THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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CESR's guidelines concerning eligible assets for investment by UCITS

The classification of hedge fund indices as financial indices

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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[1].

4. In order to fulfil the mandate, CESR undertook two rounds of public consultation[2], and delivered its final advice to the Commission in January 2006[3]. The advice set out suggested measures that could be adopted at "level 2" and "level 3"[4].

5. An implementing Directive was published in the Official Journal in March 2007[5], and at the same time CESR published its accompanying level 3 guidelines[6].

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.

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

[1] Available at http://ec.europa.eu/internal_market/securities/docs/cesr/final-mandate-clarification_en.pdf.
[2] See CESR/05-064b (March 2005) and CESR/05-490b (October 2005), available at http://www.cesr.eu.
[3] "CESR's advice to the European Commission on clarification of definitions concerning eligible assets for investments of UCITS" (CESR/06-005).
[4] 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.
[5] Directive 2007/16/EC.
[6] "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.

10. This paper contains CESR's level 3 guidelines on hedge fund indices, which relate to Article 9 of the implementing Directive. A separate feedback statement on the two papers relating to hedge fund indices mentioned above is published by CESR (Ref. CESR/07-433).

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. The level 3 guidelines on hedge fund indices relate to Article 9(1) of the implementing Directive ("Financial Indices").

17. 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.

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).

18. **Explanation.** This guideline 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.

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.

19. **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.

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.

20. **Explanation.** 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.

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").

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).

21. **Explanation.** CESR believes it is useful to include a guideline recalling some of the relevant requirements for OTC derivatives in the Directives. Although not included in the consultation paper, this does not impose any new requirements on UCITS.

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.

22. **Explanation.** A UCITS should of course carry out appropriate due diligence on any investment it proposes to make. 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.

23. 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.

24. 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.