



RESPONSE TO CESR'S ISSUES
PAPER

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

Submitted by:
Credit Suisse Index Co., Ltd.
11 MADISON AVENUE
NEW YORK, NY 10010
TEL: (212) 538 5738



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?

Background (Q1):

CESR asked whether HFIs should have to meet additional quantitative conditions in addition to those set out at level 2 on diversification, and whether there should be requirements concerning how the index is weighted.

Regarding the imposition of additional quantitative conditions, respondents' general view was that the UCITS Directive criteria were already sufficient and that HFIs should not be treated differently from other financial indices. A minority of respondents thought, however, that level 3 should set out a minimum number of index constituents. Taking into account that the diversification requirement set out in the UCITS Directive requires the index to have at least five underlyings, CESR considers there is no need for additional level 3 guidelines. It must be noted though, that whereas five constituents might be a suitable number for a narrow sectoral index, it would likely be insufficient in other cases. In this respect, CESR believes that the level 2 criteria apply and provide for adequate regulation with regard to index construction.

On the issue of whether and/or how an index is weighted, the majority of respondents said that it was not necessary to impose any additional requirements and that transparency of methodology should be sufficient to allow the UCITS to decide whether a particular weighting scheme is appropriate. According to CESR's proposals, the UCITS will be able to assess the methodology of the index in this regard, as the proposed level 3 guidelines will require its rules to be available.

We are in concurrence with CESR and believe there is no need for additional Level 3 guidelines on diversification. We also maintain our stance that HFI should be treated equally to traditional indices and no additional requirements should be necessary. An HFI should be a diversified representation of the hedge fund universe, capturing the dynamic characteristics of the industry.

To obtain a high degree of diversification, an index should be sufficiently diversified across both the index and the sub-strategies. Diversification may be supported through a minimum number of constituent's requirements 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. While there is no requirement for a minimum number of funds, having a requirement may help to ensure a minimum level of diversification.

Q2: Should the definition of what the index is trying to represent be available to the public or, 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)?

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Background (Q2 and Q3):

Representing an adequate benchmark and publication in an appropriate manner CESR asked whether the index provider's own definition of the group of underlyings it was trying to represent would satisfy the level 2 "adequate benchmark" criterion, and whether there was a role for a quantitative assessment of the coverage of the HFI.

A large majority of respondents thought that the index definition given by the index provider should be sufficient, although some respondents were of the opinion that due to the non public nature of hedge funds, often the explanation of the definition of what the index is trying to represent is not explicit enough. Therefore, CESR proposes the following level 3 guidelines:

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 the index provider clearly defines, and makes publicly available, an explanation of what the index is trying to represent. This definition should include a narrative description of what the index is trying to track and not merely list underlyings;
2. assesses whether the methodology of the index construction means the representativeness for the market to which it refers is likely to be achieved.
3. The question arises of the scope and method of the disclosure required by paragraph 1 of Box 1. As an alternative to the proposed wording, the definition of the index could be made available only to the UCITS, or to UCITS investors (possibly on an "on request" basis).

We believe an index should generally make publicly available via web or other means, index definitions and representations. This information should additionally be free of charge, which is already a common industry practice. The construction methodology is a critical part of the overall index calculation and allows the public to assess whether the index is representative. An adequate benchmark should be sufficiently diversified, representative, transparent in both construction methodology and valuations and easily explainable. It should be left to the discretion of the index provider on how to create an index methodology that meets this definition.

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

We agree with CESR's assessment from the Level 2 guidelines and have no additional comments on the Level 3 guidelines.

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.

Background (Q4):

Regarding the quantitative assessment of the coverage of the HFI, respondents' views were mixed. Some thought that it was not necessary due to diversification requirements; others were of the opinion that quantitative measures may help determine the appropriate number of index

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constituents and the representativeness of the index, but that these measures should not be mandatory. In CESR's view, although it Questions 5 and 6 in the issues paper may be helpful for a statistical measure to reflect the "breadth" of coverage of the HFI, the difficulty of mandating an appropriate measure must be acknowledged. An ideal figure might be the percentage of the "total" defined market constituted by the HFI's underlyings; although in the context of hedge funds, calculating the total size of the whole market is problematic.

However, at each index calculation point the index provider could simply be required to also publish the total disclosed or estimated monetary value of the assets of (each of) the index components. This figure would at least allow the UCITS to make a judgment about how representative an HFI was, compared to estimated figures for the total market assets for particular hedge fund strategies, for example

We agree with CESR that it is difficult to mandate an appropriate measure for breadth of coverage. An appropriate construction methodology that is disclosed to the public is important to ensure that the index is representative of its underlying universe.

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. The publication of the aggregated values of an index may help investors to assess the "breadth" of the index and should be permitted. Conversely, the disclosed or estimated monetary value of the assets from the individual underlying constituents would neither help in assessing the indices "breadth" nor are the underlying funds operating under private placement exemptions legally permitted to disclose such data to the general public as is pursuant to certain provisions of the United States Securities Act of 1933. Similar rules exist in Europe through local regulations that also restrict certain information disclosure by underlying hedge funds. 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. 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 are not required to prove their breadth of coverage, but usually disclose total AUM to enable market participants to have a better understanding of the underlying universe.

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

Background (Q5):

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 met unless the UCITS:

1. confirms that 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").

We generally agree with CESR's proposed Level 3 Guidelines and believe the index provider should require the index components to be selected based on predetermined rules and objective criteria that are publicly available and clearly state the treatment of defunct funds and classification standards.

As far as the treatment of defunct funds is concerned, it should be the responsibility of the index provider to determine this criteria, just as any similar criteria would not be monitored or requested 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.

The disclosure in the index revision methodology for constituent classification is sufficient for "publication in an appropriate manner". 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. The same process that is applied to traditional financial indices should also be applied to HFI.

Traditional indices provide the same level of information. As we stated previously, backfilling should not be incorporated or allowed into an HFI. Any index should have clear rules prohibiting the back-filling of data. Backfilling of data inaccurately represents the historical performance of any index. 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.

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

Background (Q6):

Stemming from some respondents' views and after reflecting upon the issue, CESR has concerns about the conflicts of interest that could arise if hedge funds are making payments ("fee-sharing") to HFI providers to be selected as index components. This could result in selection bias of the index components. An index constructed in such a way would not seem to represent an adequate benchmark for the market to which it refers, and so would be unacceptable from the point of view of eligible assets regulation.

There are different views as to whether there should be an explicit intervention from CESR in this respect. CESR could propose a level 3 guideline which had the practical effect of preventing UCITS from gaining exposure to HFI which receive payments from hedge funds. In particular, this may depend on the circumstances in which payments are made by hedge funds to index providers (including their level and structure).

An HFI should not be allowed to require or accept fees from constituents if these are not calculated into the index return. Fee payments and fee sharing structures made between the hedge fund, its index provider or related parties need to be entirely transparent and must always be for the benefit of the investor in index derivatives or other products based on the index. The fee income or other forms of revenues for the index provider should be public and disclosed in a very transparent way. Membership into an index should only be based on a rules based methodology and objective selection criteria that prevent the arrival of any conflicts of interest and fee sharing structures. Hedge funds should only be chosen based on their ability to meet this selection criteria, not on any independent fee sharing agreements. All hedge funds should be treated equally and any fees that may arise in addition to the proposed fee structure must be passed back into the index.

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

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investor/the public) appropriate?

Background (Q7 and Q8):

CESR asked about the necessity of an independent third party review of the HFI's methodology and calculation. Many respondents questioned the need for this on the grounds of cost and of unequal treatment in relation to equity indices. According to most respondents, the UCITS should be fully capable of carrying out the assessment of the index methodology. However, CESR believes such an independent assessment could provide valuable support to a UCITS in assessing the construction standards of a particular HFI, so increasing investor protection. Taking account of the concerns expressed by respondents, CESR proposes the following level 3 guideline:

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

The proposed minimum annual verification and independent internal committee may add value to the objectivity of the methodology. It may also assist in verifying proper pricing procedures when dealing with less liquid securities. However, while some index providers may already offer such an annual audit, it should not be a requirement but rather at the discretion of the index provider. It should be the UCITS responsibility to verify that an index complies with the necessary criteria set forth by CESR. In addition, such verification is not a requirement for traditional indices and HFI should be treated on an equal basis.

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

We maintain our position that while an independent audit may enhance the trustworthiness of an index, it is not necessary as an objective rules-based index calculation methodology should be sufficient to ensure the validity of the index calculation points and consistency with the publicly disclosed methodology.

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

Background (Q9):

Regarding the issue of investability and taking into account that in the case of HFIs it is possible that some underlying components of the index may be closed to new investment, CESR considered whether it was necessary for all HFI components to be investable, and whether an



index with only investable components could be considered as representative of the market to which it referred. It must be clarified that the issues paper asked about investability in the context of the level 2 requirement of replicability. In that respect, CESR asked whether the replicability criterion would be fulfilled if the value of the index could be verified, given price data and the HFI's methodology. The majority of respondents agreed that the ability to verify the index value was sufficient to satisfy the replicability criterion. Some respondents noted that only including investable hedge funds in the index might reduce the representativeness of the HFI. On the other hand, some respondents thought that including non-investable hedge funds in the index might not fulfill the level 2 condition.

Taking into account the reality of the hedge funds market, CESR believes that HFIs including non-investable components should be eligible to be considered financial indices, provided that their characteristics are clearly disclosed.

In fact, since the issues paper was published, the drafting of the level 2 condition on replicability has changed slightly, with the inclusion of an "if necessary" in the adequate benchmark condition (see article 9, letter (b)(iii)). CESR believes that full transparency provides an important safeguard, and so believes that a combination of level 3 guidelines should allow replication of the calculation of the value of the index. CESR proposes the following level 3 guidelines, with disclosure being to the UCITS rather than the public as a whole. In conjunction with paragraph 1 of Box 3, this should allow replication of the calculation of the index value:

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 the index provider makes available to the UCITS details of whether each index component is investable or non-investable;
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. Index providers generally disclose the information described in Box 5, including whether a fund is investable or non-investable and their weights and pricing.

We agree with CESR that it is sufficient for the criterion of "representing an adequate benchmark" to have this information disclosed to UCITS. We also agree with CESR's view that HFI including non-investable components should be eligible to be considered financial indices, provided that their characteristics are clearly disclosed. An index should be considered replicable if the index calculations are verifiable through the HFI methodology. This is independent of whether the underlying funds are open or closed to new investors, and therefore is a nonessential determinant to whether its inclusion is representative of an adequate benchmark. 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. 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.

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

Background (Q10):

CESR asked whether guidelines should be set for the underlying components of HFIs (in particular, regarding net asset value calculation and custody arrangements) or, alternatively, whether the UCITS should be required to assess the due diligence of the index provider in respect of ensuring certain characteristics of the underlyings.

A large majority of respondents opposed CESR imposing any minimum standards for the underlying components, instead favouring the view that the UCITS should monitor the due diligence of the index provider. Taking those remarks into account, the following level 3 guideline is proposed:

Box 6.

In respect of a 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 in Box 4 above should confirm the adequacy of this due diligence and that it is being appropriately carried out.

We do not think it should be a requirement to carry out due diligence on the net asset valuation calculation procedures used by each index component nor is it practically and organizationally possible to conduct such a due diligence in a way that allows to balance cost and benefit and at the same time calculate an index in a timely fashion.

Due diligence is not defined by a common set of procedures that defines a market standard. As such, the ability to confirm that the index provider has carried out due diligence on the net asset value calculation puts additional responsibility, liability and burden onto the UCITS. This may also lead to an inability to achieve the intended investor protection and potentially stifle the development of this market segment. As a matter of practicality, it is unclear what part of the returns calculated by the underlying hedge funds could be verified by the index provider, as it would be very difficult to verify prices of potentially thousands of securities which may be illiquid by nature, not traded on any exchange nor be publicly available with observable market prices. Hedge funds provide audited financial statements on an annual basis and certain parts of the audit process requires valuation and examination of the net asset value calculation procedures.



We would like further to note that an index based on managed accounts also does not satisfy the above requirement in our view. In a managed account index there are technically no underlying hedge fund components, (ignoring for now the question whether this even presents a hedge fund index) but rather a pool of money that is sub-advised by several hedge funds. The calculation of the net asset value is conducted by the managed account provider which may also be the index provider and therefore no independent valuation is provided. This leads to an inherent conflict of interest as the index provider may also calculate the net asset values of the managed accounts. Following the above guidelines, the UCITS would need to have the index/managed account provider verify that it has carried out due diligence on its own calculation. Additionally, it is well documented that HFI based on managed accounts introduce selection bias and are less representative given the fact that the vast majority of hedge funds do not agree to run managed accounts.

Drawing an analogy to the equity world on the above requirement would mean that the UCITS would need to confirm that DJ EuroStoxx, for instance, has carried out due diligence on the balance sheet and profit and loss calculation of e.g. Daimler Chrysler. This is currently not a requirement for traditional indices. As such, we ask for HFI to be treated with the same standards and equal treatment compared to traditional indices.

It is our opinion that the UCITS should confirm that the HFI is calculated in accordance with the standards and principles set forth by CESR for the eligibility of financial indices. Any additional HFI specific requirements present an unfair disadvantage and precedence.

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?

Background (Q11 and Q12):

The issues paper asked about a minimum monthly frequency of index value publication¹³. A large majority of respondents commented that this matched current industry practice. However, certain CESR members are concerned that mandating this frequency might hinder more frequent index publication from developing. On the other hand, not mandating a minimum frequency might allow HFIs to be promoted with less frequent publication. Finally, setting a frequency for calculation greater than monthly might lead to selection bias by limiting the potential index components, or be inappropriate for HFIs seeking to replicate certain hedge fund strategies.

Article 34 of the UCITS Directive requires UCITS to make public in an appropriate manner the price of its units at least twice a month¹⁴. The question arises of whether operational risk for the UCITS (in terms of its ability to frequently calculate the price) is impacted by infrequent (less than one month) publication of the index value.



There are different views as to whether CESR should recommend a minimum frequency of the index value publication and what would be a suitable timeframe.

Monthly valuations are currently the market standards in the hedge fund community. While it is possible to derive more frequent valuations it should not be a requirement. We believe that a specific minimum or maximum requirement will neither hinder nor promote more frequent or infrequent publication standards. Monthly reporting and NAV calculations are standard in the HFI industry, however weekly and in some cases daily indications can be offered if demanded by the investor. Typically a hedge fund should be capable of providing monthly performance figures as is mandated by the index provider for HFI inclusion. Reporting more frequently might be at the discretion of the index provider.

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

As the underlying hedge funds typically report their returns at least monthly, the current market practice of monthly reporting standards should not affect the UCITS ability to value its assets. An index provider should seek to be representative of the hedge fund industry and more frequent reporting standards are not characteristic of the hedge fund universe.

More frequent publication is possible, however as this frequency increases, selection bias may be introduced as only a limited set of hedge funds may provide this level of frequency.

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

Background (Q13):

CESR was also concerned about the disclosure to the UCITS investor that should take place about investment in derivatives based on HFIs¹⁵. In that regard, CESR asked market participants whether UCITS intending to invest in derivatives based on HFI had to disclose this fact in the prospectus and what degree of information would have to be disclosed. Most respondents were in favour of disclosure although views were mixed regarding the extent of that disclosure. Having considered this matter carefully, CESR considers setting out level 3 guidelines on this issue is outside the scope of the current question of whether HFIs can be considered to be financial indices. Nevertheless, CESR considers it important that there is appropriate disclosure not only to the UCITS allowing it to carry out its due diligence but also to the retail investor about their fund gaining exposure to HFIs, and may consider this issue further.

We concur with CESR that UCITS which intend to invest in derivatives based on HFI should comply with all relevant laws and regulations. Disclosure of 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 soundest means of keeping investors informed.

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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?

Background (Q14 and Q15):

Some respondents commented about HFIs constructed using managed account platforms, on issues such as diversification, selection bias, and potential issues relating to fees charged and rebates from hedge funds to the index provider. Managed account platforms are an important part of the hedge fund marketplace and CESR does not wish to stifle market innovation.

Managed accounts are neither a common feature, nor an important aspect of the hedge fund industry and as such should not be a requirement for UCITS approval. Managed accounts represent a small portion of the investment universe and as such are not deemed indicative of the industry. A study done in April 2007 by Lipper/TASS found that only 22% of the hedge fund universe currently has managed accounts. By running hedge fund indices based on managed accounts, there is a high risk that selection bias and a lack of representation will be introduced.

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

We generally agree with the additional Level 3 Guidelines proposed by CESR for the eligibility of HFI for UCITS. Our key position remains the same: Hedge Fund Indices 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.