Bundesverband Alternative Investments e.V.

OPINION

of the

BUNDESVERBAND ALTERNATIVE INVESTMENTS (BAI e.V.)

on

CESR's 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?"

(Dated February 2007; Ref: CESR/07-045)

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 should be no additional requirements for HFI diversification. In general, hedge funds by themselves are more different from each other than e.g. Bond funds, because they have much higher degrees of investment freedom. Given the same number of arbitrarily selected hedge funds compared to e.g. Bond funds, the funds will be less correlated to each other in the hedge fund index. In that regard, index diversification rules should rather be lower than for traditional indices. Also, potential index diversification criteria may be misleading, e.g. the number of funds, if the funds are highly correlated. If anything, hedge fund indices trying to replicate the whole hedge fund universe ("composite indices"), they should contain funds from the major hedge fund strategies. Unfortunately there is no common agreement with regard to the definition of the major hedge fund strategies, but one could agree on so called relative value or arbitrage funds, equity long short funds, event driven funds as well as global macro and managed futures funds, although the last category is not always considered a hedge fund strategy. If a minimum number of funds is required, Hedge fund strategy specific indices could contain a minimum number of funds which are similar to UCITs diversification rules and thus include minimum five funds.

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)?

The definition of what the index is trying to represent should be made available to the public as a whole. The only problem with this approach is that the hedge fund universe is not clearly defined since hedge funds are private placement vehicles and as such no database contains all relevant funds. This has to be taken into account in judging the representativeness of any hedge fund index. A publication on the publicly accessible part of the index provider's webpage is sufficient. It is expected, that the information will be made available free of charge in order to promote the index. The index provider should not be forced to make publicly available either all the details of the index generation process (detailed index criteria or "index formula") or the index components as such, though. Regulation should not intervene in the aspect of pricing, this should be regulated by the market.

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

No further comments.

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.

If the assets of each index component are published at each index calculation point, performance of the individual hedge funds may be assessed and both information may be in conflict with strict (e.g. US) private placement rules. An aggregated publication of the index component assets should be possible but does not appear helpful. An index representing the largest hedge funds in any strategy may seem to be most representative for the hedge fund market but on the other hand may only contain few currently popular hedge fund strategies and thus e.g. not include small cap or country specific or industry specific hedge funds. Judging the representativeness of an index by the aggregated amount of assets would favour assets weighted over equal or otherwise weighted indices. Also, an asset weighed index may be more risky than an equal weighted index, especially if the underlying largest hedge funds are more volatile than the market.

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

“Objective” in Box 2 is a criterion difficult to fulfil for any index. It should be more precisely formulated to e.g. “transparent and repeatable” criteria and could be further described as “delivering the same results if used by different parties using the same universe of potential index components”.

In Box 3 it is problematic for index providers to make fully public the full methodology of the index including weighting. Whereas the publication of weighting methodology seems to be appropriate it is undue when it comes to publication of individual weights of non-public hedge funds in the index at any calculation point. The problem with making available the full index methodology to the public at large is the fact that this information can not be legally protected against plagiarism. The recent case of the use of the DAX name by banks not willing to compensate Deutsche Börse for this use (see Deutsche Börse AG vs. Commerzbank, Oberlandesgericht Frankfurt dated 13 February 2007, Ref.: 11 U 40/06), shows the problem of making even the DAX values etc. fully public. This information should be made available to UCITS willing to invest in index linked products, though.

Box 3: Index providers should be allowed to publish estimated and preliminary index values, but it is appropriate to request not to change final and official index values and thus disencourage backfilling.

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

Payments of hedge funds to HFI providers should not be prohibited, but HFI providers should make all such payments transparent in general terms without necessary disclosing every commercial detail.

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?

No further comments.

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

Q7/Q8: Internal audits are carried out by most index providers but not external audits. Costs of external audits can be significant if the audit party wants to verify in detail every value of the different indices in the past, therefore the audit should be focused on the index methodology. The auditor should not be required to audit/analyze the information of the (audited) hedge funds in the index or a potential (audited) index tracker fund.. Also, the first audit should be made available earliest for the fiscal year starting after the introduction of the new HFI rules of UCITS. An audit can be required in general but it should be clear that the audit details should not be made public because it may contain very sensible and priviledged information. If anything, only the general audit result (OK or not OK) could be made available to institutional index linked product investors including UCITS.

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

Point 2 in Box 5 is critical, because most hedge funds are acting according to private placement rules and the publication of these details may be violating such rules. Our recommendation: The names of the index components and the weighting methodology should be made available to the institutional investors in index linked products and “index investing” UCITS once a year.

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

It should be made clear that sample tests are sufficient for the audit and a confirmation of every single due diligence quality is not required.

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?

If a minimum frequency is applied, this could be monthly. It should be allowed to allow more frequent index publications, even if these are preliminary or estimates. Hedge funds which do not report at least monthly can be excluded from the indices.

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

No. Banks and other market participants can make a market and quote daily prices for products which are not priced daily which for example is the case for all kinds of real estate related products.

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

UCITS should make reference on the potential scope of derivatives they want to use independent of HFI. Derivatives on HFI will most likely be much less risky than derivatives on many other underlyings already in general approved for UCITS.

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?

No additional rules are necessary.

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

No further comments.

This opinion was issued on the 16 April 2007. Fur any further information on this opinion please contact:

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