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A legal update from Dechert's Financial Services Group

Hedge Fund Indices: Eligible Investments for UCITS?

The Committee of European Securities Regulators ("CESR") has published a consultation paper setting out its proposals for allowing UCITS funds to invest in hedge fund indices ("HFIs") under Article 19 (1)(g) of the UCITS III Directive (85/611/EEC) ("UCITS Directive"). The final form of the requirements that HFIs will have to meet will be published after the consultation period ends on 16 April 2007.

Article 19 (1)(g) of the UCITS Directive states that financial derivative instruments whose underlying consists of, among other things, "financial indices" may be considered as an eligible investment by a UCITS.

CESR's initial view, published in January 2006, was that HFIs should not be accepted as eligible financial indices for UCITS purposes. However, in October 2006 CESR published a new issues paper ("Issues Paper") re-examining this matter. A further consultation paper was published in February 2007 ("Consultation Paper") containing proposals which, if satisfied, would enable HFIs to qualify as financial indices for the purposes of UCITS.

The Issues Paper sets out the criteria that an index would need to meet. The index must:

- Be sufficiently diversified
- Represent an adequate benchmark for the market to which it refers
- Be published in an appropriate manner.

Additional criteria for HFIs were discussed in the Issues Paper and formulated in detail in the Consultation Paper. The main criteria will be implemented shortly as Level 2 criteria by an implementing directive, and the proposed HFI-specific requirements would take effect as Level 3 criteria.

The Level 2 and proposed Level 3 criteria are described below.

Sufficiently Diversified

Level 2

For an index to be "sufficiently diversified":

- It should be composed in a way that price movements or trading activities for one component do not unduly influence the whole index
- If it is composed of eligible assets, its composition should be at least as diversified as set out under the diversification ratios of Article 22a of the UCITS Directive, subject to a 20% maximum for investment in shares and/or debt securities issued by the same body. If not, its underlying assets have to be combined with the other assets of the UCITS in order to avoid undue concentration
- If it is composed of non-eligible assets, it should be as diversified in a way which is equivalent to that described above, in case the derivatives on indices are used to track such an index or to gain high exposure in such an index, in order to avoid undue concentration. If the derivatives on these indices are used for risk-diversification purposes this diversification does not apply, provided the exposure on the individual indices complies with the 5/10/40% ratios.

Level 3

CESR thinks that the Level 2 criteria for diversification and weighting should be sufficient for HFIs found on a narrow sectoral index (though it could be insufficient in other cases).

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CESR does not anticipate imposing additional requirements to deal with whether and how an index is weighted. Full disclosure of the methodology should be sufficient to allow a UCITS to decide whether the weighting scheme of a particular index is appropriate.

Adequate Benchmark

Level 2

For an index to "represent an adequate benchmark for the market to which it refers":

- It must measure the performance of a representative group of underlyings in a way that is meaningful and useful
- It should be revised or rebalanced periodically to ensure that it continues to reflect the markets to which it refers, using criteria that are publicly available
- The underlyings should be sufficiently liquid to enable users to replicate the index if necessary.

Level 3

The UCITS must:

- Verify that the index provider clearly defines and makes publicly available an explanation of what the index is trying to represent (including a narrative description of what the index is trying to track, not merely a list of underlyings)
- Verify that the methodology of the index requires the selection of index components to be made using predetermined rules on the basis of objective criteria
- Verify 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
- Verify that the index provider makes available to the UCITS details of whether each index component is investable or non-investable
- Assess whether the methodology of the index construction means the representativeness for the market to which it refers is likely to be achieved.

Published in an Appropriate Manner

Level 2

For an index to be "published in an appropriate manner":

- Its publication process should rely on robust procedures to collect prices (including procedures to price components where a market price is not available), and to calculate and subsequently publish the index value
- The material information on matters such as index calculation and rebalancing methodologies, index change, and information relating to any operational difficulties in providing timely or accurate information must be provided on an as wide and timely basis as possible.

Level 3

The UCITS must:

- Confirm that the index provider publicly makes available the full methodology of the index, including weighting, the treatment of defunct components, and, where applicable, classification of components
- Verify that the methodology of the index does not allow retrospective changes to previously published index values ("backfilling")
- Confirm that the index provider carries out due diligence on the net asset value calculation procedures used by each index component. The adequacy of the due diligence should be confirmed in the annual audit of the index
- Verify that the index will be subject to an independent audit at least annually. The audit should consider whether the index's published methodology has been respected during the period in question, and validate that for a sample of index calculation points the index value was calculated consistently with the disclosed methodology.

Next Steps in CESR's Consultation Process

CESR has invited respondents to comment on its proposed Level 3 criteria, and in particular on:

- Whether HFIs would be negatively impacted by the requirement to carry out an audit at least annually
- What would be a suitable minimum frequency for index publication; while responses to the Issues Paper indicated that industry practice favours monthly publication, CESR would not want this to prevent more frequent index publication from developing.

CESR is also considering whether there should be a requirement to disclose to UCITS investors that their fund may invest in HFIs.

Given CESR's initial reluctance to include HFIs in the eligible assets regime, the positive nature of its recent paper is very welcome. The exact requirements are subject to change and the final form of the requirements will not be available until May 2007.

CESR members have agreed not to authorise the setting up of new UCITS with HFIs until the conclusion of the review.

Practice group contacts

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