CESR CONSULTATION PAPER RESPONSE

CAN HEDGE FUND INDICES BE CLASSIFIED AS FINANCIAL INDICES FOR THE PURPOSES OF UCITS?

MARCH 2007

MSS Capital's Response to CESR's consultation paper

Introduction

MSS Capital is the investment advisor to the FTSEhx Fund SPC. This fund drives the FTSE Hedge Index and allows the Index to be investible. The Index is based on a managed account platform which MSS is the investment advisor to.

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The purpose of this paper is to provide feedback to CESR and argue the case that hedge fund indices should be classified as financial indices for the purposes of UCITS.

Background

CESR's previous work and background to the UCITS eligble assets debate has led to the following Directives being finalised:

Level 1: Financial derivatives are eligble for UCITS, provided that their underlying (among other things) is a financial index.

Level 2: Criteria tobe met by a index in order for it to be considered a financial index for the purposes of UCITS should be fulfilled

- (a) Sufficiently diversified
    - a. Price movement/trading activity should not unduly influence index performance
    - b. Assets must be diversified
- (b) Adequate benchmark
    - a. Index should measure performance in arelevant and appropriate way
    - b. Period revision or rebalancing
    - c. Sufficient liquidity
- (c) Published in an appropriate manner
    - a. Sound procedures in collection and calculation of prices
    - b. Information on methodology is available

Level 3: General eligible asset work which covers diversifcation requirements (a-b above)

Proposed Level 3 measure

General

General outline and summary of previous CESR review to be found on page 7 & 8 of Feb 07 Consultation paper.

Assessement of hedge fund indices against level 2 criteria for financial indices

Sufficient diversification

Q1 *- If you believe that there should be additional guidelines relating to diversification for HFI's, please explain what they should be and why the requirements for HFIs should be higher than those for 'traditional' indices in the respect?*

The question of diversification should be left to market practitioners and UCITS providers to decide whether a HFI is sufficiently diversified and taking into the account the target market the UCITS provider is distributing too. The UCITS provider should take into account the current frame work already in place such as the diversification requirements stipulated by certain listing entities (such as the Irish Stock Exchange).

We would argue that transparency and disclosure is required of the defined universe which is measured, the regulatory minimum requirements which are adhered to and allow the investor to make an informed decision.

Representing an adequate benchmark and publication in an appropriate manner

Box 1
In respect of a hedge fund index, the criterion of `representing an adequate benchmark' will not be met unless the UCITS:
1 – verifies that index provider clearly defines, and makes publicly available, an explanation of what the index is trying to represent. This definition should include narrative description of what the index is trying to track and not merely list underlings
2 – assess whether the methodology of the index construction means the representative ness for the market to which it refers is likely to be achieved.

Q2 *– Should the definition of what the index is trying to represent be available to the public as a whole, just to 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 (eg the index providers website)?*

Yes, the key to any index is it's objective and definition of what it measures; how it selects and weights the components to match that objective; how it is managed and how it evolves through time. This should be available to all who use the index (ie public). This information should be available through the index providers website and the UCITS provider. In addition, the index rules should be overseen by a totally independent advisory committee.

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

The lack of public information should be noted and the lack of clear ground rules, guidelines or independent review/oversight should prevent a HFI from being an qualifying financial index.

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.*

When trying to measure market `breadth'

A – Crude measures of constituent manger AUM to universe AUM has intuitive appeal, practical collection difficulties exist as many of the components do publish regular figures (and we should not be adding to their list of deliverable items) and may not measure anything at all.
B – Representing and weight of index eg Asset weight index would be sensible, while equal weighting and capacity weighting index would should not be considered representative.
C – Tracking error is what matters when deeming if an index Is broad enough to successfully capture risk and return characteristics of that universe.

Box 2
In respect of a hedge fund index, the criterion of `representing an adequate benchmark' will not be met unless the UCITS verifies that the methodology of the index requires the selection of index components to be made using pre-determined rules, on the basis of objective criteria.

Box 3
In respect of a hedge fund index, the criterion of `publication in an appropriate manner' will not be net unless the UCITS:
1 – confirms the index provider makes publicly available the full methodology of the index, including weighting, the treatment of defunct components, and where applicable, the classification of components;
2 – verifies that the methodology of the index does not allow retrospective changes to previously published index values ('backfilling').

Q5 *– Please provide your comments on the proposed level 3 guidelines.*

With regard to the comment in Box 2, we would feel that it is the role of the index provider to verify and evidence that the index and it's components comply with the objectives and publicly available index rules. The role of the UCITS should be to use the appropriate t index for the product they wish to distribute. It is not the role of the UCITS provider to enforce guidelines on index providers, but to use HFI which best satisfy their requirements. Items which UCITS providers should ensure are done correctly would include the role of the independent oversight committee and the independence of the parties delivering the HFI.

With regard to the comments in Box 3, this should be seen as a self-regulating point and done in the normal course of business to ensure that the product which is promised, is in fact the product which is delivered. Methodology, weighting, treatment of components and classification should all be publicly available items.

The UCITS provider should have performed the required due diligence to ensure that the HFI does not partake in retrospective changes to previously published index value. These index values should be public information. Changes to the index methodology should only be made with the agreement of a fully independent advisory committee.

- Conflicts of interest arising from fee-sharing.
- Should CESR intervene?

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

A HFI that is involved in fee sharing cannot be considered a representative HFI as this leads to clear selection bias and can no longer be considered to be a representative HFI.

Box 4
In respect of a hedge fund index, the criterion of `publication in an appropriate manner' will not be met unless, the UCITS verifies that the index will be subject to an independent audit at least annually. The audit can be conducted by either a third party, or an internal unit within the index provider (eg an `audit committee') which is independent of a department in cgarhe of

managing the index. The summary audit opinion must be available to the UCITS on request. As a minimum, the audit should:
1 – consider whether the index's published methodology has been respected during the period in question (including where applicable, the treatment of defunct components an classification of components)
2 – validate that, for a sample of index calculation points, the index value was calculated consistently with the disclosed methodology.

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 estimated 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?*

Any review of this type should be done independently. It may be convened and chaired by the index provider, however the people who make up the 'audit team' should be independent from the index provider. An example would the Independent Index committees which oversee all the FTSE indices. These are made up of knowledgeable and experienced individuals who partake of the role free of charge to further remove any conflict of interest. The committee should meet regularly to, inter alia, meet the requirements of Box 4.

UCITS providers should be comfortable with the existence of such an independent oversight committee and that it has fulfilled its role.

Q8 *- Please provide your comments on this proposed level 3 guideline*

We would agree that the all indices should have an independent body overseeing the process and ensures transparency and adherence. However, it is important that those with the correct skill set are entrusted to execute this role. Fund auditors are not the best group to ensure a hedge fund index complies with the rules/guidelines. The auditors role should be the essential role of auditing the investment vehicles into instuitions or individuals invest their money.

Box 5
In respect of a hedge fund index, the criterion of 'representing an adequate benchmark' will not be met unless the UCITS:
1 – verifies that index provider makes available to the UCITS details of whether each index component is investible or non-investible;
2 – verifies that the index provider makes available to the UCITS details of the index components (including a list of components and their prices and weight in the index) for each index calculation point.

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

An index is only useful as a benchmark if it is
- Diversified / diversifying – ie complete
- Investible – ie liquid and the returns are achievable
- Transparent – with regard to rules, components and weights
- Rule driven – ie these should be known in advance

With regard to point (1) it should disclose the fact that it contains no non-investible components. If it claims to represent both invesitible and non-investible components, then this should be stated.

Again as part of the UCITS providers due diligence process, they should confirm for themselves that this is the case.

With regard to point (2) the decision to disclose components and weights/values to a UCITS provider should the index provider's decision.

Box 6
In respect of hedge fund index, the criterion ‘publication in an appropriate manner’ will not be met unless the UCITS confirms that the index provider carries out due diligence on the net asset value calculation procedures used by each index component

The audit referred to the Box 4 above should confirm the adequacy of this due diligence and that it is being appropriately carried out.

Q10 *– Please provide your comments on this proposed level 3 guidelines*.

FTSE & MSS have a number of safety checks to ensure that NAV calculation is accurate and complete. Firstly, an in independent administrator collects all the underlying transactions on a daily basis and calculates the values of the assets independently from the managers themselves. This ensures consistent pricing and pricing which is not influence by the investment manager. This process would also highlight any miss priced positions in the investment managers books when the fund NAV as calculated by the administrator as compared to that of the investment manager.

The UCITS should perform suitable due diligence on the entity which is calculating the NAV to ensure they are comfortable with the process.

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 to a different frequency, and what should that frequency be?*

There is no reason not to publicise the indicative values daily index valuation points, however give the liquidity of the components, it is hard to match the liquidity of the index with any thing other than monthly index valuation points.

A HFI would include a wide range of strategies with differing liquidity features. Some hedge fund strategies are characterised by very short notice periods and up to daily liquidity terms. This is however determined by the depth, breath and liquidity of the underlying assets the hedge fund invests in. Liquid strategies would include Fixed Income and CTA/Managed Futures and some Equity managers. Certain strategies such as Distressed ad Opportunities and Merger Arbitrage have far less liquid strategies and may have greater than monthly liquidity terms. A HFI must balance the differing strategy characteristics.

By imposing twice monthly liquidity on the HFI, the liquidity terms would not be representative of the underlying components.

We would suggest monthly index publication at a minimum, with the encouragement of `indicative’ index values intra month. This would aid UCITS valuations and help with product construction that need greater than monthly liquidity.

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

The ability to value assets would be affected if no indicative index value could be supplied in-between trading dates. Hence daily indicative values would be preferable with regard to ongoing index valuation by both the UCITS and the public.

Disclosure of derivatives based on HFIs.

Q13 *- Should CESR carry out further work on the issue?*

It is not the role of the HFI to disclose the derivatives which have been used in the UCITS product. This is the responsibility of the UCITS provider to disclose this to their investors.

It should be necessary for the HFI to disclose in a broad sense the types of assets which are included in the HFI, as part of the strategy definitions, so that investors or users are clear as to the risks which are being taken.

Managed Account Platforms

Comments made about HFIs constructed using managed account platforms on issues such as diversification, selection bias, fee charging and rebates.

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?*

Managed accounts, enhance the ability of CESR/UCITS provider to adhere to the guidance given previously with regard to NAV calculation, index publication, due diligence and independence. Investors fully benefit from the transparency, liquidity and segregation advantages that are attached to managed accounts.

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

Not at this time.