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UCITS – ANCHOR TO THE WEAKENED HEDGE FUND INDUSTRY?

The financial crisis has highlighted systemic risks spanning the financial sector. The hedge fund industry has been severely affected as weaknesses in risk management and due diligence processes were amplified by the adverse effects of substantial leverage, liquidity and counterparty risks in a global recession. Estimates suggest that global hedge fund assets under management have tumbled below $1 trillion during the second quarter of 2009, from a high of $1.9 trillion at the end of 2007.[1] In addition, the number of hedge fund liquidations continues to outpace the number of launches, with 292 liquidating during the second quarter of 2009 (and 668 liquidating during the first half of 2009), compared to 182 new funds launches during the same period.[2]

The combination of snowballing investor redemption requests and a lack of exit options from illiquid assets has compelled managers to invoke contractual redemption "gates" to stem the haemorrhaging and avert an unwinding of their funds. These performance and operational failures have caused questions of legitimacy for certain hedge fund managers, who built their reputations on the promise of absolute returns under all markets conditions. Further, these factors, compounded by reputational issues surrounding offshore investment centres which often nest hedge funds, have deterred many investors from investing in traditional hedge fund vehicles and fuelled calls for heightened transparency and regulation of the industry.

By contrast, European Union ("EU") Undertakings for Collective Investment in Transferable Securities ("UCITS")[3] have posted back-to-back net inflows amounting to €30 billion during the second quarter of 2009, raising the total assets under management of UCITS to €4,8 trillion.[4] This positive trend has been boosted by the recognition of the UCITS "brand" as an international "gold standard" leading to the global proliferation of UCITS sales beyond EU borders, as well as by the increasing sophistication of the UCITS regulatory framework and its responsiveness to market demands.

These and other developments implicitly call into question the very foundational assumptions underpinning the hedge fund industry – such as the viability of market neutral strategies, the benefits of high leverage, the actual degree of systemic risk posed by large, privately-placed open-ended funds and the ability of sophisticated investors to properly ascertain the associated risks.

These concerns have raised the question of whether the UCITS regime could offer hedge fund managers affected by recent developments an opportunity to utilize a more regulated legal framework such as UCITS. A number of leading fund promoters seem to think so and have already launched UCITS-compliant funds, with others likely to follow shortly.

[1] BarclayHedge, Alternative Investment Databases, at: http://www.barclayhedge.com/research/indices/ghs/mum/HF_Money_Under_Management.html#?btg_trk=OLD-BARCLAY-WEBSITE-REFFERAL;
Reuters, at: http://www.reuters.com/article/reutersEdge/idUSTRE5462RI20090507.
[2] Hedge Fund Research, at: https://www.hedgefundresearch.com/pdf/pr_20090917.pdf.
[3] UCITS are funds organized and operated within the UCITS regulatory regime currently consisting of Directive 85/611/EEC of 20 December 1985 (UCITS I) amended, inter alia, by Directives 2001/107/EC and 2001/108/EC of 21 January 2002, together also known as the UCITS III Directive.
[4] EFAMA, *Quarterly Statistical Release*, October 2009.

Investor Needs in the Aftermath of the Financial Crisis

The severe market oscillations witnessed since 2007, and especially those immediately following the Lehman Brothers collapse more than a year ago, have severely bruised most investors' portfolios and confidence, and this bruise has been further pummelled by the revelation of massive frauds, such as that of the Madoff scandal.

As a result, the needs of some investors have shifted from the purely performance-driven to the more balanced investment strategies. These investors tend to be more risk averse and sensitive to the importance of investing with reputable managers subject to appropriate regulatory oversight in a trusted jurisdiction. In a reversal of pre-recession tendencies, high levels of transparency and investment liquidity and the avoidance of overly complex investment products are now among the key drivers of investor appetite.

The UCITS framework offers answers to a number of these dilemmas. The UCITS Directive sets forth the general requirements for the organisation, management and oversight of UCITS funds and defines the parameters for, among other things, fund investment, leverage, diversification, portfolio liquidity, audits, asset custody, prospectus disclosure and engagement of service providers. Investors in UCITS benefit from high levels of investor protection and transparency and are able to redeem their investments at least fortnightly.

UCITS – a Viable Answer?

Managers today face the challenge of aligning their alternative investment strategies with post-crisis investor appetite in a reshaped global landscape for investment funds. Recognizing the need for an industry makeover, the world's largest hedge fund representative body, AIMA, has issued a set of "sound practices", while also supporting legislative initiatives in the US and regulatory guidelines issued by IOSCO.[5]

Some managers have embraced managed account schemes as a means of mitigating the perceived fraud, liquidity and transparency risks of hedge funds. This approach is based on the idea of establishing a comprehensive set of checks and balances on the manager's authority over the assets to reduce the risks involved. Other managers have identified the UCITS framework as a viable alternative to the exiting hedge fund regime.

But would such a transition to UCITS simply represent a cosmetic rebranding, or could it in fact yield genuine long-term value, both for the fund manager and its investors?

The Benefits

The UCITS regime offers fund promoters a number of benefits, such as new sales channels, broader geographic reach, economies of scale and a recognized brand as highly regulated investment funds.

UCITS can be freely marketed to retail investors across the EU, subject only to compliance in each host state with the notification procedures laid out in the UCITS Directive. In addition, marketing success within the EU has bred marketing success outside of the EU, particularly within Asia, South America and the Middle East (and more recently Canada), where investors and regulators are becoming increasingly aware of and comfortable with the UCITS regime. In fact, non-EU sales have accounted for approximately 40% of aggregate UCITS sales in recent years.

[5] The Alternative Investment Management Association (AIMA) has over 1,100 members. For a list of press releases on the subject, see: http://www.aima.org/en/media_centre/press-releases.cfm/page/1/.

Further, the geographic expansion of UCITS allows promoters to establish a single, flagship investment product with global reach, thereby reducing product replication costs and generating considerable economies of scale.

Finally, the UCITS brand, which has rapidly evolved into a benchmark for international excellence, is generally associated with investment vehicles subject to robust oversight and strict compliance within the long-only sphere, while providing enhanced risk management through the separation of functions among service providers and the imposition of strict liquidity restrictions. As such, UCITS managers generally are not burdened with the negative "stigma" often applied to hedge fund managers or associated with risky speculation conducted from an unregulated tax haven.

The Challenges

Fund managers should be aware that the substantial benefits of operating a UCITS vehicle, required to domicile within the EU, come at a premium price. Operating a fund in compliance with the UCITS Directive involves considerable costs. In addition, distribution of a UCITS-compliant fund beyond EU borders requires the implementation of global risk management, legal and tax compliance and product development processes. While UCITS can be publicly marketed to retail investors in the EU, their distribution in non-EU jurisdictions - except where local regulators trust in the EU's supervision procedures for UCITS and, therefore, only require adherence to a simple notification process for the registration and subsequent public offering of UCITS funds in their local market - will be made on a private placement basis and therefore, as in the case of traditional hedge funds, only directed toward institutional and otherwise qualified investors.

The range of investments in which UCITS can invest (so-called "eligible assets"), albeit significantly broadened by the UCITS III Directive to include rather complex instruments such as derivatives, continues to restrict strategies available to UCITS products. Direct exposure to commodities and real property remain firmly outside the list of eligible assets, while investments in transferable instruments other than eligible assets are limited to 10% of the UCITS vehicle's net asset value ("NAV"). In addition, as a fundamental principle, the UCITS Directive precludes liquidity mismatches and imposes strict portfolio diversification and leverage restraint requirements.

Key Characteristics

Risk Diversification

UCITS are required to maintain an appropriate spread of investments in order to diversify risk. Generally, except for government and public securities, the so-called "5/10/40" rule applies, requiring that no more than 10% of a UCITS' net assets be invested in securities issued by the same body, with a further aggregate limitation of 40% of the vehicle's net assets on exposures greater than 5% to single issuers. Among other things, this rule prevented master-feeder structures within the UCITS framework until UCITS IV (see below). Further risk spreading rules apply to deposits, derivatives and investments in other collective investments schemes.

Eligible Assets[6]

The UCITS III Directive has significantly increased the range of eligible investments for UCITS. Key to this expansion is a broader definition of "transferable securities" which now includes (i) shares in companies and equivalent securities; (ii) debt securities; and (iii) any other securities that carry the right to acquire securities

[6] See Annex for an overview of eligible asset classes and applicable limitations under the UCITS III Directive.

under (i) and (ii) by subscription or exchange. In addition, the UCITS III Directive no longer restricts UCITS investments solely to transferable securities, but offers a broader range of eligible assets, including:

(a) transferable securities and money market instruments admitted to an official listing on a stock exchange or which are dealt on a market which is regulated, operating regularly, recognized and open to the public;
(b) recently issued transferable securities which will be admitted to an official listing on a stock exchange or other market (as described above) within a year;
(c) money market instruments other than those dealt in on a regulated market, if the issue or issuer of such instruments is itself regulated for the purpose of protecting investors and savings, and provided that they satisfy certain additional requirements;
(d) units of other UCITS or other collective investment vehicles, provided they comply with standards similar to those imposed by the UCITS Directive;
(e) deposits with credit institutions; and
(f) financial derivative instruments dealt with on a regulated market or over-the-counter ("OTC"), provided that such OTC derivatives satisfy certain counterparty, valuation and liquidity requirements.

The continuing evolution of financial instruments in the years following the adoption of the UCITS III Directive led to considerable uncertainty as to whether such new instruments are captured under the definition of UCITS eligible assets. The European Commission provided much-needed clarification in this regard with the adoption of the final implementing Directive[7] (the "Implementing Directive") relating to eligible assets for UCITS funds. The Implementing Directive provides guidance to UCITS funds, clarifying when they are allowed to invest in particular financial instruments, such as (i) asset-backed securities; (ii) listed closed end funds; (iii) Euro commercial paper; (iv) index-based derivatives; and (v) credit derivatives.

An additional attractive feature of UCITS is the possibility of using a much broader range of financial derivative instruments ("FDIs") which allow for the leveraging of such funds by up to 100%. In addition, under UCITS III, FDIs can be used as part of the principal investment objective of the fund, as well as for efficient portfolio management purposes such as hedging. FDIs that can be used in this manner include:

(a) CFDs: The manager can be long up to 100% in directly held equity securities and short up to 100% using stock specific derivatives such as contracts for difference ("CFDs") or stock specific futures, allowing fund leverage up to 100% of NAV;[8]
(b) CDSs: Credit default swaps ("CDSs") can be used in a number of ways in fixed income strategies, for example hedging exposures and buy/write protection, or playing the basis between the CDS and its underlying corporate spreads;
(c) Total Return Swaps: This involves investing in a portfolio and swapping its return through a total return swap for a return that is related to an index; and
(d) Certificates: Certificates, issued either individually or in a series, can also be used within the UCITS III framework to replicate structured products; alternatively, a UCITS-eligible index can be created to

[7] Directive 2007/16/EC of 19 March 2007. The Implementing Directive followed guidelines concerning eligible assets for investment by UCITS funds issued by the Committee of European Securities Regulators ("CESR"), published in March 2007 and last updated in September 2008 (available at: http://www.cesr-eu.org/popup2.php?id=5280).

[8] Physical shorting is not permitted under the UCITS Directive. The Irish Financial Services Regulatory Authority issued a policy in October 2007 that allowed covered physical shorting. However, after consulting with CESR, the European Commission later clarified that physical shorting, whether covered or "naked", is incompatible with the UCITS Directive.

replicate all of the underlying hedge fund strategies, as long as such index meets the UCITS criteria of eligibility.

Notably, the rules relating to the use of such instruments are designed to ensure that the general UCITS-eligible assets and diversification requirements are not circumvented through such use, and their scope of use within the UCITS platform is, therefore, limited. In addition, UCITS using FDIs as a main part of their investment strategy and/or replicating hedge fund strategies (often called "sophisticated" UCITS III funds or "Superfunds") are required to implement additional risk management/measuring (e.g., value-at-risk) and reporting processes that correspond to the risk and complexity of the strategy adopted. Sophisticated funds must also calculate their NAV on a daily basis. Generally, managers are also required to explain to the relevant regulator the manner in which the derivatives are being used, the risks involved, and how such risks are being controlled and monitored.

Liquidity

A key principle of the UCITS Directive is to ensure high levels of liquidity within UCITS and prevent any mismatches between investor redemption rights and portfolio structuring. Units in a UCITS must be redeemable (generally at NAV) at least twice a month. Regulators may in limited cases reduce this requirement to monthly redemptions provided such derogation does not prejudice the investors' rights. In addition, investors must be allowed to redeem their units on short notice. Further, any investment made by a UCITS, even if an "eligible asset", must not compromise the overall liquidity of the fund's portfolio and its ability to satisfy redemption requests. Finally, "gates" and other restrictions can only be applied on a temporary basis and under exceptional circumstances, and notice of such gating must be promptly given to the relevant authorities.

In addition to the liquidity requirements, a UCITS may only borrow up to 10% of its NAV for temporary purposes (for liquidity), while aggregate leverage is limited to 100% of the UCITS NAV in case of FDI exposure, as described above.

A particular challenge for UCITS fund managers and their service providers (in particular the fund's administrator) who are accustomed to servicing traditional long-only UCITS funds, is the adaptation of the operational requirements relating to increasingly complex, less liquid instruments, such as OTC-investments. In particular, administrators must implement thorough pricing policies for such instruments to satisfy the (sometimes daily) NAV calculation requirements.

In addition, managers are not permitted to establish "side pockets" and may therefore encounter difficulty in ensuring that the portfolio's liquidity profile aligns with the fund's redemption frequency requirements – an acutely sensitive issue for UCITS dealing extensively with OTC-investments. Finally, the replication within the UCITS framework of performance fee structures traditionally used by hedge fund managers is particularly challenging due to daily capital movements and can only be achieved through complex automated performance fee computing systems.

MARKET OVERVIEW

The increased flexibility of the UCITS regime has resulted in a broad range of fund structures and strategies represented in the market. UCITS are formed as single manager or funds of funds, and their investment strategies run the whole gamut from plain-vanilla long-only to alternative strategies, such as long-short equity, managed futures, global macro, and commodity trading adviser (CTA) funds.

Some trademark alternative fund manager names have already dipped into the UCITS market, and others are expected to join them, in particular after the implementation of the UCITS IV framework. The pursuit of

alternative strategies within a UCITS-compliant fund is generally achieved through (i) direct trading within the UCITS universe (e.g. long-short and managed futures); (ii) investing in eligible certificates replicating structured products (e.g. replicating the risk profile of a fund of hedge funds); and (iii) the formation of so-called "index" or "tracker" funds (provided that the index is recognized by the UCITS home Member State authorities).

However, the comparably high costs of operating a UCITS vehicle, and the liquidity and leverage restrictions imposed by the UCITS Directive, still constitute substantial hurdles to certain managers and investment strategies (such as distressed debt) which remain firmly outside the scope of the UCITS brand.

UCITS IV

Looking ahead, the flexibility of the UCITS product and its appeal for hedge fund managers are expected to rise to the next level with the advent of Directive 2009/65/EEC ("UCITS IV").[9] UCITS IV, required to come into force via transposition into national law in each EU Member State no later than June 30, 2011, will facilitate master-feeder structures and cross-border UCITS fund mergers, while also speeding up cross-border marketing and sales of UCITS. This, in turn, should lower the establishment and operating costs for UCITS promoters/managers and allow for additional strategies to be implemented within the UCITS platform.

Conclusion

The prospect of achieving absolute performance within a robust and flexible regulatory framework that allows fund managers access to a global investor base has already driven a number of hedge fund managers to the UCITS brand. This trend has been further accentuated by the spread of UCITS products from retail to institutional investors who have sought higher levels of transparency, risk management and improved liquidity in the aftermath of the financial crisis. In this light, fund managers view the UCITS brand as a means of both complementing, if not mirroring, their other alternative investment products and expanding their global client base.

While UCITS III already permits many "hedge fund-like" strategies to be pursued within the UCITS framework, the additional flexibility and lowered costs expected to result from UCITS IV should attract additional alternative fund managers to the platform.

This could be particularly true in the wake of the European Commission's proposal for a EU Directive on Alternative Investment Fund Managers (the "AIFM Directive").[10] If enacted in its current form, the AIFM Directive would require all managers managing non-UCITS funds marketed to EU investors to be authorized within the EU and subject to regulatory oversight. New requirements would be imposed on such fund managers, including the appointment of independent service providers, the establishment of adequate risk management, liquidity and transparency policies, and potentially subjecting such managers to prescribed remuneration policies.

Regardless of the specific provisions of the adopted form of AIFM Directive, the impending substantial regulation of non-UCITS funds is likely to impact the perception of fund promoters and further enhance the general perception of UCITS regulatory requirements as presenting structuring and marketing opportunities rather than

[9] UCITS IV was adopted by the European Parliament on January 13, 2009 and by the EU Council on June 22, 2009, and published in the official gazette of the EU on November 17, 2009.
[10] Proposal published on April 30, 2009. For further information, please visit: http://curtis-ifg.blogspot.com/#uds-search-results.

barriers to entry. For many managers, the migration to the UCITS brand will likely be viewed as not only a logical transition but also as the next step in the natural evolution of alternative investment vehicles, as business models strive to adjust to ever new market realities.

Annex
Eligible Assets Table

Asset Type	Limit*	Comment
Shares, Bonds, Certificates	100%	Listed, or to be listed within 1 year after issue
Money market instruments	100%	Listed, or when issuer satisfies the conditions in Article 19.1(h) of the UCITS Directive
UCITS funds and other open-ended non-UCITS funds	100%	Provided conditions in Article 19.1(e) of the UCITS Directive are met
Closed-end funds	100%	If compliant with Article 2.2 of Implementing Directive
Deposits with credit institutions	100%	Short-term deposits (max 12 months). Certain conditions for credit institution apply
Financial derivatives	100%	Listed
OTC derivatives	100%	Conditions relating to underlying instruments, counterparty and valuations apply
Commodities, Precious metals	100%	Only through structured products that qualify as transferrable securities. Derivatives on a single commodity remain forbidden.
Hedge funds, Real estate funds, and Private-equity funds	0- 10%	Depending on jurisdiction. When permitted, only if asset complies with Article 2.1 of Implementing Directive
Other non-listed instruments	10%	

* Percentage of aggregate UCITS fund assets that may be invested in such asset type.

This table does not purport to provide, nor does it provide, a comprehensive overview of the eligible assets requirements applicable under the UCITS Directive and the Implementing Directive. In particular, in addition to the limitations applicable to certain asset types listed above, any prospective UCITS investment must comply with the general eligibility requirements under the UCITS Directive. Further, the UCITS Directive imposes strict risk spreading and single-issuer limits on a fund's portfolio. Finally, further rules and exemptions may be applied by the relevant regulator in each EU Member State jurisdiction, and such rules should be assessed on an individual basis depending on the applicable jurisdiction.

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