

New Guidelines Permitting European Mutual Funds to Invest in Hedge Fund Indices

The Committee of European Securities Regulators (“CESR”) has issued guidelines (the “Guidelines”) on the eligibility of hedge fund indices (“HFIs”) for UCITS, the acronym for authorised funds which meet certain criteria and which can be sold across the EU. The guidelines follow consultation on this topic over the last few months.

The Guidelines now permit investment by UCITS in HFIs subject to the following requirements:

- To fall under the classification of a “financial index”, a hedge fund index must be sufficiently diversified, represent an adequate benchmark and be published in an appropriate manner (requirements already in place for financial indices).
- 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;
 - if the index provider accepts payments from potential index companies for the purpose of being included in the index; or
 - if the methodology of the index allows retrospective changes to previously published index values (“backfilling”).
- When gaining exposure to a hedge fund index by means of an OTC directive, a UCITS must comply with the relevant requirements laid down in the UCITS Directive itself and in the implementing Directive of 2007, including requirements about counterparties, valuation and the ability to close a position, risk management and valuation processes, and risk exposure.
- 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 making that assessment, the UCITS must take into account at least:
 - the comprehensiveness of the index methodology;
 - the availability of information about the index; and

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- 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.

These Guidelines must be implemented by CESR members, the regulatory authorities of the EU states, by March 2008 when the door will be open to funds to invest in HFIs. As with all new investment opportunities momentum may be slow to build and fund operators may determine that the HFI as an investment is best left outside the retail market, but time will tell.

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