

Confidential response. Not for publication

CESR (The Committee of European Securities Regulators)
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Consultation on CESR's Issues Paper: Can hedge fund indices be classified as financial indices for the purposes of UCITS?

Morgan Stanley welcomes the opportunity to respond to CESR's Issue Paper on whether hedge fund indices can be classified as financial indices for the purpose of UCITS.

Morgan Stanley is a global financial services firm, offering a wide range of financial products to governments, corporations, institutions and individuals. We have a significant pan-European business, both on a cross-border basis and through local offices in the United Kingdom, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Spain, and Sweden, comprising both passported branches and separate legal entities. Morgan Stanley's investment management division provides investment management services to a wide range of UCITS compliant and non-compliant fund structures including the Morgan Stanley SICAV which was established in Luxembourg in 1998 as an open ended UCITS investment fund; a UK based Open Ended Investment Company and the Morgan Stanley Liquidity Funds based in Dublin. Morgan Stanley also has a strong knowledge and experience of the alternative asset management industry with long established relationships with hedge funds and hedge fund managers alike including through its position as the industry's leading prime broker.

In this response we set out our comments on the specific questions asked by CESR but before doing so we have some general comments on the appropriateness of hedge fund indices for UCITS investment.

I. General Comments

The interest among investors in investing in hedge fund indices ("HFI") stems from the growing demand for exposure to prime quality alternative investments. As suggested by CESR, we believe that eligibility criteria should be considered in order for HFI to be treated as an eligible instrument for UCITS. The principal criteria we believe to be relevant are: transparency, diversification and representativeness.

- **Transparency** should be understood as the use of a well defined methodology made publicly available. Any change in the methodology should be announced prior to its implementation. Moreover, transparency should be given to investors as regards the constituents of the HFI.

- **Diversification** must be achieved at two levels: at the level of the constituents (a minimum number of constituents) but also through a balanced split per strategy and regions.
- **Representativeness** should require on one side the selection of underlying components in a representative way compared to the composition of the overall hedge fund universe, and on the other side regular rebalancing of the index to take into account new market trends.

Each of these criteria may be affected by biases, as pointed out by the CESR.

Biases such as “sample bias”, “defunct fund bias” and “classification bias” may typically affect diversification and representativeness. As explained in further detail in our response, we believe that some of these biases may be partially neutralized, or at least mitigated by using suitable HFI methodologies and adequate types of constituents. Some residual biases may still exist but, in our view, they do not exceed those affecting equity indices and should not prevent the use of HFI in UCITS.

One bias, specific to HFI is the capacity to invest in the constituents of the index. Investors have to negotiate access with each hedge fund manager. So far the hedge fund industry has addressed that issue by using managed accounts (fund controlled by the managed account platform manager with a delegation of investment to the hedge fund manager). Access to the managed accounts is under the control of the managed account platform manager. In our view, this creates an unacceptable bias that contradicts UCITS diversification rules. Any default from the managed account platform manager would affect all the constituents of the index. The recent closure of the Standard and Poors - PlusFunds index could be seen as an illustration of the consequences of a concentration of risk of HFI based on a managed account platform. (Standard and Poor's index used PlusFunds' managed accounts, called Sphinx Funds). The impact on investors appears to have been more adverse than what would have been suffered had there been a direct investment in the underlying hedge funds.

One tool that could help to achieve transparency without the risk of a single managed account counterparty are hedge funds programs. Hedge fund programs can be described as real funds adhering to a common set of strict quality and risk standards monitored by independent qualified third parties to avoid any conflict of interest with the program sponsor. HFI constructed with funds participating in such programs, as opposed to any form of managed account, avoid the idiosyncratic risk of a single counterparty, while maintaining a higher level of transparency and control of the assets.

Accordingly, we think that HFIs should be eligible to UCITS as long as:

- they respect some transparency, diversification and representativeness criteria; and
- they are based on hedge funds managed and controlled by different fund managers and not on managed accounts or any alternative solution that expose investors to a default risk from a single counterpart

In our view, HFI based on hedge fund programs should be seen by the regulators as the most suitable form of structuring a HFI which would be appropriate for investment by a UCITS.

II. Answers to the specific questions posed by CESR

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

HFI biases can be partially neutralized, or at least mitigated by using suitable HFI's methodologies and appropriate types of constituents.

Our view is that alternative investment benchmarks should be seen, to some extent, similar to equity indices, as both can rely on an objective methodology and independent underlying components.

The methodology of both equity and hedge fund indices should be transparent, objective (minimum AUM, minimum length of the track record) and made publicly available.

Sample bias, defunct fund bias, classification bias:

- These potential biases are not exclusive to HFIs and can equally be found within existing fund indices.
- For example, sample biases can also be observed in equity indices: public companies are included whereas private companies are by definition excluded. This is analogous to the inclusion and exclusion of open funds and funds closed to investment.
- We believe that sample biases are magnified for HFIs investing on managed accounts as the investable universe is limited to funds available under a managed account format. Given the constraints associated with the creation of a managed account (compulsory choice of administrator, prime broker, etc.), some hedge fund managers may be deterred to create a managed account.
- Equity indices also suffer from defunct bias, as poor performing companies tend to be excluded from market capitalization and free float weighted indices by reference to objective criteria.
- Regarding classification bias, equities index providers may also sometimes find it hard to classify one equity stock (how would Vivendi Universal be classified before the spin off: utilities or communications).

Index weighting bias:

- Each weighting mechanism has its pros and cons.
- We consider that it is the index providers and investors' responsibilities to choose the type of weighting mechanism that best matches their representation criteria.
- Common features exist between equity and hedge funds indices:
 - asset based ~market cap weighted (SP 500)

- investability ~ free floating weighted (CAC40, FTSE indices, DJ Stoxx indices)
- equal weighted ~ (value line).

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

The nature of the constituents of the index (real independent funds vs. managed accounts) may introduce additional biases into a HFI:

Fees Bias:

- HFIs composed of managed accounts suffer from additional layers of fees (platform fees), on top of the managers' fees.
- Those additional layers of fees, which are sometimes very significant, tend to amplify the tracking error between investable (burdened with additional fees) and non investable HFIs (not impacted by any fees).
- On the opposite side, HFIs composed of real independent funds do not support additional layers of fees, and therefore do not suffer this bias.

Manager selection bias based on fee sharing agreements:

- Some managed account platforms require from the portfolio managers a very significant level of fee sharing. This may lead to a biased selection process based on the willingness of managers to share their fees, especially incentive fees.

Q3: Should a 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.

Yes, a HFI should respect minimum diversification requirements:

- Minimum number of managers (different number if broad HFI or sub strategy HFI).
- Minimum number of funds.
- For multi-strategy indices, a minimum representation of each sub-strategy should be ascertained.

Q4: What requirements on weighting should HFIs have to fulfill to qualify as financial indices? Please explain precisely the grounds underlying your comments.

In our view, weighting mechanisms should be freely decided by the index provider, as long as the methodology is objective, transparent and measurable.

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.

Yes, however, that definition may differ from one index provider to another in terms of number of funds, sub-strategies, style and regions.

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

Yes. We believe that it is appropriate that benchmark minimum coverage requirements, such as a minimum number of funds are prescribed. The minimum coverage should depend on depth and the type of the strategy of the HFI.

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

Yes. Backfilling distorts a fair representation of the past performance of non-investable hedge funds.

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

- Defunct funds should be removed at the rebalancing dates of the index, according to an objective methodology, publicly available and known in advance.
- The criteria set forth to remove defunct funds should be the same as those used to remove equities from equity indices when they no longer meet the eligibility requirements of the index (following a takeover for example).

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.

The index provider should not be able to revise the index methodology in such a way that investors cannot replicate the changes.

Classification for the index should be made systematically and adjusted on an ongoing basis by a party independent from the underlying hedge fund managers or the hedge fund platform provider.

Q10: Can the UCITS assess the revision methodology of the HFI adequately or should an independent third party be required to review the HFI's methodology? If the latter, how would this work? Please explain precisely the grounds underlying your comments.

Participating hedge fund managers and investors, including UCITS, should be informed in advance of any structural revision.

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. We should also note that beyond the passive and active selection of funds other distinguishing features of fund of funds are active and discretionary changes in weightings, number of funds, and to some extent the addition of market hedges.

Another key difference between funds of hedge funds and indices is the fee structure: management and incentive fees are common features of funds of hedge funds and a flat license fee is the industry standard for indices

Within HFIs, differences also exist between a HFI based on managed accounts vs. a HFI based on real funds:

- With HFIs based on managed accounts, the index faces one single counterparty (the platform provider), i.e. one single source of operational, reputational and credit risks.
- In case of a major fraud or scandal, indices may be badly impacted by disruption of the managed accounts. An illustration of this could be the recent closure of the Standard & Poors - PlusFunds index, which was adversely affected by its exposure to Refco (Standard & Poors' HFIs referenced PlusFunds' Sphinx managed accounts).
- By comparison, HFIs based on real funds have a broader base of investment and diversify the counterparty risk across a series of independent managers.

Ultimately, HFIs based on individual hedge funds, participating into a programme, are not exposed to a single counterparty risk.

Q12: Should only HFIs 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.

Yes. The selection process should be transparent and objective. The only subjective layer in the selection process should be at the level of due diligence and the assessment of the quality of the hedge fund managers and their strategies.

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.

- Index providers should have a transparent publicly available fee structure.
- Like fund of funds the selection of hedge fund managers should not be biased by their willingness to rebate a more significant portion of their fees beyond a standard and transparent index or platform fee.

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. All NAVs of HFIs' constituents should be publicly available.

Q15: Should CESR set requirements for verification of NAV calculation and independent custody arrangements/robust governance structures for the underlying constituents of HFIs 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.

Yes. We believe that all the issues specific to HFIs versus equity indices relate to non market risks (NAV calculation, custody agreements....). CESR should impose rules to prevent any eligible index to embed any concentrated non market risk. A concentration of key functions in the same hands (such as, for example, former SP HFIs exposed only to the PlusFunds managed accounts) would appear to contradict the principle of risk diversification.

To impose diversification rules on all functions is not a suitable answer as it would prevent fund managers to freely choose their partners (prime brokers, administrators...).

A rule on diversification of Fund managers combined with a fully independent choice by funds managers of their partners is the solution we would suggest:

- the fund managers should be diversified. Delegation of management by one single manager to a diversified number of “sub” managers does not address the non-market risk issue but creates one;
- administration and prime brokerage agreements should be left at the discretion of the underlying managers, provided that they respect certain prudential rules and deal with recognized counterparties; and
- due diligence procedures should be in place but the form of these should not be something which is prescribed by regulation.

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

Yes

Q17: Should CESR require an independent audit of the calculation of HFIs 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. The market should be allowed to assess the quality and reliability of an index provider.

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?

Yes.

Q19: To qualify as financial indices, should HFIs 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.

Yes.

Q20: Should a UCITS which intends to invest in derivatives based on HFIs 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 HFIs have to disclose in its prospectus? Please explain precisely the grounds underlying your comments.

Yes. UCITS intending to invest in HFIs should disclose in their prospectus the type of exposure and related risks for the investor.

Q21: Do you have any other comments relating to hedge fund indices that CESR should consider? What are they?

No

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 HFIs and funds of hedge funds? Please explain precisely the grounds underlying your comments.

From a regulatory and retail perspective, HFIs and funds of hedge funds should be considered from different angles:

- HFIs should be managed according to a pre-defined and publicly available methodology that ensures a good diversification and fair representation. HFIs focusing on sub-strategies, regions or styles should be allowed to match investors' objectives, as long as they match diversification and representativeness criteria.
- Funds of hedge funds do not have the same objectives and constraints in terms of representativeness and diversification. Hence, the rules designed to protect investors should be tighter.
- Some funds of hedge funds may have the objective to track HFIs. As these specific funds of hedge funds aim at tracking a vehicle relying on a methodology which itself adheres to a series of quality standards, we think that they should be seen as an exception and be subject to less stringent constraints than regular funds of hedge funds.

We hope that our response to this consultation has been of assistance and, if CESR considers it helpful, we would welcome the opportunity to participate in any further dialogue with CESR on these issues. We would be grateful if you would treat this as a non-public response.

Morgan Stanley

Should you have any further questions please do not hesitate to contact either Guy Clayton on +44 (0) 207 677 2448, or myself on +44 (0) 207 425 7376.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Philippe Keime', written over a horizontal line.

Philippe Keime
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