



RESPONSE TO CESR'S ISSUES PAPER

“CAN HEDGE FUND INDICES
BE CLASSIFIED AS FINANCIAL
INDICES FOR THE PURPOSE
OF UCITS?”

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Consolidated list of questions for CESR

We continue our effort to encourage the Committee of European Securities Regulators to include derivatives on Hedge Fund Indices as eligible assets for UCITS. Hedge Fund Indices should be classified as financial indices pursuant to the meaning of Article 19 (1) (g) of the Directive. Herewith, we answer the questions drawn from the most recent *CESR's Issues Paper: Can Hedge Fund Indices be classified as financial indices for the purpose of UCITS?*

Our key position remains the same: Hedge Fund Indices ("HFI") should qualify under the UCITS directive as financial indices and be included as eligible assets for UCITS. Hedge Fund Indices generally follow the same common market practices as those of traditional indices, and therefore should be considered as an eligible asset for UCITS. As with traditional indices, UCITS should determine the eligibility of an index by following certain guidelines in order to ensure that each Hedge Fund Index is appropriate and compliant.

Furthermore, financial exposure to hedge funds is already available to retail investors through a broad range of instruments including; structured notes, certificates, shares, special purpose vehicles and life insurance policies. UCITS funds provide an opportunity to standardize a minimally regulated industry, as most of the other derivative instruments listed above are not as regulated. Should CESR decide to prohibit the eligibility of HFI, the use of hedge funds in investments funds and alternative instruments may prevail with limited regulation and investor protection. If HFI are deemed eligible, CESR may set standards and guidelines to further regulate the hedge fund industry. From the angle of investor protection it may be preferable to have such products monitored by financial supervisory authorities since availability of hedge funds and the increasing demand will not be changed by an adverse CESR ruling.

The following responses provide feedback to CESR's questions and outline general guidelines that Hedge Fund Indices should follow.

Q1: What are your views on the potential biases described in this section and on how they can affect HFI? Please explain your comments.

We consider CESR's concerns on the potential biases listed in Section 1 of the *CESR's Issues Paper* to be tenuous. Biases are inherent characteristics of traditional equity indices and HFI alike. However, if an index is representative, objective and based on clear index rules, the effects of potential biases should be substantially reduced. Again, the emphasis is that both traditional and HFI face potential biases. These biases are widely accepted in UCITS-eligible traditional indices and therefore HFI should be treated similarly.

We have outlined our opinion on the mentioned biases as listed below, and summarized the guidelines that we believe should be followed by UCITS:

1. Selection and Database Bias

The use of qualitative or selective quantitative factors (such as frequency of pricing, performance or correlation statistics) or other subjective factors should be avoided in HFI as they are inconsistent with the commonly accepted construction methodologies for indices, and should be minimized to avoid selection bias. For instance, managed accounts (which may offer preferred quantitative factors) may be included in an index, but should not be a requirement as this may introduce a source for selection bias. Any index should have clear and objective index rules that clearly describe the addition and deletion of member funds, thus minimizing the potential for subjectivity and selection bias. Generally, hedge funds are selected based on their assets under management, a criterion comparable to the market capitalization for stocks in traditional equity indices, and their investability, which is comparable to traditional indices' free float for securities. If this selection methodology is applied, HFI should qualify for UCITS.

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The similarities between the selection guidelines of an investable Hedge Fund Index (The Credit Suisse/Tremont Investable Hedge Fund Index, "INVX") and leading traditional indices (STOXX 50 and S&P 500) are outlined below:

	INVX	STOXX 50	S&P 500
Selection Process / Criteria	The INVX consists of the 6 largest "open" funds by AUM in each of the 10 industry sectors that meet the following criteria: (1) Hedge funds must be a part of the Credit Suisse / Tremont Hedge Fund Index ("The Broad Index") (2) Hedge funds must be open to new investments and redemptions and must meet the liquidity constraints of their respective sector.	The selection process for index inclusion is: (1) The component companies of the 18 Dow Jones STOXX 600 Supersector indices are ranked by free float market capitalization. (2) The largest 40 companies are chosen as components. (3) The remaining current components of the Dow Jones STOXX 50 ranked between 41 and 60 are added as index components. (4) If the component number is still below 50, the largest companies on the selection list are added until the index contains 50 companies.	The criteria to be included in the index are: (1) The company must be a public U.S. company, (2) The market cap must be in excess of USD\$4 billion, (3) The financial viability usually consists of 4 consecutive quarters of positive earnings, (4) The company must have adequate liquidity and reasonable price, (5) The free float must be at least 50%, (6) The sector representation must maintain a sector balance in line with the eligible companies greater than \$4 billion, (7) It must be an operating company.
Valuation Frequency	Weekly/Monthly	Daily	Daily

Source: Credit Suisse Tremont Index LLC

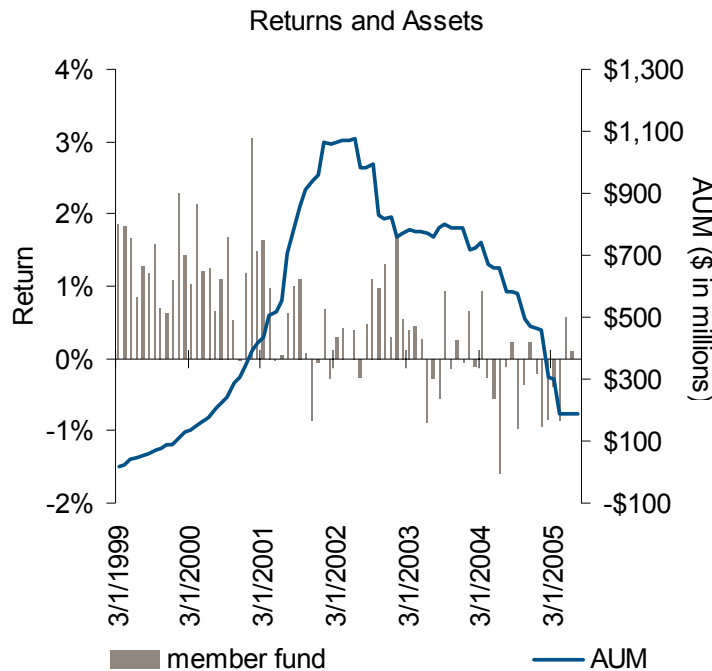
Database selection bias can be considered an extension of selection bias and may be minimized through comprehensive, high quality databases operating within a professional infrastructure. This forms the basis to ensure accuracy and ongoing operational efficiency. All available information should be captured in a systematic way relying on clear reporting and monitoring standards and criteria for inclusion of hedge funds in the databases and index. Database selection bias may also affect traditional indices as constituents are required to be listed on an exchange for calculation purposes, creating a bias through the listing requirement.

2. Survivorship Bias and Defunct Fund Bias

Survivorship bias and defunct fund bias (which are inherently similar) typically describe the fact that for a given period of performance history, only the data points of surviving members of the population of hedge funds are considered. This is largely a problem for data and performance numbers within databases, and not so much for indices or, in this case, investable HFI. One can only include data points of existing member funds of the population when first launching an index. Investable HFI generally behave no differently from traditional indices that are considered eligible financial indices for UCITS. 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. As a guideline, any index should have objective and clear index rules describing the addition and deletion of member funds at the rebalance and should disallow the retrospective change of historical index performance, thus eliminating survivorship bias in its index construction. Furthermore, the index rules should require that the performance of hedge funds as they liquidate or "blow up" is kept in the index throughout the liquidation (or over a materially significant time period) or blow up period in its entirety (thus ensuring that the potential negative performance is represented in the HFI performance). This reflects the fact that downside performance is also representative of the industry. This methodology is very similar as that used in most widely accepted equity indices (e.g. DAX, STOXX, S&P 500), which are eligible assets for UCITS.

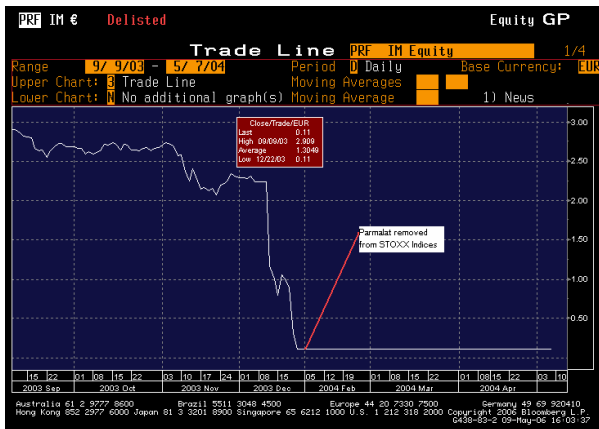
An example of a convertible arbitrage member fund's removal from the INVX is exhibited below. After a period of poor performance and asset outflows, the fund started its liquidation process in June 2005 but remained in the index until October 2005. The negative performance throughout this time period was captured in the INVX, thus eliminating any potential survivorship bias.

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Source: Bloomberg

An example of a company's removal from a traditional index is exhibited below in the STOXX 600's removal of Parmalat Finanziaria after it filed for bankruptcy protection on 24 December 2003. Parmalat's stock decreased on 11 November 2003 after auditors questioned the accounting transactions of a company linked to Parmalat. The company was deleted from the Dow Jones STOXX 600 Index on 1 January 2004.



Source: Bloomberg

Parmalat and the convertible arbitrage fund in the INVX typify the procedural similarities in the removal of defunct constituents by hedge fund and traditional indices. As traditional indices are eligible under the UCITS directive and HFI follow a similar methodology, HFI should also be eligible.

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3. *Sample Bias*

Sample bias describes the introduction of a bias in performance through the selective inclusion of sample data, which is very similar to Selection Bias. When selecting a sample, certain variables may be chosen over others, and these variables (such as fund size) may be deemed by the index provider to be more representative of the industry than others. Index providers therefore intentionally introduce sample bias to increase representation. The use of a rules-based, asset-weighted index methodology can ensure that these variables are not arbitrarily assigned and indeed seek to heighten the degree of representation of the index. As stated in selection bias, the use of qualitative or selective quantitative factors (such as performance or correlation statistics) or other subjective factors is inconsistent with commonly accepted construction methodologies of traditional indices and should be minimized to avoid sample bias. An index with clear and objective rules shall minimize the potential for subjectivity and sample bias. Generally for HFI as compared to traditional indices, hedge funds are selected based on their assets under management, a criterion comparable to the market capitalization for stocks, and on their investability, which is comparable to the traditional indices free float for stocks. With this in mind, index providers offer different interpretations of how a sample should best represent an index, and this leads to differing methodologies. This is an inherent characteristic in both traditional indices and HFI and generally does not affect the underlying goal of an index.

4. *Classification Bias*

We consider CESR's concern over classification bias or sector consistency to be superfluous. Both traditional and HFI have constituents that change classification or sector. It is the specific methodology that the index employs when changing classifications that is important. An index provider should take careful and educated consideration when designing a sector or industry classification and subsequent assignment of members within this classification. In a Hedge Fund Index, 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 meet the definition and can be observed and monitored accordingly.

Although there should be a consistent classification system, the classification system should also be capable of changing and evolving to represent the current industry landscape, and should be broad enough in strategy definition to account for the unique nature of many hedge funds.

As shown below, equity indices face similar issues with changing company profiles and are exposed to classification changes and are still eligible assets in UCITS.

Company Name	Initial Strategy Classification	Subsequent Strategy Classification
MSCI GICS*		
CSR (UK)	Communications Equipment	Semiconductors
Travis Perkins (UK)	Home Improvement Retail	Trading Companies & Distributors
Cendant Corp (USA)	Diversified Commercial Professional	Trucking
Credit Suisse/Tremont Investable Hedge Fund Index		
Alexandra Global Investment Fund	Convertible Arbitrage	Multi-Strategy
Permal Europe	Global Macro	Long/Short Equity
Deephaven Market Neutral Fund	Convertible Arbitrage	Multi-Strategy

*Global Industry Classification Standard, developed by Morgan Stanley Capital International.

As a guideline, an HFI provider should have a sufficient monitoring system intact to attempt to ensure consistent constituent classification. In the absence of an exchange or self regulatory organization to

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regulate the actions of the hedge fund industry, an overall index methodology may set standards of process for fund manager selection and classification replacing those of a traditional exchange.

5. Index weighting:

The type and methodology for the weighting scheme of an index should seek to ensure a high degree of industry representation. In order to maximize representation and adequately reflect the hedge fund universe, and any underlying member fund's contributions, an asset-weighted scheme can be considered ideal. An asset-weighted index selects the largest available and eligible hedge funds for index inclusion, and weights members accordingly. Asset-weighted indices are widely accepted in the traditional index arena, and these traditional indices are eligible for UCITS.

Through an asset-weighted index methodology, index members and weights are designed to be representative of the hedge fund universe and eliminate subjective constituent selection, thereby generating a generally unbiased representation of the hedge fund industry. An equally-weighted index may not be as ideal as it may introduce weighting biases when its small and large constituents are equally weighted, suggesting that the impact of small constituents on index performance should be no different than that of large constituents. Asset-weighted indices instead attempt to maximize representation by allowing the contribution of a constituent to vary according to a constituent's size within its universe.

Q2: Are there any other material sources of bias affecting HFI that CESR should consider?

No, CESR has accurately identified and described the most important potential biases that face both traditional and HFI.

Q3: Should an HFI have to meet certain additional quantitative criteria other than level 2 requirements, or should compliance with the level 2 requirement of sufficient diversification be left to the UCITS to assess? Please explain precisely the grounds underlying your comments.

We believe it is sufficient that HFI meet the current criteria of level 2 requirements without additional quantitative criteria. As we drafted in our response to CESR's request for applicable HFI criteria standards for UCITS eligibility and in concurrence to the assessment done by Professor L'Habitant, we maintain the same stance that the criteria of representation, objectivity, diversification, transparency, investability and replicability are sufficient for HFI eligibility and adequately comply with the Level 2 Requirements set out in the CESR Draft Advice. Additionally, as HFI are typically highly diversified in terms of the number of underlying hedge funds and investment strategies, compliance with the level 2 requirement of sufficient diversification should therefore be left for the UCITS to assess rather than being made the subject of CESR.

The following guidelines may be considered. It is our opinion that these guidelines both parallel the construction requirements of equity or traditional indices that are already eligible for UCITS and limit the biases that potentially exist in indices. These guidelines follow established and commonly accepted principles for indices in traditional asset classes. It is our opinion that the principles of representation and objectivity in the construction process are key to any index, and the hedge fund industry gives no justification to grossly divert from these principles. The additional guidelines are outlined as follows:

1) Representation:

An HFI should adequately represent the hedge fund universe by a smaller representative sample population. The index needs to be sufficiently diversified across the entire index and the relevant sub-

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strategies to represent the breadth of the universe. An ongoing monitoring process should ensure proper classification and satisfaction that each member fund meets the eligibility criteria. The changing characteristics of the hedge fund universe can be accounted for through periodic revisions, rebalances, and weighting schemes to ensure the continued representation of the evolving underlying market. These revisions and rebalances must be explicitly documented in the index rules and should be publicly available. In order to maximize representation and adequately reflect the hedge fund universe and any underlying fund's contributions, the index should be asset-weighted and select the largest available and eligible hedge funds, a concept that has been widely accepted in traditional indices.

Any arbitrary introduction of quantitative or qualitative screening or filter mechanisms should be avoided as they may introduce selection bias, and are both highly dependent on input parameters (in particular in the case of statistical tests) and can potentially jeopardize the integrity of the index. Additional criteria that do not aim to represent the industry as a whole but rather create an index that represents individual funds through certain transparency and risk profile requirements conflict with the goal of representation for an index. For instance, managed accounts may be included in an index, but should not be a requirement as they may introduce a source of selection bias.

A comprehensive, high quality database operating within a professional infrastructure forms the basis to ensure accuracy and ongoing operational efficiency. All available information should be captured in a systematic way relying on clear reporting and monitoring standards and criteria for inclusion of hedge funds in the database and index.

2) Objectivity:

An HFI that objectively represents an underlying universe should be based on precise, documented construction rules that limit discretionary decision methods in the selection process. Index construction rules should be objective and should not rely on criteria or methodology that is based on the valuation or the selection of hedge funds, which introduces subjectivity. Index rules need to be clear, understandable and concise, explaining all relevant formulas, while eligibility criteria and rebalancing of the index should be stated in a publicly available document. Objectivity manifests itself through the ability of a third party to independently replicate the index solely with the relevant dataset and index rules. Hedge fund-specific idiosyncrasies such as liquidity terms, lock-ups, and investability, need to be clearly defined, and their treatment in the index properly documented.

3) Diversification

An HFI should be a diversified benchmark of the hedge fund universe, capturing the dynamic characteristics of the industry. To obtain a high degree of diversification, an index should be broadly diversified across both the index and the sub-strategies to avoid being overexposed or concentrated in individual hedge funds or sub-strategies. Maximum weight constraints set for individual funds and/or sectors may ensure a higher degree of diversification. While there is no requirement for a fixed number of funds, most traditional indices rely on this concept as it ensures diversification and allows for an objective construction methodology.

4) Transparency

HFI should offer maximum transparency subject to possible legal restrictions inherent in the hedge fund industry. This should include the index methodology, valuations, and member funds. To the extent that it is legally possible, this information should be publicly available and easily accessible. Additional transparency to underlying holding information (e.g. risk profiles or exposures) is atypical for an index provider and may be offered, but should not be a requirement or relied upon for construction of the index due to the introduction of selection bias.



5) Investability and Replicability

The nature of the hedge fund industry today does not allow investability and replicability to be defined in the same way as for traditional indices. The underlying hedge funds are private investments, which are based on a bilateral agreement rather than public availability. However, HFI should be replicable, through direct investment in the underlying hedge funds or products offered by the investment community. It has to be noted that replication of an HFI is not always feasible, but similarly it is not necessarily possible to replicate a traditional index through direct investments. The key to replicability is in the objective and transparent index rules and construction and the avoidance of subjectivity that does not allow for replication of the index.

Additionally, the liquidity of UCITS products based on HFI is provided by the OTC counterparty, not by the index constituents. The UCITS 3 Directive contains all the necessary safeguards in order to deal with the OTC counterparty risk (e.g., 5/10% limitation [art. 22(1)]. OTC counterparties must be supervised financial institutions [art. 19(1g)]. The question of whether a particular Hedge Fund Index is investable is only relevant for the OTC counterparty when implementing a hedging strategy.

In our opinion, representation, objectivity, diversification, transparency, investability and replicability should be the criteria that serve as the principles of a Hedge Fund Index. Despite the idiosyncrasies that are inherent within the hedge fund industry, these criteria serve to limit any biases that may occur within the index. Furthermore, HFI are constructed similarly to traditional indices, and should therefore be treated equally. The information provided above serves as an overview and guideline that in our opinion should be considered when determining eligibility criteria for HFI. We are happy to provide any additional information that may further aid your decision-making process for the approval of HFI for UCITs eligibility.

Q4: What requirements on weighting should HFI have to fulfill to qualify as financial indices?

The market should be left to decide whether asset-weighted or equally-weighted methods are more appropriate. It should be noted however that most market leading equity indices, including DJ EuroStoxx, FTSE 100, DAX, CAC 40 and S&P 500, are free-float capitalization weighted and typically follow objective, measurable rules based on the largest constituents in order to maximize representation and minimize potential biases (please see the table below for the additional similarities between traditional and Hedge Fund Indices).

Diversification can be supported through a minimum number of constituent's requirement and via maximum weight constraints at the strategy and/or fund level. Index providers offer different interpretations of how a sample should be most representative, leading to differing methodologies in terms of minimum number of funds and weighting methods. This is an inherent characteristic in both traditional and HFI, and does not affect the underlying goal of an index.

The below table illustrates the comparisons of the INVX versus traditional indices:



	INVX*	STOXX 50	DAX	CAC 40	FTSE 100	S&P 500
No. of Funds	60	50	30	40	100	500
Weighting	Asset	Free float market capitalization	Trading volume and free float market capitalization	Free float market capitalization	Free float market capitalization	Free float market capitalization
Weight Cap (Fund/Company)	8%	10%	N/A	15%	N/A	N/A
Construction	Rules based to include largest investable hedge funds	Rules based to include largest exchange-listed companies	Rules based to include largest exchange-listed companies	Rules based to include largest exchange-listed companies	Rules based to include largest exchange-listed companies	Rules based to include largest exchange-listed companies
Valuation Frequency	Weekly	Daily	Daily	Daily	Daily	Daily
Selection Process	6 largest investable hedge funds across each of 10 sectors	50 largest companies in the 18 DJ STOXX Supersector Indices	30 largest and most actively traded German companies	40 of the largest 100 companies on the Paris Stock Exchange	100 largest United Kingdom companies	500 largest companies in the U.S. economy
Fully Investable / Replicable	Yes	Yes	Yes	Yes	Yes	Yes
Transparency	Full	Full	Full	Full	Full	Full
Rebalance Frequency	Semi-annual	Yearly	Yearly	Quarterly	Quarterly	As necessary

*See INVX Rules document at www.hedgeindex.com

Sources: hedgeindex.com

Third party data from: stoxx.com, finix.at, ftse.com, euronext.com, boerse-frankfurt.com, en.wikipedia.org,

Q5: Is the definition of the representative group of underlyings made by the index provider sufficient to satisfy the criterion of “adequate benchmark?” Please provide comments what is an adequate benchmark?

An adequate benchmark should be sufficiently diversified, representative, transparent in both construction methodology and valuations, investable and replicable. It should be left to the discretion of the index provider on how to create an index methodology that meets this definition.

As stated in the investability and replicability section, the nature of the hedge fund industry today does not allow investability and replicability to be defined in the same way as traditional indices. The underlying hedge funds are private investments, which are based on a bilateral agreement rather than public availability. However, an HFI should be replicable, through direct investment in the underlying hedge funds or products offered by the investment community. It has to be noted that replication of a hedge fund index is not always feasible, but similarly it is not necessarily possible to replicate a traditional index through direct investments. The key to replicability is in the objective and transparent index rules and construction and the avoidance of subjectivity that does not allow for replication of the index.

While traditional indices are considered to be eligible for UCITS, constituents of some traditional indices can be highly concentrated in favor of a single security and yet these indices are deemed representative of the industry and eligible for the use of UCITS. For example, the Finland OMX Helsinki Index's methodology weights the index in favor of their largest company, Nokia, with an approximately 31% weight, similarly Switzerland's SMI Index has 5 companies representing approximately 70% of the weight in the index and the Netherland AEX Index's top two companies make up approximately 30% of the index. The above mentioned traditional indices are eligible for UCITS and are allowed to use their discretion in determining a proper methodology for optional industry representation. HFI should be treated in a parallel manner.

Q6: Is there a role for any quantitative assessment of the 'breadth' of coverage of the HFI? If so, how would this work?

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Yes, quantitative measures may help determine the number of constituents that are appropriate for breadth of coverage; however, the index provider should not be restricted to this quantitative assessment. Furthermore, statistical techniques to determine the number of funds are atypical for index providers and may not add measurable value to the breadth of coverage. The goal of an index is to be representative of the industry it seeks to represent. HFI follow a similar method to traditional indices of offering differing methodologies to what is a commonly accepted method in the traditional index arena. Therefore, there should be no particular formulaic code in the methodology but rather an emphasis put on the indices ability to be sufficiently diversified based on the discretion of the index provider. As is demonstrated below, both traditional and HFI differ in the number of member funds that encompass their representative sample of the industry due to how the individual provider defines the universe, and yet these traditional indices are eligible for UCITS.

Traditional Equity Indices vs. Hedge Fund Indices	Number of Constituent Funds
US Stock Indices	
Russel 2000 Index	2000
S&P 500	500
German Indices	
Dax30	30
HDAX	110
Pan-European Indices	
Stoxx50	50
Stoxx600	600
Hedge Fund Indices	
Credit Suisse/Tremont HF Index	437
Credit Suisse/Tremont Investable HF Index	60
FTSE	40
HFRX	50

Source: Bloomberg; Credit Suisse Tremont Index LLC

Q7: Should backfilling be banned for HFI to qualify as financial indices? If not, why not? Please explain precisely the grounds underlying your comments.

Yes, backfilling should not be incorporated into an HFI. As stated above in the section on potential biases that face a Hedge Fund Index, any index should have clear rules prohibiting the back-filling of data. Backfilling of data inaccurately represents the historical performance of any index, affecting both survivorship and selection bias. Backfilling should not be restricted on the database level to ensure that the industry universe is accurately represented as database managers typically backfill to ensure a complete sample. However, backfilling should not be passed on to a Hedge Fund Index by adjusting historical performance. An index should have clear and objective rules preventing the backfilling of historical performance data. As in traditional indices, the performance of a new constituent in an HFI should only be included from the day of inclusion going forward.

Q8: Should CESR set criteria for the treatment of defunct funds by HFI for them to qualify as financial indices? If so, what should they be? Please explain precisely the grounds underlying your comments.

No, we believe that CESR should not be responsible for setting the criteria for the treatment of defunct funds in HFI. Instead, it should be the responsibility of the index provider to determine this criteria, just as

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any similar criteria would not be monitored by CESR for a traditional index. The criteria should be set, and upheld by the index itself and perhaps monitored by UCITS when assessing an HFI for specific inclusion.

In addition, the following could be considered when assessing the treatment of defunct funds in HFI. An HFI should have a clear rules-based criteria for the removal of defunct funds. Member funds that become defunct should stay in the Index until completion of the liquidation or when the fund becomes statistically insignificant, capturing the potential downside performance during this period in the index.

	INVX	STOXX 50	S&P 500
Removal Criteria	Hedge funds that liquidate stay in the INVX until fully liquidated, capturing the performance during this period in the index. The rules for the eventual removal are defined by the Special Rebalancing Situations as defined in the INVX Rules.*	Bankrupt companies have the option to be removed immediately from the index if their illiquidity is due to: (1) not being traded for ten consecutive days, (2) being suspended from trading, or (3) ongoing bankruptcy proceedings. Changes are announced immediately, implemented two days later, and become effective the trading day after implementation.	The S&P 500 Committee will review companies on the S&P500 that liquidate, as shares decrease. Liquidity concerns can be used as a reason to eliminate poor performing companies.

Source: Credit Suisse Tremont Index LLC, dowjones.com, standardandpoors.com.

As described above, HFI methodologies are in line with various stock indices, including the S&P 500 and STOXX 600, which remove funds filing for bankruptcy protection. A publicly traded company filing for bankruptcy protection is very similar to a hedge fund liquidating its portfolio. For example, Enron Corporation was added to the S&P 500 Index on 2 January 1946. In August 2000, Enron's stock price hit its highest value of \$90. The company filed for bankruptcy protection on 2 December 2001, and Enron Corporation was deleted from the S&P 500 Index on 29 November 2001. As HFI and traditional indices face similar removal issues with funds going defunct and companies going bankrupt and also maintain similar criteria for removal, HFI should also be considered eligible for UCITS approval.

Q9: Is disclosure of the index revision methodology sufficient or should controls be placed on the frequency, method or amount of due diligence the index provider must carry out regarding ongoing constituent classification? If so, what should they be? Please explain precisely the grounds underlying your comments.

Yes, disclosure of the index revision methodology is sufficient. Additional controls do not necessarily need to be placed on the frequency, method or amount of due diligence the index provider must carry out regarding ongoing constituent classification. Ultimately, the index provider should appropriately classify and monitor changes in the classification of the underlying hedge funds. Classifications should generally be aligned with industry standards and monitored closely to ensure that proper classifications can be appropriately applied. In addition, each index provider should have a detailed methodology and procedure in place to monitor funds. These procedures should be documented and tracked in order to systemize the process on an ongoing basis.

Furthermore, while there should be proper classification standards of underlying hedge funds, the classification system should be capable of changing and evolving to represent current industry norms. Equity indices face similar classification issues to HFI, as shown in the table below that compares the changes in the classification of securities within the MSCI Index to changes within the fund sector classifications of the INVX. Again, the same process that is applied to traditional financial indices should also be applied to HFI.

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Company Name	Initial Strategy Classification	Subsequent Strategy Classification
MSCI GICS*		
CSR (UK)	Communications Equipment	Semiconductors
Travis Perkins (UK)	Home Improvement Retail	Trading Companies & Distributors
Cendant Corp (USA)	Diversified Commercial Professional	Trucking
Credit Suisse/Tremont Investable Hedge Fund Index		
Alexandra Global Investment Fund	Convertible Arbitrage	Multi-Strategy
Permal Europe	Global Macro	Long/Short Equity
Deephaven Market Neutral Fund	Convertible Arbitrage	Multi-Strategy

*Global Industry Classification Standard, developed by Morgan Stanley Capital International.

Q11: Is passive versus active selection of constituents the key difference between an HFI and a fund of hedge funds respectively? What could be the other differences? Please explain precisely the grounds underlying your comments.

Yes, passive versus active selection of constituents is the key difference between HFI and fund of hedge funds. In general the difference between HFI and fund of hedge funds is very similar to that of the passive (index) and active investment fund industry.

HFI are constructed via a clear and objective rules-based methodology, thus minimizing subjectivity. HFI are designed to be transparent, representative and replicable, acting as a market barometer of the hedge fund universe. Thus, constituent selection is passive with minimal qualitative assessments.

Comparatively, a fund of hedge fund's main focus is to subjectively evaluate and qualitatively assess hedge fund managers for possible portfolio inclusion. Their key role is to assess constituents on several levels, including evaluating a manager's investment strategy and skill. Further, fund of hedge funds generally offer comprehensive and evaluative due diligence, as well as risk management. The most important element for a fund of hedge funds is to actively select hedge funds for specific portfolios to meet specific investment objectives and investor needs. The investor in a fund of hedge funds typically relies on the skill of the fund of hedge funds manager to successfully implement and execute this process.

Q12: Should only HFI where constituent selection depends solely on publicly available objective rules qualify as financial indices? If not, why not? What sort of subjective judgments could be used to select underlying constituents? Please explain precisely the grounds underlying your comments.

It is a common market practice for financial indices to select constituents based on publicly available, objective rules based criteria. Thus, it is a sound practice for Hedge Fund Index providers to conduct a similar process. HFI should execute a minimum of subjectivity in order to not divert from commonly assumed principles of (traditional) indices by (retail) investors. Due to the absence of a regulated exchange or self regulatory organization for hedge funds, a minimal amount of subjective operational due diligence may be employed to determine the operational integrity of the constituent funds.

Q13: Are there any competition aspects CESR should consider in the context of Hedge Fund Indices compared to funds of hedge funds? Please explain precisely the grounds underlying your comments.

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We believe there may be competitive aspects between HFI and fund of hedge funds (“FOFs”), however they do not diverge from the traditional arena and should not be considered by CESR in a different manner. Competition between HFI and FOFs is no different than the competition between actively managed and passively managed investment funds in the traditional equity and fixed income arena.

Q14: Do respondents agree that the ability to verify the value of the index given price data and the HFI methodology satisfies the replicability criterion? If not, why not?

Yes, an index should be considered replicable if price data and HFI methodology are verifiable and coincide with index data that is publicly available. However, since the underlying hedge funds in HFI are private investments which are based on bilateral agreements, the nature of the hedge fund industry does not allow investability and replicability to be defined in the same way as for traditional indices. Therefore, an HFI should be replicable, through direct investments in the underlying hedge funds or through products offered by the investment community, even if information on the constituent funds is not publicly available. It should further be noted that replication of a Hedge Fund Index is not always feasible, but similarly it is not necessarily possible to replicate a traditional index through direct investments. The key to replicability is in the objective and transparent index construction rules, generally leading to the avoidance of subjectivity that does not allow for replication of the index.

Traditional indices may face similar obstacles and are not always fully replicable, as traditional index constituents are not always disclosed. Nonetheless, some of these indices are eligible for UCITS.

Q15: Should CESR set requirements for verification of NAV calculation and independent custody arrangements/robust governance structures for the underlying constituents of HFI to qualify as financial indices; or as an alternative, should the UCITS be required to assess the due diligence procedures of the index provider in respect of the underlyings in this regard? Please explain precisely the grounds underlying your comments.

No, it is not necessary for CESR to set such requirements as it is a standard and common practice for Hedge Fund Index providers to calculate NAVs in a reliable and appropriate manner. However, it may be prudent for UCITS to assess and determine that the calculation procedures of the Hedge Fund Index are sound, properly implemented and adequately resourced. HFI generally implement the same practice as traditional indices, and therefore should be treated with the same consideration.

Q16: Should a minimum monthly publication frequency be a requirement for HFI to qualify as financial indices? If not, why not, and what frequency would be suitable?

No, there should not be a publication frequency requirement for HFI to qualify as financial indices, although it is common market practice in the hedge fund industry to publish monthly returns. More frequent publication is possible, however as this frequency increases, selection bias may be introduced as only a limited set of hedge funds or construction methodologies may provide this level of frequency (i.e., managed account requirements).

Q17: Should CESR require an independent audit of the calculation of HFI to qualify as financial indices, or should the market be left to decide whether this would be an attractive option for an index provider to put in place? Please explain precisely the grounds underlying your comments.

No, CESR should not require an independent audit of the calculation of HFI. The market should be left to decide whether an independent audit of HFI calculation is necessary and appropriate.



Q18: Should it be a requirement for an HFI to qualify as a financial index that its full rules are publicly available (rather than just material rules)? If not, why not?

No, it should not be a requirement for an HFI to make their rules publicly available. As in any index, publicly available rules are good industry practice, yet should not be mandatory. The same standards used to govern traditional indices should be used for the treatment of HFI in order to be considered as a financial index.

Q19: To qualify as financial indices, should HFI be required to disclose at all times details of their constituents (eg list of underlyings, their classification, and the weight applying to them, if appropriate)? Is there other information about the HFI that should be disclosed? Would this be done via the index provider's website? Please explain precisely the grounds underlying your comments.

Generally, it is a good practice for HFI to provide as much transparency as possible including: a list of underlying hedge funds, their classification and strategy weights. However, this should not be a requirement for an HFI to be considered as a financial index. The same common market practice that is used by traditional indices is also implemented by HFI. Alternatively, as most hedge funds adhere to private placement rules, full transparency on underlying hedge funds may not be legally available. Furthermore, traditional indices often do not disclose the type of information listed above and yet are still eligible for UCITS.

Q20: Should a UCITS which intends to invest in derivatives based on HFI have to disclose this fact in its prospectus or other documents? What degree of information should a UCITS which intends to invest in derivatives based on HFI have to disclose in its prospectus? Please explain precisely the grounds underlying your comments.

UCITS which intend to invest in derivatives based on HFI should comply with all relevant laws and regulations. Disclosure on derivatives on HFI should not be treated differently than other financial indices eligible for UCITS. The ability of investors to understand derivatives, whether based on alternative or traditional investments (indices), is paramount. Proper disclosure is generally considered the most sound means of keeping investors informed.

Q21: Do you have any other comments relating to Hedge Fund Indices that CESR should consider? What are they?

We would like to continue to emphasize that the Hedge Fund Index industry was developed generally using the model of traditional indices of both the equity and fixed income varieties. It is only natural that the HFI universe would generally keep in-line with the standards and rules that govern traditional indices when creating HFI guidelines and methodologies. As we demonstrated in our analysis, most concerns that apply to the HFI arena are also concerns of the traditional universe which are eligible for UCITS. We feel that due to these inherent similarities and underlying goals HFI should also be considered financial indices and as such be eligible for UCITS.

Financial exposure to hedge funds can be sold to investors using a broad range of instruments, including structured notes, certificates, shares, special purpose vehicles and life insurance policies. UCITS funds are only one amongst many others. Should UCITS funds be prohibited from offering exposure to hedge funds through HFI, it is possible that other derivatives as above could be used as alternatives. This may result in a loss of market share for UCITS funds. Furthermore, there may be market opportunities where the appetite of retail and institutional investors for these types of products is still growing. Moreover,

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UCITS funds are regulated products while most of the alternative derivatives referred to above are not. From the angle of investor protection it may be preferable to have such products monitored by financial supervisory authorities.

The hedge fund industry is a fast growing and still developing market that has already captured significant market share. Moreover there are many passported UCITS funds providing an indirect exposure to HFI which may benefit from a more governed environment.

Q22: From the regulatory and retail investors' point of views, how do you assess the situation of competition between funds investing in derivatives based on HFI and funds of hedge funds? Please explain precisely the grounds underlying your comments.

These competitive aspects may set HFI and fund of funds apart, yet the inherent differences also exist in the traditional arena and should not instigate different treatment by CESR. Competition between HFI and FOFs are no different than the competition between actively-managed and passively-managed investment funds in the traditional equity and fixed income arena.

HFI generally offer simplicity and transparency, which may be most appropriate for retail investors. Since information on HFI is readily and publicly available, investors and regulators alike are able to consistently and reliably keep abreast of nearly all aspects of the Hedge Fund Index.

In addition, it is important to bear in mind that the liquidity of the index constituents is irrelevant for the UCITS fund's investors. The liquidity of UCITS products based on HFI is provided by the OTC counterparty, not by the index constituents. The UCITS 3 Directive contains all the necessary safeguards in order to deal with the OTC counterparty risk (e.g., 5/10% limitation [art. 22(1)]. OTC counterparties must be supervised financial institutions [art. 19(1)g)]. The question of whether a particular Hedge Fund Index is investable is only relevant for the OTC counterparty when implementing a hedging strategy.



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