

**COMMISSION de SURVEILLANCE
du SECTEUR FINANCIER**

In case of discrepancies between the French and the English text, the French text shall prevail

Luxembourg, 19 February 2008

To all Luxembourg undertakings for collective investment and to all those that take part in the functioning and control of these undertakings

CIRCULAR CSSF 08/339

as amended by Circular CSSF 08/380

Re: Guidelines of the Committee of European Securities Regulators (CESR) concerning eligible assets for investment by UCITS

Ladies and Gentlemen,

This circular draws the attention of UCITS subject to Part I of the amended Law of 20 December 2002 relating to undertakings for collective investment to the publication of the following guidelines published by the Committee of European Securities Regulators (“CESR”):

- 1) *CESR’s guidelines concerning eligible assets for investment by UCITS – March 2007, Ref.: CESR/07-044. The document has been updated by Circular CSSF 08/380.*
- 2) *CESR’s guidelines concerning eligible assets for investment by UCITS – The classification of hedge fund indices as financial indices – July 2007, ref.: CESR/07-434.*

These documents are appended to this circular, and are moreover available on the CESR website: <http://www.cesr.eu>.

CESR's guidelines should be read in conjunction with the provisions of Commission Directive 2007/16/EC of 19 March 2007 implementing Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended, as regards the clarification of certain definitions.

Directive 2007/16/EC purports to clarify certain definitions of Directive 85/611/EEC, as amended, concerning eligible assets for investment by UCITS in order to ensure uniform application of this Directive throughout the European Union.

Directive 2007/16/EC has been transposed into Luxembourg law through Grand-ducal regulation of 8 February 2008 concerning certain definitions of the amended law of 20 December 2002 relating to undertakings for collective investment. This regulation has been published in *Mémorial A* – No 19 of 19 February 2008.

In relation to the provisions of Directive 2007/16/EC and Grand-ducal regulation of 8 February 2008, the guidelines issued by CESR in the document "*CESR's guidelines concerning eligible assets for investment in UCITS*" provide additional clarifications relating to eligible assets for investment by UCITS covered by Directive 85/611/EEC, as amended.

Point 23 of "*CESR's guidelines concerning eligible assets for investment by UCITS*" provides further details in relation to Article 10 of Directive 2007/16/EC on transferable securities and money market instruments embedding derivatives. It is important to note in this context that UCITS are responsible for assessing, where applicable, whether these transferable securities and money market instruments embed a derivative.

Special attention should be paid to point 26 of “*CESR’s guidelines concerning eligible assets for investment by UCITS*” which provides further details on the first two indents of Article 41(1)e) of the amended Law of 20 December 2002 relating to undertakings for collective investment.

The above document defines in particular the factors that can be used to assess whether the supervision to which a collective investment undertaking must be subject is equivalent in order to qualify as an eligible undertaking for collective investment in the context of the investment policy of a UCITS.

The guidelines issued by CESR in the document “*CESR’s guidelines concerning eligible assets for investment by UCITS – The classification of hedge fund indices as financial indices*” provide further specific details on the eligibility of hedge fund indices as underlying instruments of derivatives. Moreover, this document specifies that when gaining exposure to a hedge fund index, UCITS must carry out appropriate due diligence. This includes consideration of the quality of the hedge fund index by the UCITS.

All supervisory authorities members of CESR committed to apply these CESR guidelines.

UCITS shall thus take into account these guidelines when assessing whether a specific financial instrument can be considered as an eligible asset for investment within the meaning of the relevant provisions of the amended Law of 20 December 2002, as further specified in Grand-ducal regulation of 8 February 2008.

The guidelines issued by CESR are applicable as from the entry into force of Grand-ducal regulation of 8 February 2008.

UCITS already set up at the time of the implementation of the guidelines issued by CESR benefit from an extension until 23 July 2008 at the latest to comply with these guidelines.

Yours sincerely,

COMMISSION DE SURVEILLANCE DU SECTEUR FINANCIER

Simone DELCOURT
Director

Jean-Nicolas SCHAUS
Director General

Annexes :

Annexe I: *CESR's guidelines concerning eligible assets for investment by UCITS – March 2007, Ref.: CESR/07-044*
The document has been updated by Circular CSSF 08/380.

Annexe II: *CESR's guidelines concerning eligible assets for investment by UCITS – The classification of hedge fund indices as financial indices – July 2007, Ref.: CESR/07-434*



THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-044

CESR's guidelines concerning eligible assets for investment by UCITS

March 2007



INDEX

Overview	p. 3
Definitions	p. 5
The guidelines	p. 6



OVERVIEW

Introduction

1. The UCITS Directive lays down a set of rules concerning what financial instruments a UCITS can invest in ("eligible assets"). 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 assets¹.

Process

4. Having received the mandate, CESR proceeded to carry out two rounds of public consultation, including open hearings. As part of this process, two documents were published (available on CESR's website):
 - CESR's advice on clarification of definitions concerning eligible assets for investments of UCITS – consultation paper (March 2005)²; and
 - CESR's draft advice on clarification of definitions concerning eligible assets for investments of UCITS – 2nd consultation paper (October 2005)³.
5. Following this period of consultation, CESR published its final advice to the Commission in January 2006⁴, together with a feedback statement⁵. The advice set out suggested measures that could be adopted at "level 2" and "level 3"⁶.
6. Preparation of the advice was undertaken by the Expert Group on Investment Management. The Group is chaired by Mr Lamberto Cardia, Chairman of the Italian securities regulator, the Commissione nazionale per le società e la Borsa (CONSOB). The Expert Group set up two working sub-groups on this issue, co-ordinated by Mme Pauline Leclerc-Glorieux from the AMF and Mr Dan Waters from the FSA. The Expert Group is

¹ Available at http://ec.europa.eu/internal_market/securities/docs/cesr/final-mandate-clarification_en.pdf.

² CESR/05-064b.

³ CESR/05-490b.

⁴ "CESR's advice to the European Commission on clarification of definitions concerning eligible assets for investments of UCITS" (CESR/06-005, January 2006).

⁵ "CESR's advice to the European Commission on clarification of definitions concerning eligible assets for investments of UCITS – feedback statement" (CESR/06-013, January 2006).

⁶ 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.



assisted by the Consultative Working Group on Investment Management composed of sixteen market practitioners and consumers' representatives.

7. The Commission has considered CESR's advice, and an implementing Directive has been adopted by the Commission on 19 March 2007.

Level 3 guidelines

8. CESR has compared the text of the implementing Directive with its advice to the Commission, and has decided to adopt at level 3 guidelines covering the text which was not included in the implementing Directive (for material classified both as level 2 and level 3 in the advice).
9. Much of the wording of the level 3 guidelines is identical to that included in CESR's final advice to the Commission. Where this is the case, the guidelines can be read in conjunction with that advice. However, in some areas changes have had to be made to reflect the wording used in the implementing Directive. In these cases the advice may provide useful background information.

Next steps

10. CESR members will bring the implementing Directive and these guidelines into effect as a single package of measures. This will be by March 2008 at the latest.
11. One area of potential level 3 material remains outstanding, relating to the classification of hedge fund indices as eligible assets for investment by UCITS. CESR is currently consulting on this issue, and if appropriate, will issue additional level 3 guidelines in mid-2007.



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 the Directive adopted by the Commission on 19 March 2007 on the eligible assets under UCITS Directive.
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. Where possible, the level 3 guidelines have been cross-referenced to the relevant article in the implementing Directive.

17. Article 2 - Transferable securities

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
2(1)(a)	A partly paid security must not expose the UCITS to loss beyond the amount to be paid for it.
2(1)(g)	The security's risks and their contribution to the overall risk profile of the portfolio must be assessed on an ongoing basis.
2(1)	<p>Where information is available to the UCITS that would lead it to determine that a transferable security could compromise the ability of the UCITS to comply with Article 37 of Directive 85/611/EEC, the UCITS must assess its liquidity risk.</p> <p>The liquidity risk is a factor that the UCITS must consider when investing in any financial instrument in order to be compliant with the portfolio liquidity requirement to the extent required by Article 37. In taking this prudent approach, the following are examples of the matters a UCITS may need to consider:</p> <ul style="list-style-type: none"> • the volume and turnover in the transferable security; • if price is determined by supply and demand in the market, the issue size, and the portion of the issue that the asset manager plans to buy; also evaluation of the opportunity and timeframe to buy or sell; • where necessary, an independent analysis of bid and offer prices over a period of time may indicate the relative liquidity and marketability of the instrument, as may the comparability of available prices; • in assessing the quality of secondary market activity in a transferable security, analysis of the quality and number of intermediaries and market makers dealing in the transferable security concerned should be considered. <p>In the case of transferable securities which are not admitted to trading on a regulated market as defined in Article 19(1) of Directive 85/611/EEC, liquidity cannot automatically be presumed. The UCITS will therefore need to assess the liquidity of such securities where this is necessary to meet the requirements of Article 37.</p> <p>If the security is assessed as insufficiently liquid to meet foreseeable redemption requests, the security must only be bought or held if there are sufficiently liquid securities in the portfolio so as to be able to meet the requirements of Article 37.</p>

	In the case of transferable securities which are not admitted to trading on a regulated market as defined in Article 19(1), negotiability cannot automatically be presumed. The UCITS must assess the negotiability of securities held in the portfolio, with a view to ensuring compliance with the requirements of Article 37.
2(2)	UCITS may not make investments in closed end funds for the purpose of circumventing the investment limits provided for UCITS by Directive 85/611/EEC.
2(2)(b)(ii)	<p>In assessing whether the corporate governance mechanisms for funds in contractual form are equivalent, the following factors are indicators which can be used as a guidance:</p> <p>Unit holders' rights. The contract on which the fund is based should provide for:</p> <ul style="list-style-type: none"> • right to vote of the unit holders in the essential decision making processes of the fund (including appointment and removal of asset management company, amendment to the contract which set up the fund, modification of investment policy, merger, liquidation); • right to control the investment policy of the fund through appropriate mechanisms. <p>It is understood that the assets of the fund should be separate and distinct from that of the asset manager and the fund will be subject to liquidation rules adequately protecting the unit holders.</p>

18. Article 3 - Instruments normally dealt in on the money market

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
3(1)	<p>CESR's view is that there is no scope for gaining exposure to precious metals through investment in money market instruments.</p> <p>CESR's view is that Article 42 of Directive 85/611/EEC prohibits the short selling of money market instruments by a UCITS.</p> <p>CESR's view is that money market instruments referred to in Article 19(2)(a) of Directive 85/611/EEC are those instruments that comply with the definition of a money market instrument as set out by Article 1(9) of Directive 85/611/EEC (i.e. are normally dealt in on the money market and fulfil the requirements of liquidity and accurate valuation), but do not, however, fall in the categories defined by Article 19(1)(a) to (d) or (h).</p>
3(2)	Treasury and local authority bills, certificates of deposit, commercial paper, and banker's acceptances will usually comply with the criterion "normally dealt in on the money market".

19. Article 4 – Liquid instruments with a value which can be accurately determined at any time

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
4(1)	<p>When assessing the liquidity of a money market instrument (MMI), the following cumulative factors have to be taken into account:</p> <ul style="list-style-type: none"> - at the instrument level: <ul style="list-style-type: none"> • frequency of trades and quotes for the instrument in question; • number of dealers willing to purchase and sell the instrument, willingness of the dealers to make a market in the instrument in question, nature of market place trades (times needed to sell the instrument, method for soliciting offers and mechanics of transfer); • size of issuance/program; • possibility to repurchase, redeem or sell the MMI in a short period (e.g. seven business days), at limited cost, in terms of low fees and bid/offer prices and with very short settlement delay; - at the fund level, the following relevant factors should be considered in order to ensure that any individual MMI would not affect the liquidity of the UCITS at the fund level: <ul style="list-style-type: none"> • unit holder structure and concentration of unit holders of the UCITS; • purpose of funding of unit holders; • quality of information on the fund's cash flow patterns; • prospectuses' guidelines on limiting withdrawals. <p>The fact that some of these conditions are not fulfilled does not automatically imply that the financial instruments should be considered as non-liquid.</p> <p>These elements must ensure that UCITS will have sufficient planning in the structuring of the portfolio and in foreseeing cash flows in order to match anticipated cash flows with the selling of appropriately liquid instruments in the portfolio to meet those demands.</p>
4(2)	<p>With respect to the criterion "value which can be accurately determined at any time", if the UCITS considers that an amortization method can be used to assess the value of a MMI, it must ensure that this will not result in a material discrepancy between the value of the MMI and the value calculated according to the amortization method. The following UCITS/MMI will usually comply with the latter principles:</p> <ul style="list-style-type: none"> • MMI with a residual maturity of less than three months and with no specific sensitivity to market parameters, including credit risk; or • UCITS investing solely in high-quality instruments with as a general rule a maturity or residual maturity of at most 397 days or regular yield adjustments in line with the maturities mentioned before and with a weighted average maturity of 60 days. The requirement that the instruments be high-quality instruments should be adequately monitored, taking into account both the credit risk and the final maturity of the instrument. <p>These principles along with adequate procedures defined by the UCITS should avoid the situation where discrepancies between the value of the</p>

	MMI as defined at Level 2 and the value calculated according to the amortization method would become material, whether at the individual MMI or at the UCITS level. These procedures might include updating the credit spread of the issuer or selling the MMI.
4(3)	Where the presumption of "liquidity" and "accurate valuation" cannot be relied upon, the MMI should be subject to an appropriate assessment by the UCITS.

20. Article 5 - Instruments of which the issue or issuer is regulated for the purpose of protecting investors and savings

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
5(1)	It remains the responsibility of the UCITS to ensure whether a money market instrument (MMI) that is not dealt in on a regulated market is an eligible asset.
5(2)(b)	CESR's view is that regular updates should normally occur on an annual basis.
5(2)(c)	Such third parties should specialise in the verification of legal or financial documentation and be composed of persons meeting professional standards of integrity.

21. Article 8 – Financial liquid assets with respect to financial derivative instruments

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
8(2)(d)	A UCITS must undertake the risk assessment with the highest care when the counterparty to the derivative is a related party of the UCITS or the credit issuer.
8(4)(a)	<p>For the purpose of applying Article 21(1) of Directive 85/611/EEC in conjunction with Article 19(1)(g) third indent of Directive 85/611/EEC, the criteria "process for accurate and independent assessment of the value of OTC derivatives" means:</p> <ul style="list-style-type: none"> • regarding the accurate assessment of the value of the over-the-counter (OTC) derivative: a process which enables the UCITS throughout the life of the derivative to value the investment concerned with reasonable accuracy at its fair value on a reliable basis reflecting an up-to-date market value; • organization and means allowing for a risk analysis realized by a department independent from commercial or operational units and from the counterparty or, if these conditions cannot be fulfilled, by an independent third party. In the latter case, the UCITS remains responsible for the correct valuation of the OTC derivatives. Lastly, this organization of the UCITS implies that risk limits are to be defined.
8(4)(b)(i)	The UCITS remains responsible for the correct valuation of OTC derivatives

	and must, inter alia, check that the independent third party can adequately value the types of OTC derivatives it wishes to conclude.
8(4)(b)(ii)	CESR's view is that "independent" and "adequately equipped" in this context mean a unit which has the adequate means (both human and technical) to perform this valuation. This implies that the UCITS use its own valuation systems, which can however be provided by an independent third party. This excludes the use of valuation models provided by a party- related to the UCITS (such as a dealing room with which OTC derivatives are concluded) which have not been reviewed by the UCITS. This also excludes the use of data (such as volatility or correlations) produced by a process which has not been qualified by the UCITS.
8(5)	CESR's view is that eligible assets exclude non-financial indices.

22. Article 9 – Financial indices

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
9(1)	Indices based on financial derivatives on commodities or indices on property may be eligible provided they comply with the criteria set down for financial indices.
9(1)(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.
9(1)(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.

23. Article 10 - Transferable securities and money market instruments embedding derivatives

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
10	Collateralized debt obligations (CDOs) or asset backed securities using derivatives, with or without an active management, will generally not qualify as structured financial instruments (SFIs) embedding derivatives, except if: <ul style="list-style-type: none"> • they are leveraged, i.e. the CDOs or asset backed securities are not limited recourse vehicles and the investors' loss can be

	<p>higher than their initial investment; or</p> <ul style="list-style-type: none"> • they are not sufficiently diversified. <p>Where a product is structured as an alternative to an over-the-counter (OTC) derivative, its treatment should be similar to that of the OTC derivative instrument, if the consistency of the Directive provisions is to be ensured. This will be the case for tailor-made hybrid instruments, such as a single tranche CDO structured to meet the specific needs of a UCITS, which should be considered as embedding a derivative from the Directive point of view. Such a product offers an alternative to the use of an OTC derivative, for the same purpose of achieving a diversified exposure with a pre-set credit risk level to a portfolio of entities.</p> <p>CESR's view is that the following list of SFIs, which is illustrative and non-exhaustive, could be assumed by a UCITS to embed a derivative:</p> <ul style="list-style-type: none"> • credit linked notes; • SFIs whose performance is linked to the performance of a bond index; • SFIs whose performance is linked to the performance of a basket of shares with or without active management; • SFIs with a nominal fully guaranteed whose performance is linked to the performance of a basket of shares, with or without active management; • convertible bonds; and • exchangeable bonds. <p>UCITS using SFIs embedding derivatives must respect the principles of the Directive 85/611/EEC. These include:</p> <ul style="list-style-type: none"> - embedded derivatives may never be used to circumvent the principles and rules set out in the Directive (Recital 13 of Directive 2001/108/EC); - in compliance with the third indent of Article 21(3) of Directive 85/611/EEC, "when a transferable security or money market instrument embeds a derivative, the latter must be taken into account when complying with the requirements of (Article 21)". As a consequence, the UCITS must: <ul style="list-style-type: none"> • employ "a risk-management process which enables it to monitor and measure at any time the risk of the positions and their contribution to the overall risk profile of the portfolio" (Article 21(1)); • have a global exposure relating to derivative instruments that does not exceed the total net value of its portfolio (Article 21(3)); • comply with all the investment limits set by Article 22 and Article 22a of Directive 85/611/EEC: "A UCITS may invest ... in financial derivative instruments provided that the exposure to the underlying assets does not exceed in aggregate the investment limits set laid down in Article 22" (Article 21(3)). More specifically: <ul style="list-style-type: none"> - UCITS using SFIs embedding derivatives should refer to the
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	<p>Commission Recommendation 2004/383/EC of 27 April 2004 on the use of financial derivative instruments by UCITS in order to comply with the risk spreading rules required by Article 22 of the Directive, as this Recommendation sets out how the underlying assets of financial derivative instruments should be taken into account when assessing compliance with the risk limits set by the above-mentioned article; and</p> <ul style="list-style-type: none"> - embedded derivatives will generally not be taken into account when calculating counterparty limits, except if these products enable the issuer of the hybrid instrument to pass the counterparty risk of underlying derivatives to the UCITS. <p>It is the responsibility of the UCITS to check that investment in hybrid instruments embedding derivatives complies with these requirements. The nature, frequency and scope of checks performed will depend on the characteristics of the embedded derivatives and on their impact on the UCITS, taking into account its stated investment objective and risk profile.</p> <p>Where the UCITS considers that this impact is not significant, controls can be tailored accordingly. In such cases, the UCITS may for instance rely on predefined investment limits to ensure compliance with the above mentioned principles.</p>
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24. Article 11 - Techniques and instruments for the purpose of efficient portfolio management

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
11	<p>Techniques and instruments relating to transferable securities and money market instruments include, but are not limited to, collateral under the provisions of Directive 2002/47/EC on financial collateral arrangements, repurchase agreements, guarantees received, and securities lending and securities borrowing. The requirement to comply with the provisions of Article 21 of Directive 85/611/EEC imply in particular that if UCITS are authorized to use repurchase agreements or securities lending or securities borrowing to generate leverage through the re-investment of collateral, these operations must be taken into account to calculate the global exposure of the UCITS.</p> <p>Regarding the coherence between Article 19 and Article 21(2) of Directive 85/611/EEC, CESR notes that currently only financial derivative instruments are subject to both articles. Therefore, in accordance with the wording of Article 21(2), financial derivative instruments used under Article 21(2) must comply simultaneously with the provisions of Article 19. However, financial derivative instruments used under provisions of Article 19 are not automatically subject to the "efficient portfolio management" requirement of Article 21(2).</p> <p>Article 28 of Directive 85/611/EEC defining the obligations concerning the information to be supplied to unit holders by UCITS implies that techniques and instruments relating to transferable securities and money market instruments can not result in a change of the fund's declared investment objective or add substantial supplementary risks in comparison to the concerned fund's general risk policy as described in its</p>

applicable sales documents.

25. Article 12 – Index replicating UCITS

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
12(2)	A UCITS should provide appropriate information for the subscribers in the simplified prospectus, if the limit for investment in shares and/or debt securities issued by the same body is raised above 20% and to a maximum of 35% for a single issuer, in compliance with Article 22a(2) of Directive 85/611/EEC, in order to justify exceptional market conditions.

26. Other collective investment undertakings (article 19(1)(e) of Directive 85/611/EEC)

ARTICLE REFERENCE	LEVEL 3 GUIDELINES
n/a	<p>In CESR's view, the following matters can be used by the competent authorities to assess whether a collective investment undertaking is subject to supervision "equivalent to that laid down in Community law", as provided in Article 19(1)(e), first indent of Directive 85/611/EEC. These factors can be used to guide a decision on equivalence:</p> <ul style="list-style-type: none"> • Memoranda of Understanding (bilateral or multilateral), membership of an international organization of regulators, or other co-operative arrangements (such as an exchange of letters) to ensure satisfactory cooperation between the authorities; • the management company of the target collective investment undertaking, its rules and choice of depositary have been approved by its regulator; and • authorisation of the collective investment undertaking in an OECD country. <p>In CESR's view, the following matters can be considered in deciding whether the level of protection of unit holders is "equivalent to that provided for unit holders in a UCITS", as referred to in Article 19(1)(e), second indent. These factors can be used to guide a decision on equivalence:</p> <ul style="list-style-type: none"> • rules guaranteeing the autonomy of the management of the collective investment undertaking, and management in the exclusive interest of the unit holders; • the existence of an independent trustee/custodian with similar duties and responsibilities in relation to both safekeeping and supervision. Where an independent trustee/custodian is not a requirement of local law as regards collective investment schemes, robust governance structures may provide a suitable alternative; • availability of pricing information and reporting requirements; • redemption facilities and frequency; • restrictions in relation to dealings by related parties;



	<ul style="list-style-type: none">• the extent of asset segregation; and• the local requirements for borrowing, lending and uncovered sales of transferable securities and money market instruments regarding the portfolio of the collective investment undertaking.
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THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref: CESR/07-434

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

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

July 2007



CONTENTS

Overview

Definitions

The guidelines



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 assets¹.
4. In order to fulfil the mandate, CESR undertook two rounds of public consultation², and delivered its final advice to the Commission in January 2006³. 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 2007⁵, and at the same time CESR published its accompanying level 3 guidelines⁶.
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.