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■ THE CLASSIFICATION OF HEDGE FUND INDICES AS FINANCIAL INDICES

Introduction

Pursuant to the new level three guidelines issued by the Committee of European Securities Regulators ("CESR") on 17th July, 2007, CESR has approved in principle the classification of hedge fund indices as financial indices for the purposes of the UCITS Directive^[1] subject to the satisfaction of certain criteria.

Background

Pursuant to Article 19(1)(g) of the UCITS Directive, a UCITS fund may invest in liquid financial derivative instruments whose underlyings consists of one or more securities in which a UCITS fund can invest in directly as well as financial indices, interest rates, foreign exchange rates or currencies. Whilst CESR has previously issued previous guidelines in relation to the nature of "eligible assets" for the purposes of UCITS funds (the "original Level 3 guidelines")^[2], both the original Level 3 guidelines and the subsequent implementing directive (the "Implementing Directive")^[3] left open the question as to whether or not hedge fund indices could be properly classified as "financial indices" for the purposes of the UCITS Directive.

New Level Three Guidelines

The new level three guidelines for eligible hedge fund indices builds upon the criteria applicable to all financial indices, as set out in Article 9(1) of the Implementing Directive. However, the new level three guidelines provide that in order for hedge fund indices to be deemed eligible underlyings for financial derivatives, such indices must be subject to additional requirements regarding publication of their selection and construction methodologies as set out below:

^[1] Directive 85/611/EEC as amended by Directive 2001/107/EC and Directive 2001/108/EC.

^{[2] &}quot;CESR's guidelines concerning eligible assets for investment by UCITS" (CESR/07-044, March 2007)

^[3] Directive 2007/16/EC adopted by the European Commission on 19th March 2007

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	The criteria applicable to all financia indices as set out in the Implementing Directive	The additional criteria set down by the new guidelines in respect of hedge funds
Sufficient diversification	(i) the Index must be composed in a way that price movements or trading activities regarding one component do not unduly influence the performance of the whole index;	No additional requirements imposed.
	(ii) If the index is composed of eligible assets, it should be at least as diversified as set out under the diversification ratios of Article 22a(2) of the UCITS Directive;	
	(iii) If the index is composed of non-eligible assets, the index should be diversified in a way which is <i>equivalent</i> to that provided for in Article 22a(2) of the UCITS Directive.	
	By way of further clarification, the original Level 3 guidelines clarify that if the index is not at least as diversified as under Article 22(a), the fund must combine its underlying assets with the other assets of the fund to ensure that there is sufficient diversification unless the derivative on the index is used for risk-diversification purposes only in which case there would be no "look through" provided that the exposure of the UCITS to individual indices	

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	complies with the 5/10/40% ratios.	
Adequate benchmark	 (i) The index must measure the performance of a representative group of underlyings in a relevant and appropriate way; (ii) The index must be 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 of the index must be sufficiently liquid, which allows users to replicate the index, if necessary. 	In addition: (i) The methodology must provide for the selection and re-balancing of components on the basis of predetermined rules and objective criteria; (ii) The index must not be influenced by any payments made to the provider; and (iii) The methodology must ban any "backfilling practice", (that is to say, any retrospective changes to previously published index values)
Published in an appropriate manner	 (i) the publication process of the index must rely 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; and (ii) material information on matters such as index calculation, rebalancing methodologies, index changes or any operational difficulties in providing timely or accurate information must be provided on a wide and timely basis. 	A UCITS must also carry out appropriate "due diligence" measures. This includes consideration by the UCITS of the "quality" of the index below. Such due diligence measures include the assessment of the quality of the index. In assessing the quality of the index, the UCITS fund must take into account as a minimum, as outlined in the guidelines: (a) the comprehensiveness of the index methodology (including whether or not the methodology contains an adequate explanation of subjects such as the weighting

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and classification of components and the treatment of defunct components and whether or not the index represents an adequate benchmark), (b) the availability of information about the index (e.g. is there a clear description of the index, whether or not the index subject to an audit, the frequency of publication of the audit), and (c) matters relating to the treatment of index components (including the procedures by which the index provider carries out due diligence of the nav calculation process of the index, the level of details about the index components and their navs and the diversification of the index). The UCITS must keep a record of its assessment.

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