CESR Draft Advice on Clarification of Definitions concerning Eligible Assets for Investment of UCITS (ref: CESR/05-490b)

CSFB/Tremont Index LLC comments on CESR's approach to Hedge Fund Indices (Box 14)

1 Introduction

In its draft advice, CESR excludes hedge fund indices as eligible assets for UCITS, for a period of at least 12 months (Box 14, point 2). CESR justifies this view, "given the complexities of hedge fund indices and the fact that they are still developing". In addition, CESR expressed five specific concerns, which it considers hedge fund indices may give rise to, (para 122), namely:

1.1 Survivor bias: CESR's concern is that performance shown by a hedge fund index may only reflect the performance of the funds that survived the investment period and that the performance from funds liquidated before the end of an investment period is removed from the historical index calculation, potentially giving an artificially high impression of performance.

1.2 Selection bias: CESR's concern is that selection bias may be introduced to hedge fund indices, by limiting the possible funds that may be included into the indices, thus resulting in under reporting of unsuccessful hedge funds and over reporting of successful hedge funds.

1.3 Consistency: Concern that the hedge fund sector that the hedge fund index is deemed to be representative of is not consistent.

1.4 Backfilling: The concern that the hedge fund indices will "backfill" valuation data from hedge funds newly included in an index, potentially favouring data from better performing hedge funds.

1.5 Investable vs Non-investable indices: The concern there are differences in treatment of investable and non-investable funds (the latter meaning funds which are closed and do not accept new money from investors).

We provide below our response to CESR's question "do you agree with the approach as suggested in Box 14?" and specifically with respect to its concerns expressed on hedge fund indices.

2 Comments

We disagree with the approach in CESR's draft advice (the "Draft Advice"), which treats hedge fund indices differently from other financial indices for the purpose of financial derivative instruments. Under CESR's interpretation, a financial index is permitted as an eligible underlying financial instrument, if it complies with CESR's criteria set out in Box 14, while a hedge fund index is not permitted, even if it complies with the requirements in Box 14. We believe that non-investable hedge fund indices should be considered as financial instrument similar to other financial indices in assessing eligibility as investments for UCITS. The CSFB/Tremont Investable Hedge Fund Index ("INVX") complies with CESR's criteria, for eligibility of financial indices mentioned in paragraph 121 of CESR's Draft Advice.

We wish to draw CESR's attention to the specific comments CESR makes in its Draft Advice and related commentary:

General comments

2.1 While there is no definition in Art. 19 (1) g of the UCITS Directive of the nature of financial indices, which are eligible as underlying instruments for financial derivative instruments, the most common criteria are those specified in notes 120 and 121 of CESR's Draft Advice. CESR also requires that financial indices have to comply with the criteria set by Art. 22a (1) of the UCITS Directive, which means that financial indices must be sufficiently diversified, represent an adequate benchmark for the market to which they refer to and that they are published in an appropriate manner. INVX meets all of the criteria referred to above.

2.2 In its Level 2 eligibility criteria for financial indices (Box 14), CESR places considerable emphasis on the importance of financial indices being sufficiently diversified if they are to constitute eligible financial instruments. Hedge fund indices are generally highly diversified in terms of the number of underlying hedge funds and investment strategies. INVX e.g. contains sixty constituents across ten different hedge fund sectors (similarly defined as the industry classification used by stock indices). This number of constituents in hedge fund indices is generally higher than comparable numbers in established European stock indices like e.g. DJ STOXX50, DAX, MIB or CAC40.

2.3 In response to CESR's request for examples of established hedge fund indices with clear and objective valuation criteria, we would draw to your attention to INVX, which is an example of an established investable hedge fund index (launched on 1 August 2003). INVX is constructed using clear and objective valuation criteria similar to those typically used in established stock indices and measures the performance of a representative group of hedge funds. In addition, as a general premise index rules are objective, transparent and publicly available in a detailed technical document with full disclosure of the index calculation, selection and rebalance procedures. INVX is based on objective calculation rules and limits the possibility for discretionary decisions to include funds in the index as much as possible. The database on which the index is based is required to be representative of the overall hedge fund universe. The construction rules ensure the index is representative of such database.

2.4 Investors can obtain financial exposure to a hedge fund indices by using a broad range of products, including e.g. structured notes, certificates, shares, special purpose vehicles and life insurance policies. UCITS funds are only one type of a specific delivery of products linked to hedge fund indices among many others. Should UCITS funds be prevented from offering an exposure to hedge fund indices, the other products referred to above will be used as alternatives. The consequence could be that UCITS funds would lose a significant market share to other types of investment products while the demand from retail and institutional investors for this type of product is still growing. Moreover, UCITS funds are regulated products, whilst most of the hedge fund index products referred to above are not. From the perspective of a regulator and for the purpose of investor protection, it should be desirable to have hedge fund index products in a regulated environment and therefore supervised by financial supervisory authorities.

2.5 CESR has expressed concern about the ability of retail investors to understand alternative investment strategies. We believe this concern is not limited to hedge fund indices and should not be a factor.

2.6 Transitional provisions: If CESR's proposals are resolved in a restrictive way, this could mean that some UCITS that have already been approved under the UCITS Directives in EU Member States, would not be in compliance with the UCITS investment restrictions (unless provision were made for these to be "grandfathered" but CESR's Draft Advice warns that "the possible transitional measures can only be of a very limited nature"). Although we understand that no such arrangements have yet been discussed by CESR and/or the Commission, we request that CESR assess the impact of its proposal to exclude hedge fund indices, both in terms of impact on existing products and potential future products, in light of the findings of the cost benefit analysis, which is mandatory for Level 2 measures. We also request CESR to address at this time the uncertainty caused by the lack of clarity in its approach to transitional measures in this area, again in light of the mandatory cost benefit analysis.

Comments in response to CESR's specific concerns concerning hedge fund indices

2.7 We consider CESR's **survivor bias** concern to be unfounded. Survivor [ship] bias typically describes the fact that for a given period of a performance history only data points of surviving members of the population [hedge funds] are considered. This is largely a problem for performance numbers based on databases not so much for indices or in this case investable hedge fund indices. When launching any index one can obviously only include data points of exiting members of the population at this point in time. Investable hedge fund indices behave here no different from e.g. the launch of the DJ STOXX indices which are considered eligible financial indices for UCITS by CESR. After the launch of an index it is imperative that under no circumstances the addition or deletion of members can retrospectively change the historical performance of the index. INVX has objective and clear index rules describing the addition and deletion of member funds at the rebalance and disallowing the retrospective change of historical index performance thus eliminating survivor [ship] bias in its index construction. Furthermore, the index rules describe in detail that the performance of hedge funds that liquidate or "blow up" are kept in the index and thus the potential negative performance is represented in the hedge fund index performance.

This methodology is the same as that being used in most widely accepted equity indices (e.g. DAX, STOXX, S&P 500), which CESR would permit as eligible assets for UCITS. If an index constituent becomes ineligible by bankruptcy or any other index rule, a new index member will be selected according to the index rules and the performance of the old fund is used until its elimination from the index, from which point the relevant factor is the performance of the new constituent at the time it is added to the index.

2.8 We consider CESR's **selection bias** concern to be unfounded. Any index should be representative, objective and based on clear index rules. The use of qualitative or selective quantitative factors (such as e.g. performance or correlation statistics) or other subjective factors is inconsistent with the commonly accepted construction methodologies for indices and should be minimal to avoid minimize selection bias. INVX has objective and clear index rules describing the addition and deletion of member funds minimizing the potential for subjectivity and selection bias. Generally hedge funds are selected based on their assets under management (comparable to the market capitalization for stocks) and their investability (comparable to the free float for stocks).

2.9 We consider CESR's **sector consistency** concern to be unfounded. An index provider typically takes a careful approach and consideration when designing the sector or industry classification and subsequent assignment of members in this case hedge funds. It is important to have a sector classification that is sufficiently defined to represent a particular trading style of hedge funds while ensuring that its member hedge funds and data which is responsible for the sector assignment can be observed and monitored accordingly. INVX assigns hedge funds to one of ten sectors defined by the CSFB/Tremont sector classification which is one of the oldest and most widely accepted in the industry. The sector classification has clear and observable definitions for each sector aiming at representation of that particular sector and hedge funds undergo a detailed analysis of the investment objective prior to the assignment and are monitored on an ongoing basis.

2.10 We consider CESR's **backfill bias** concern to be unfounded. Any index should have clear rules prohibiting the back-filling of data and as such inaccurately representing the historical performance. As stated before in respect to the survivor [ship]- and selection bias, INVX has clear and objective rules preventing back-filling of historical performance data. As in traditional indices, the performance of a new constituent in a hedge fund index, which should not be selected based on subjective, qualitative factors, because of the selection bias risk should only start being accounted for as of the day of the inclusion in the index.

2.11 We consider CESR's **investable/non-investable treatment** concern to be unfounded. Any investable hedge fund index should represent the performance of an objectively constructed hedge fund index based on investment opportunities available to investors at the point of calculation of the index. Closed funds are not available for investment and therefore can not be legitimately included in an investable hedge fund index. Their inclusion would lead to an inaccurate representation of the performance. This concept is not unique to hedge fund indices and can best be compared to the free-float approach used in many equity indices. INVX has clear and objective rules defining the eligibility criteria for investable hedge funds and their inclusion in the index.

For the reasons set forth above, we hereby request that CESR does not exclude hedge fund indices as an eligible UCITS financial instrument and ask that you concur with our view that hedge fund indices should be an eligible UCITS financial instrument.

If the CESR is not inclined to include hedge fund indices as an eligible UCITS financial instrument, we would appreciate the opportunity to discuss the matter with you, either telephonically or in person. Please direct any questions concerning this letter to me at 212-538-8179 or via email at oliver.schupp@csfb.com.

Sincerely,

Oliver Schupp
President
CSFB/Tremont Index, LLC