

Liquidity bias – both in terms of the constituent funds’ redemption limits and their underlying investments - was also mentioned.



*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.*

Most respondents felt the level 2 requirements provided sufficient minimum diversification and provided flexibility for the index market to develop. A small number felt a (higher) minimum number of constituents should be set down at level 3.

One respondent suggested that indices based on managed accounts should be subject to stricter diversification requirements to compensate for the increased operational risk involved.

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

Most respondents felt the choice of weighting should be left to the index provider, although it was noted that the majority of indices are asset-weighted.

*Q5. Is the definition of the representative group of underlying assets made by the index provider sufficient to satisfy the criterion of “adequate benchmark”? Please provide comments.*

Respondents argued that it was crucial for the index provider to accurately disclose what market the performance of the index is trying to represent.

Several respondents commented that details of the original “broad” universe of funds (the database) from which index components are selected should also be disclosed, due to the non-public nature of hedge funds and the need to give the UCITS sufficient explicit information to make an informed judgment about investing.

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

There were mixed views from respondents on whether this would be useful information, but most agreed it should not be mandatory.

Possible measures suggested included setting a simple minimum number of underlyings (depending on the strategy being followed by the index), or comparing the percentage of assets under management of an index’s underlying funds with the total size of the funds in the hedge fund strategy that the index claims to cover.

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

The vast majority of respondents agreed that backfilling should be banned for indices. Some noted that backfilling was a feature of fund databases rather than the indices drawn from them.

*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.*

Although one respondent claimed that defunct fund bias is typically insignificant, other respondents explained how they felt failed funds should be dealt with.



Typically this involved a failed fund being kept in the index until it was fully liquidated; or that the fund should be replaced, on a fixed date, at an equal value.

Two respondents felt CESR should promote guidelines in this area, although others noted there was no problem for investable indices as they had an implicit treatment of defunct funds. An index provider commented that clear rules-based criteria for the removal of these funds would allow the UCITS to assess the index.

*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.*

Most respondents argued that imposing requirements over and above methodology disclosure would burden hedge fund indices compared to traditional indices; and that disclosure would allow comparison with classification standards already available in the marketplace. It was noted that any classification system would need to be able to evolve to take into account potential developments in investment strategies.

One respondent argued there should have to be a periodic independent audit of the methodology; another that any change of an underlying fund's classification should always take place independently of that fund's manager.

*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.*

The vast majority of respondents argued that a UCITS could carry out this assessment adequately – although it could always engage an appropriate third party to advise if it felt that was necessary.

It was suggested that the depositary could assess compliance of the index in the context of the UCITS' investment objectives. One respondent argued that CESR should sponsor an independent review of all new indices.

*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.*

Although generally agreeing with the passive/active distinction, respondents commented that hedge fund indices could involve some minimum qualitative criteria by which potential underlyings were filtered. One respondent commented that an index based on a managed account platform demonstrated active selection.

The other differences between indices and fund of hedge funds highlighted included:

- an index would likely have more underlyings than a fund of hedge funds;
- a fund of hedge funds would display more frequent changes in its underlyings and their weightings;
- the fee structures of a fund of hedge funds and an index differ;
- the aim of the two products is different – for example, a fund of hedge funds might have a target return;
- an index will have a transparent methodology.



*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.*

The vast majority of respondents agreed with this proposition, while noting that there might need to be a minimal amount of due diligence on the underlying funds (eg in terms of a minimum size or history requirement).

One respondent drew an analogy to credit rating agencies which have public criteria, but do not carry out ratings on a purely mechanical basis.

*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.*

There was a split in views between respondents in answer to this question. Some respondents argued there were no competition aspects, or that they were irrelevant to the question under discussion of whether hedge fund indices should be eligible assets.

Others argued that the correct comparison for hedge fund indices and funds of hedge funds was the competition between equity index tracking funds and actively managed equity UCITS.

A third group argued that hedge fund indices would be gaining a competitive advantage over funds of hedge funds, and it seemed a perverse outcome to allow the relatively more complex product (exposure to the index would be via a derivative) to be eligible for investment by UCITS while funds of hedge funds could not be sold to retail investors on a cross-border basis.

Two respondents argued that the real competitive issue concerned whether UCITS could compete with other less regulated structures (eg certificates or unit-linked products) which already allowed investors to gain exposure to the performance of hedge funds.

*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?*

Most respondents agreed with this proposal, although some believed that investability of the underlying index components was required to fulfil the requirement of replicability.

*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.*

The majority of respondents thought that the UCITS would be capable of assessing the index provider's due diligence procedures. It was argued that providers should disclose their methodology relating to obtaining net asset value information from the underlying hedge funds. One respondent suggested that these procedures could be subject to an audit, and that CESR could propose a standard due diligence questionnaire.



The minority of respondents who felt CESR should set requirements noted that the difficulty of obtaining the values of the index constituents was the key difference between hedge fund and traditional indices, and that CESR should prevent eligible hedge fund indices from embedding concentrated non-market risk.

*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?*

The vast majority of respondents agreed that this suggested frequency reflected (current) industry practice. A requirement for more frequent publication might cause selection bias by artificially limiting potential underlyings.

One respondent argued that the frequency of index calculation and publication needed to match the frequency of net asset value calculation of the UCITS (minimum fortnightly).

*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.*

While one respondent argued that an independent auditor should carry out an annual verification exercise, the vast majority of respondents believed that it should be left to the index provider to decide whether an audit would make their index more attractive in the marketplace. It was noted that an audit was not a requirement for traditional indices.

*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?*

There was a mix of views, between respondents who thought full rules should be publicly available, and those who thought the same requirements should apply as for other indices. One respondent noted the issue of licensing/intellectual property in index methodologies.

*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.*

There was a split between respondents who agreed that full disclosure of the details of constituents should take place and those who felt the same standards should apply to hedge fund indices as traditional indices.

Respondents in the latter category argued that enhanced disclosure might cause problems with intellectual property protection or breach private placement/financial promotion rules in some jurisdictions (leading to selection bias if the choice of potential underlyings was limited as a result).

However, one respondent pointed out that constituent disclosure would allow verification of how the index provider had classified the underlying hedge funds.

*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.*



Some respondents thought disclosure requirements should be the same as for traditional indices and investments in derivatives, but others felt there should be specific disclosure of the fact of exposure to hedge fund indices and the associated risks in the prospectus.

One respondent suggested that UCITS gaining exposure to hedge fund indices should guarantee that their managers have the skills to analyse such products.

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

One respondent argued that it was better for investors to gain access to hedge fund performance through UCITS than other, less regulated, products. Another noted that exposure via a derivative provided comfort to the end investor, as a derivative would not be written unless there was a replicable instrument with fair pricing to use for hedging.

A fund manager association argued that EU harmonisation of hedge funds outside the UCITS framework should be considered.

*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.*

Respondents contrasted the current low market penetration of hedge fund indices with the popularity of equity index tracking.

One respondent argued that the transparency and objectivity of hedge fund indices meant they should be subject to less regulation than funds of hedge funds; however, another pointed out that active management could achieve better returns for investors than indexing.

Two respondents argued that hedge fund indices and funds of hedge funds served different purposes in an investor's portfolio: indices are for those who want to gain exposure to "the market".





## Annex B

### Feedback on CESR/07-045 (“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?”)

Twenty-six responses were received to the consultation paper (CESR/07-045), and can be viewed on CESR’s website. This Annex summarises the responses to each question asked in the consultation paper.

#### *General comments*

A wide variety of general/introductory comments were made in response to the consultation. Many respondents supported the general eligibility of hedge fund indices, and stressed that CESR should not unnecessarily restrict continued market innovation in the asset management industry by imposing disproportionate regulatory requirements.

Several respondents suggested that no additional criteria, over and above those for traditional indices, should apply to hedge fund indices. Others supported the proposed guidelines as important investor protection measures. Transparency and disclosure were supported as key principles, in order to allow UCITS to make considered investment decisions.

Two respondents noted the concerns about hedge fund indices expressed by the European Commission’s Expert Group on Alternative Investment Funds, and called for the equal treatment of indices and funds of hedge funds – for example, that funds of hedge funds either become eligible for investment by UCITS, or that a European framework for cross-border distribution of funds of hedge funds be created. It was questioned whether some hedge fund indices were in fact disguised funds of hedge funds, and that there was a risk of regulatory arbitrage between the two products.

*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?*

The vast majority of respondents believed that no additional guidelines were necessary. A small number referred to academic research that showed five to ten funds were sufficient to achieve diversification.

*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)?*

Many respondents agreed that the definition of what the index is trying to represent should be publicly available via the index provider’s website, free-of-charge, although others believed the level of detail of available information should be higher for the UCITS than (potential) investors.

Several respondents argued that information about the components of the index should be restricted, on the grounds of protection of intellectual property and concern at potentially breaching restrictive private placement/marketing rules in certain jurisdictions.

*Q3. Do you have any other comments on these proposed level 3 guidelines [concerning public disclosure of what the index is trying to represent and a requirement on the UCITS to assess the methodology of the index in terms of representativeness]?*

Two respondents suggested a minimum list of contents that should be covered in the index’s methodology; one noted that ongoing due diligence and review requirements on the UCITS would be disproportionate if exposure to the hedge fund index only formed a small part of its assets.



*Q4. Respondents are invited to provide their comments on the above [the index provider publishing the total disclosed or estimated value of the assets of (each of) the index components at each index calculation point], taking into account that the UCITS always needs to properly value its portfolio and assess the risks therein.*

There were mixed views from respondents on this question. Those who supported the proposal felt it would increase transparency. Several respondents commented that publication of the value of each individual component could breach rules on private placement in various jurisdictions.

Others thought disclosure of this type was irrelevant, or worse, misleading. Some thought the question of information provision should be left to the index provider, comparing the requirement with those for traditional indices; others thought risk measures would be a more useful disclosure than the value of underlyings.

*Q5. Please provide your comments on these proposed level 3 guidelines [that index components must be selected objectively, on the basis of pre-determined rules; that the full index methodology must be made public; and that the index must not allow “backfilling”].*

Respondents generally agreed with the proposed guidelines, although some questioned the degree of due diligence being placed on the UCITS, based on the use of the words “confirms” and “verifies” in the level 3 text. One respondent suggested CESR draw up a concise index reporting summary, which the index provider could publish periodically on their website; another commented that the UCITS should be able to rely on information supplied by the index provider.

One asset management trade association thought the proposals did not add value, as the UCITS gains exposure to the index via a derivative.

*Q6. Respondents are invited to provide their comments on the above [payments from hedge funds to index providers to be included in indices].*

Many respondents felt that such practices should render an index ineligible for investment by a UCITS. Others believed that while payments resulted in a conflict of interest, the issue could be dealt with by disclosure and/or a requirement that such payments should be included in the index return, thus benefiting investors.

*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?*

Most respondents believed an audit should not be required as this would add unnecessary costs when compared to traditional indices. It was noted that UCITS and the underlying hedge fund components themselves were already subject to audits. Several respondents noted that publication of the hedge fund index’s methodology provided a sufficient market incentive, in terms of reputational risk to the provider, to ensure it was followed correctly.

One respondent argued that an audit should be required as hedge fund indices are more sophisticated than traditional indices. Two respondents argued that requiring the index to have an audit would relieve some of the burden on the UCITS to verify compliance of the index with its methodology. It was pointed out that index providers could carry out voluntary audits if this made their product more attractive in the marketplace.

*Q8. Please provide your comments on this proposed level 3 guideline [the requirement to have an independent audit at least annually].*

Most respondents referred to the arguments they had made in response to question 7. One respondent commented that the audit guidelines should also include risk evaluation and control, to create a level playing field between hedge fund indices and funds of hedge funds.



Another argued that the audit should not include further inspection of already audited information from the underlying hedge funds.

*Q9. Please provide your comments on these proposed level 3 guidelines [the requirement to disclose whether each index component is investable or not, and to make available to the UCITS the price and weight of each component at every index calculation point].*

Respondents differed over whether non-investable hedge funds should be allowed as index components. Those who disagreed pointed out that the biases identified by CESR mainly affected indices including non-investable components, while those who believed non-investable components should be allowed argued that replicability was still achievable via a transparent methodology, and that the investability of underlyings was an issue for the derivative provider, not the UCITS. CESR would also have to provide a definition of investable/non-investable to prevent non-investable components, which was not straightforward.

There were also different views on how much component information should be disclosed: some thought this should be left to the index provider to decide, while others believed more information could be provided to the UCITS than publicly. One respondent argued that publication of detailed component information could violate private placement rules in some jurisdictions, while another stated that the UCITS did not need such information as it gain exposure to the index via derivatives. The need to make detailed disclosures every time the index was calculated would be a disincentive to more frequent index publication.

*Q10. Please provide your comments on this proposed level 3 guideline [the requirement that the index provider carries out due diligence on the net asset value calculation procedures of the underlying hedge funds, and that the adequacy of this due diligence is confirmed by the index audit].*

Most respondents opposed the proposed guideline on the grounds of cost and practicality, and the argument that traditional indices were not required to carry out due diligence on the financial statements of their underlying components (ie companies). Others felt the proposal might be acceptable if the extent of the due diligence required could be suitably constrained (for example, if the index provider could rely on an unqualified audit report from the underlying fund, or if the underlying funds complied with the IOSCO or AIMA valuation principles for hedge funds).

One respondent argued the due diligence should extend further than simply net asset value calculation, to include aspects such as fund governance. This would create a level playing field between hedge fund indices and funds of hedge funds.

An index provider argued that indices based on managed account platforms could not comply with the proposed guidelines, as there were technically no underlying components, and the managed account provider calculated the net asset value themselves.

*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?*

Respondents noted the mismatch between the required frequency of net asset value publication of the UCITS and that of the underlying hedge funds in an index, most of which calculated their net asset values on a monthly basis.

Some respondents argued that a weekly publication frequency would be desirable, but others argued that it was not necessary for CESR to set a minimum frequency, and that as the market developed frequency of index publication would improve. A fund manager trade association argued that some hedge fund strategies (eg market neutral or long/short funds) could provide more frequent valuations due to the higher liquidity of their underlying investments.



Two respondents noted that the UCITS' exposure would be via an over-the-counter derivative, whose value would have to be marked-to-market each day, with the fund manager making a check of the valuation. More frequent index publication would make this process easier.

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

Some respondents believed this would be the case, and that UCITS should be encouraged to invest in indices with frequent publication. Others pointed out that exposure would be gained by a derivative, where there is already a requirement for daily valuation (a respondent pointed out that daily quotes were available for other products which were not priced daily, eg real estate products).

It was noted that some indices provide estimated values more frequently than their official calculations. An index provider pointed out that requiring underlying index components to calculate their net asset value more frequently than monthly would result in selection bias by limiting the potential number of eligible underlyings.

*Q13. Should CESR carry out further work on this issue [disclosure to investors about a UCITS investing in hedge fund indices]?*

Respondents differed in their views about whether CESR needed to carry out further work in this area. Two respondents felt that this issue should be considered as part of the forthcoming work to revise the simplified prospectus, to ensure a coherent overall (rather than asset-by-asset) solution.

On the substantive issue itself, several respondents thought that the current prospectus disclosure requirements were sufficient, or that market demand would result in a sufficient focus on appropriate and useful disclosures, rather than regulators requiring more unhelpful and indecipherable "boilerplate" text.

*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?*

Most respondents felt that no additional guidelines were necessary.

Views were expressed in favour and against the use of managed accounts for indices. Those in favour argued that they were a method to avoid the operational risks of hedge funds and provided independence, transparency and liquidity benefits. Those against pointed out that a managed account would be unable to replicate the performance of an underlying fund exactly and that only a restricted subset of potential underlying hedge funds would be available through a managed account.

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

Two respondents commented that there should be a level playing field between hedge fund indices and funds of hedge funds.



**Annex C Consolidated list of final level 3 guidelines and summary table comparing consultation paper and final guidelines**

Final level 3 guidelines

**New Box 1**

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, to fall under the classification of a “financial index”, a hedge fund index must comply with the conditions laid down in Article 9 of Directive 2007/16/EC.

CESR has published level 3 guidelines to accompany Article 9 (see CESR/07-044).

**New Box 2**

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, a hedge fund index will not fall under the classification of a “financial index” unless the methodology of the index requires the passive selection of components using pre-determined rules, on the basis of objective criteria.

**New Box 3**

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, a hedge fund index will not fall under the classification of a “financial index” if the index provider accepts payments from potential index components for the purpose of being included in the index.

**New Box 4**

For the purposes of Article 19(1)(g) of Directive 85/611/EEC, a hedge fund index will not fall under the classification of a “financial index” if the methodology of the index allows retrospective changes to previously published index values (“backfilling”).

**New Box 5**

When gaining exposure to a hedge fund index by means of an OTC derivative, a UCITS must comply with the relevant requirements laid down in Directives 85/611/EEC and 2007/16/EC.

These include:

- requirements about counterparties (Article 19(1)(g) of Directive 85/611/EEC);
- requirements about valuation and the ability to close a position (Article 19(1)(g) of Directive 85/611/EEC and Article 8 of Directive 2007/16/EC);
- requirements about risk management and valuation processes (Article 21(1) of Directive 85/611/EEC); and
- requirements about risk exposure (Article 22 of Directive 85/611/EEC).

CESR has published level 3 guidelines to accompany Article 8 of Directive 2007/16/EC (see CESR/07-044).

**New Box 6**

When gaining exposure to a hedge fund index, a UCITS must carry out appropriate due diligence. This includes consideration by the UCITS of the “quality” of the index.

In assessing the quality of the index, the UCITS must take into account at least the following factors. The UCITS must keep a record of its assessment.

(a) the comprehensiveness of the index methodology, including

- whether the methodology contains an adequate explanation of subjects such as the weighting and classification of components (eg on the basis of the investment strategy of the selected hedge funds), and the treatment of defunct components;
- whether the index represents an adequate benchmark for the kind of hedge funds to which it refers;

(b) the availability of information about the index, including

- whether there is a clear narrative description of what the index is trying to represent;
- whether the index is subject to an independent audit and the scope of the audit (eg that the index methodology has been followed, that the index has been calculated correctly);
- how frequently the index is published and whether this will affect the ability of the UCITS to accurately calculate its net asset value (NAV);

(c) matters relating to the treatment of index components, including

- the procedures by which the index provider carries out any due diligence on the NAV calculation procedures of index components;
- what level of detail about the index components and their NAVs are made available (including whether they are investable or non-investable);
- whether the number of components in the index achieves sufficient diversification.

**Annex D List of non-confidential respondents to CESR/07-045**

| <b>No.</b> | <b>Name</b>                                    | <b>Activity</b>                       |
|------------|--|---------------------------------------|
| 1          | European Association of Co-operative Banks     | Banking                               |
| 2          | European Banking Federation                    | Banking                               |
| 3          | French Banking Federation                      | Banking                               |
| 4          | Credit Suisse                                  | Banking                               |
| 5          | Bayerische Hypo- und Vereinsbank AG            | Banking                               |
| 6          | Austrian Federal Economic Chamber              | Government, regulatory & enforcement  |
| 7          | CNMV Advisory Committee                        | Government, regulatory & enforcement  |
| 8          | ADi Investments                                | Insurance, pension & asset management |
| 9          | Barclays Global Investors                      | Insurance, pension & asset management |
| 10         | EFAMA  | Insurance, pension & asset management |
| 11         | German Insurance Association                   | Insurance, pension & asset management |
| 12         | Greenwich Alternative Investments              | Insurance, pension & asset management |
| 13         | MSS Capital                                    | Insurance, pension & asset management |
| 14         | Raiffeisen Capital Management                  | Insurance, pension & asset management |
| 15         | Bundesverband Alternative Investments          | Insurance, pension & asset management |
| 16         | INVERCO  | Insurance, pension & asset management |
| 17         | Irish Funds Industry Association               | Insurance, pension & asset management |
| 18         | Association Francaise de la Gestion Financiere | Insurance, pension & asset management |
| 19         | UBP Alternative Investments                    | Insurance, pension & asset management |
| 20         | Alternative Investment Management Association  | Insurance, pension & asset management |
| 21         | Alternative Investment Association (Austria)   | Insurance, pension & asset management |
| 22         | Assogestioni                                   | Insurance, pension & asset management |
| 23         | ALFI   | Insurance, pension & asset management |
| 24         | Danish Shareholders Association                | Investor relations                    |
| 25         | Financial Services Consumer Panel              | Investor relations                    |
| 26         | EDHEC  | Others                                |