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Mr Fabrice Demarigny
Secretary General
Committee of European Securities
Regulators (CESR)
11-13, Avenue de Friedland
75008 Paris

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AFG Response to 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?”

Dear Mr Demarigny,

The Association Française de la Gestion Financière (AFG)¹ welcomes CESR consultation concerning eligible assets for investment by UCITS, a question that is of utmost importance for the asset management industry.

For several years now, AFG has been actively contributing to European discussions and consultations relating to the UCITS Directive, either directly or through the European Fund and Asset Management Association (EFAMA).

¹ The Association Française de la Gestion financière (AFG)¹ represents the France-based investment management industry, both for collective and discretionary individual portfolio managements. Our members include almost 400 management companies and more than 700 investment companies.

They are entrepreneurial or belong to French or foreign banking, insurance or asset management groups. AFG members are managing more than 2500 billion euros in the field of investment management, making in particular the French industry the leader in Europe in terms of financial management location for collective investments (with nearly 1500 billion euros managed, i.e. 22% of all EU investment funds assets under management, wherever the funds are domiciled in the EU) and the second at worldwide level. In the field of collective investment, our industry includes – beside UCITS – the employee savings schemes funds and products such as regulated hedge funds/funds of hedge funds and a significant part of private equity funds. AFG is of course an active member of the European Fund and Asset Management Association (EFAMA) and of the International Investment Funds Association (IIFA).

GENERAL COMMENTS:

1. In its different responses to CESR's consultations on the clarification of definitions concerning eligible assets for investments of UCITS, on the eligibility of hedge funds indices, as well as in its response to the European Commission Hedge Funds Expert Group, AFG has always refused to turn down the eligibility of UCITS investments of those Hedge Funds Indices, which might fully comply with the criteria of the directive established at "Level 2 and Level 3".

This position is a part of a more global one: the list of assets eligible to UCITS should be regularly (and not every 15 years) expended to take into account financial innovation. This being said, we are aware of the current existing dispute on potential biases in HFI and in databases used to elaborate them, especially impacting their representativity. Therefore we supported the expert group's position on alternative investment management which expressed doubts on the existing indices' reliability and performance. We subsequently reiterated reservations in our response to CESR's Consultation, underlying that some current existing indices might not comply with the principles of the UCITS directive.

2. AFG has also always stated that equivalent products should be equally treated. HFIs are in many ways similar investments than regulated Hedge Funds; therefore a level playing field between the two types of products is essential for us, in order to avoid any discriminatory policy between regulated products. The absence of global European rules in the investment management field seriously damages cross-border selling, we called for a European regime for alternative regulated funds (including of course Funds of Hedge Funds), providing them with a "passport". UCITS investing in Hedge Funds and Funds of Hedge Funds should not be treated differently.

In fact, it cannot reasonably be accepted that HFIs could benefit from retailing advantages associated with UCITS funds if regulated funds of hedge funds cannot also benefit from any European label and the associated marketing straightforwardness. Otherwise, similar products in terms of their financial planed objectives would be subject, without any reason, to two different marketing regimes: a liberal one versus a restrictive one.

From our standpoint, this point should be part of the global adjustments announced to the UCITS Directive. As of today, it is unfortunately still not the case and we deeply regret the postponement of reflexion on a ‘European label’, which would naturally have to tackle with the issue of the level playing field between Alternative Funds and funds investing in HFIs.

3. At a point of time when the UK regulator, following the road opened by a significant number of its continental counterpart, has expressed the wish to permit the implementation of a new regulated vehicle (FAIFs) allowing “retail” customers to gain access into non regulated alternative schemes, we strongly recommend CESR to focus on competition issues.

We surely understand that CESR’s mandate, in the way consultation reinforces it, only covers clarification of eligible assets notion and not the topic of the alternative investment funds. However, the need for a level playing field objective between equivalent products does not appear achievable to us without asking for the status concerning alternative investment funds coincidentally with HFIs eligibility issue. CESR should deliver that message to the Commission.

ANSWERS TO CESR'S SPECIFIC QUESTIONS

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?

There is no clear and easy answer to the question.

As diversification rules are one of the most important and powerful mean to avoid the risk due to “over concentration”, some of our members believe that a “5/10/20/40 – like” rule should be applied to HFIs.

Other members, in accordance with several empirical studies, believe that holding between 5 to 10 underlying provides most of the diversification benefits.

Some of our members highlight that diversification is not the major problem. The number of funds in an index is not the sole determinant of the risk of such an index, especially in a non “mean variance” world. They think that diversification rules should be identical to those imposed to all UCITS funds. For them the critical question is how to choose HF that are included in an index.

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)?

Given the non public nature of HF and the complexity of some strategies, a high level of transparency should be required. The majority of our members is in favor of a total and free of charge transparency. Understandable information must be included into the funds' prospectus.

One of our members wants to underline that indices do not reflect a market, but only the index provider's view on the performance of a strategy.

Q3: Do you have any other comments on these proposed level 3 guidelines?

No

Q4: Respondents are invited to provide their comments on the above, taking into account that the UCITS always needs to properly value its portfolio and assess the risks therein.

Even if some of our members believe that representativity does not depend on the size of the sample compared to the universe, one of them thinks that a monetary figure is not appropriate to assess the weighting of hedge funds. The key constituents are the level of risks in the portfolio, as it is the determining factor of sensitivity to market moves. Any index should disclose both weighting in nominal value and risks, based on a VaR approach, with details of

the key parameters that are relevant to describe the index, and allow for comparison between the products.

Another part of AFG members are of the opinion that to ensure equal treatment of HFIs and Funds of Hedge Funds – as well as to improve information on breadth of coverage – HFI providers should be subject to the same information and audit requirements as Funds of Hedge Funds. Specifically, the HFI provider should supply the UCITS with a complete risk overview on the basis of information received from index constituents.

Q5: Please provide your comments on these proposed level 3 guidelines.

Our members agree with Boxes 2 and 3. However, and even if our members did not provide us with feedback on this particular topic, we think that, as mentioned into the EFAMA reply, it is not clear how UCITS can discharge its obligations to “verify” and “confirm”.

One of our members thinks that the treatment of defunct funds (as well as new entrants) may skew the presentation of performances that become “pro forma”. There is significant reluctance to accept pro forma historical performances as an indication of the managers’ skill.

Q6: Respondents are invited to provide their comments on the above.

As we already mentioned in the first consultation on HFIs, a lot of existing indices are not, for the time being, fully compliant with UCITS directive, especially in term of selection bias. In order to avoid such biases, CESR must provide adequate guidelines which aim at preventing UCITS from gaining exposure to HFIs which receive payments from hedge funds. Indeed, such practices (“fee-sharing”) would potentially create a bias in favour of non-performing hedge funds.

Some of our members think regulators should punish such practices.

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?

Q8: Please provide your comments on this proposed level 3 guideline.

On this specific topic, some of our members argue that, from a “level playing field” point of view, HFIs providers should be regulated with as stringent constraints as Funds of Funds managers are. Such requirement would include appropriate authorisations and leave the regulator the choice of accepting or refusing the Index Provider. It seems particularly incomprehensible for them that a product built by an unregulated third party could be directly or indirectly sold to retail whereas regulated products are subjected to different constraints. Clearly it should include at least an annual audit as this is compulsory for regulated FoHF.

On the other hand, others of our members notice that such an obligation is not required for other indices and do not understand why HFIs have to be considered in another way, as far as the UCITS using HFIs is itself regulated like all other UCITS funds. These members support the point concerning reputation risk: if the methodology is clearly published in an appropriate manner, there are sufficient incentives for the index provider to follow its methodology. A 'deviation' would put it in a situation of reputation risk

Q9: Please provide your comments on these proposed level 3 guidelines.

One of our members argues that the problem of investibility is more an issue for the bank that provides derivatives based on Hedge Funds and that there is no need to regulate this. In practice, we believe that indices will be made of investable constituents in order to allow banks to hedge them.

Some of our members do not believe that it is necessary to provide details of components. However, others believe that details should include the components, the weighting in monetary value and all the risk data for each component.

Q10: Please provide your comments on this proposed level 3 guideline.

Our members have differing opinions on that subject.

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?

See Q12

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

One of our members believes that a weekly publication is possible and would be in line with the UCITS Directive.

Other members underline that a monthly index publication matches markets standards.

From our point of view, the most important question is how to manage the asymmetry between the valuation of the HFI and the valuation of its underlying.

On this critical point, we want to highlight and bring our support to the French regulation for funds of hedge funds which extended to 60 days the limit between the notice date and the payment date for FoHF in order to allow managers to publish accurate NAV and to avoid systemic risk due to massive redemptions.

Q13: Should CESR carry out further work on this issue?

One of our members believes that no further debate is needed whereas others believe that further work is needed.

From another point of view, expressed by a few members, all data that permit the investor to understand risk, returns, strategy put in place, objectives, etc... must be clearly disclosed in the prospectus. It is very important, from this point of view, that investors have all the data to make an informed choice and choose the appropriate investments.

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?

For our members who develop managed account platforms (MAP), it is the best way to build HFIs without inherent operational risk. Moreover, investable indices are less biased than non investable indices. They do not ask the regulators to provide any guidelines.

For other members, even if MAP solve some HFIs biases, MAP carry other disadvantages (such as the difficulty to duplicate the exact returns of strategies due to the necessity to maintain liquidity...) and so it is not the ultimate solution. However, they do not ask regulators to provide additional guidelines as long as they will not get any advantages.

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

We can only stress again that urgent work is needed on a European passport, and not only so-called “private placement rules”, for regulated Hedge Funds and regulated Funds of Hedge Funds. As long as it is not done by the Commission, the task it has assigned to CESR on the eligibility of Hedge Funds Indices will prove to be a bone of contention for our industry, opposing artificially two rightful views : those who rightly want to expand the list of eligible assets to keep in pace with innovation and offer access to their specific advantages, and those, who are also right, who think that, to keep a level playing field, the extension could and should be done if Hedge Funds and funds of Hedge Funds benefit also from the marketing plus of the current UCITS directive.

If you wish to discuss the contents of this letter with us, please contact myself at 01 44 94 94 14 (e-mail: p.bollon@afg.asso.fr), Stephane Janin, Head of International Affairs Division, at 01 44 94 94 04 (e-mail: s.janin@afg.asso.fr) or Bertrand Gibeau, Asset Management Expert, at 01 44 94 94 31 (e-mail: b.gibeau@afg.asso.fr).

Yours sincerely,

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