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CONTENTS

THE USE OF FINANCIAL INDICES BY UCITS FUNDS

Financial indices have traditionally been used by funds for benchmarking investment performance and for replication purposes but are now being used in more complex and innovative ways, typically through the use of financial derivative instruments and in some cases to gain exposure to investments that may otherwise be ineligible for investment. The purpose of this briefing is to set out the circumstances under which a UCITS must seek approval from the Financial Regulator before using a particular index and to explain the type of information the Financial Regulator requires in order to issue such an approval.

When an index submission is not required

The primary diversification rule for a UCITS is that it may only invest up to 10% of its net assets in transferable securities or money market instruments issued by the one issuer. In addition, the total value of such investments held with any one issuer in which the UCITS invests more than 5% must be less than 40% of the net asset value of the UCITS. This rule is commonly known as the 5/10/40 rule. Notwithstanding this general rule, a UCITS may[1] replicate a financial index comprised of equity and debt instruments and invest up to 20% of its net assets per issuer.[2] The 5/10/40 rule no longer applies in this situation.

A UCITS wishing to use a financial index whether for replication, investment or efficient portfolio management purposes is not required to seek pre-clearance from the Financial Regulator to do so where:

- the constituents of the index meet the diversification requirements of the 5/10/40 rule or do so on a "look through" basis whereby the exposure of the individual constituents of the index are consolidated with the rest of the UCITS portfolio; and
- the constituents of the index are eligible assets.

In this case no pre-approval of the use of the index is required by the Financial Regulator. However, the UCITS must confirm to the Financial Regulator that the index meets these requirements and the investment criteria listed below.

Also, where the index is used solely as a performance benchmark the Financial Regulator does not review the index.

[1] where its constitutional document permits

[2] and 35% for a single issuer in certain exceptional circumstances

When an index submission is required

Unless the use of the index satisfies the requirements above, a submission must be made to the Financial Regulator seeking its prior approval of the use of an index. For example, if the UCITS proposes to use an index comprised of eligible assets but it is not possible for the UCITS to invest directly in the underlying assets of the index without breaching the 5/10/40 rule approval of the use of the index is needed. Similarly, where it is not possible for the UCITS to invest directly in the underlying constituents of the index (for example, an index based on commodities or property) or the UCITS proposes to gain exposure to an index through the use of financial derivative instruments an application for approval of the index must be made to the Financial Regulator.

The application must be made in advance of the application for authorisation of the UCITS and so promoters need to build into their timetable for bringing the fund to launch the need to pre-clear the use of the index in these circumstances.

Index investment criteria

The submission made to the Financial Regulator must demonstrate that the index meets four basic requirements in order to be an acceptable index.

The index must:

- be sufficiently diversified;
- represent an adequate benchmark for the market to which it refers;
- be published in an appropriate manner; and
- be independently managed from the management of the UCITS.

To the extent that a UCITS uses multiple indices each index must meet these requirements.

The guidance note 2/07 (the "Guidance Note") issued by the Financial Regulator expands upon the way in which the criteria need to be met and includes a checklist in its appendix to assist in the preparation of any submission to the Financial Regulator. Any technical and marketing document issued by the index provider should also accompany the submission. The submission should address each of the four headings in turn and provide sufficient detail to allow the Regulator to assess the submission in relation to each particular aspect of the criteria.

Diversification

The index must be sufficiently diversified. Each individual constituent of an index may not have a weighting greater than 20% of the UCITS net asset value. On a case by case basis, and where an adequate written explanation is provided to the Financial Regulator, one constituent only of the index may have an individual weighting of up to 35% of the net asset value of the UCITS (for example, because of market dominance or exceptional market conditions).

Adequate Benchmark

The submission must include the rationale as to how the index achieves the objective of being a benchmark for the market to which it refers. The index must measure the performance it is purporting to represent and in order to satisfy this requirement the methodology used to construct the index needs to be adequately described. Details of the selection criteria for constituents of the index, price collection procedures, asset allocation rules and details on the re-balancing of the index and its constituents need to be included in the submission. The submission must address how the index is revised and rebalanced periodically to ensure that it continues to reflect the performance of the assets to which it refers and to ensure that the concentration limits are satisfied. It is acknowledged however that passive breaches may occur periodically due to market movements but provided that these breaches are of a limited duration and the rebalancing of the index occurs on a frequent basis these breaches will not be problematic. Details of how the index calculation methodology is verified also needs to be included in this section of the submission.

Publication

The index must be published in an appropriate manner so that investors may freely, easily and continually access relevant material about the index (such as its constituents, calculation and the rebalancing methodology). This information can, for example, be provided via the internet.

Independently managed

To the extent that there is any relationship between the management of the UCITS and the index sponsor the Financial Regulator will need to consider how the index is calculated in an independent environment, free from any external influences. This does not preclude the index provider and the manager of the UCITS forming part of the same economic group but the submission must address what arrangements are in place to ensure the adequate management of conflicts of interests in this situation.

Disclosure requirements

Where an index is used for efficient portfolio management purposes details of the index do not need to be disclosed in the prospectus. Where an index is used for investment purposes the prospectus must include sufficient disclosure to allow prospective investors to understand the market the index is representing, why it is being used as part of the investment strategy and how the investment will be made (i.e. directly or indirectly through the use of financial derivative instruments).

If the investment strategy is such that it is not possible to specify the particular indices then the prospectus must include sufficient detail on the range and type of indices being used in order to satisfy this requirement.

Hedge fund indices

The Committee of European Securities Regulators ("CESR") issued guidelines in 2007 which confirmed that a hedge fund index can be classified as an eligible financial index. However, certain additional specific criteria need to be satisfied in relation to the use of a hedge fund index as well as it having to meet the criteria referred to above.

The Guidance Note specifies that a hedge fund will fall outside the definition of a financial index unless the methodology of the index provides for the selection and rebalancing of the components on the basis of pre-determined rules and objective criteria. Similarly, a hedge fund index will not be considered an eligible financial index if the index provider accepts payments from potential index components for the purposes of being included in the index as this runs contrary to the principle of objective component selection and the index representing an adequate benchmark for the market to which it refers. Also, if the methodology of the index allows retrospective changes to previously published index values, a practice known as "backfilling", it also cannot be classified as a financial index.

Where a UCITS will gain exposure to a hedge fund index through the use of over-the-counter derivatives it must comply with all of the usual requirements in relation to over-the-counter derivatives relating to the eligibility counterparty, the valuation requirements, UCITS risk management requirements and the risk spreading rules.

In addition, the UCITS must carry out due diligence in relation to the quality of the hedge fund index and keep a record of its assessment. In assessing quality the UCITS must take in to account the following factors:

1. the comprehensiveness of the index methodology, including the weighting and classification of components and whether the index represents an adequate benchmark for the kind of hedge fund to which it refers;
2. the availability of information about the index, including what the index is seeking to represent, whether it is subject to an independent audit, how frequently the index is published and whether this will affect the ability of the UCITS to calculate accurately its net asset value; and
3. matters relating to the treatment of index components, including the level of detail about the index components, their weighting and the due diligence on the calculation procedures of these components.

Conclusion

As a general comment, the Guidance Note sets out in a concise way the requirements of the Financial Regulator in assessing whether an index is likely to be considered an eligible financial index for UCITS purposes. With regard to the clarification issued by CESR in relation to the use of hedge fund indices this enables UCITS, which to date have not been to invest directly in hedge funds, to gain exposure to an index of hedge funds through derivative instruments provided certain criteria are satisfied.

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