UCITS III for Hedge Fund Strategies: A Brief Guide

What are UCITS?

UCITS are funds that comply with the European Directive for retail open-ended investment funds, are incorporated and authorised by the regulator in an EEA member state and can be distributed throughout the European Economic Area.

UCITS is a framework to standardise rules for the authorisation, supervision, structure and activities of collective investment undertakings in the EEA and so to enable them to be marketed throughout the EEA.

To be UCITS a fund must be open-ended, liquid, well-diversified, invest only in certain ‘eligible’ assets (namely quoted securities, money market instruments, deposits, certain derivatives and units in other UCITS) and can only employ limited leverage.

Why would a hedge fund manager offer a UCITS version of their fund?

Managers who are able to offer their strategies in UCITS format will be able to access a large universe of investors attracted by the UCITS brand in Europe, globally, and particularly in the Asia.

The transparency, liquidity and regulatory oversight required in a UCITS addresses investor concerns in a post-Madoff, post-credit 2008 crunch environment.

A UCITS lies outside the scope of the European draft Alternative Investment Fund Managers Directive which is likely to impact unregulated offshore hedge funds in yet undefined ways. This is potentially beneficial as the AIFM Directive is likely to impose constraints on European investors investing in third-country funds, which would include those domiciled in offshore jurisdictions such as Cayman Islands and Bermuda.

What is the process of launching a UCITS?

It's complicated but it can be largely outsourced. Below is a list of the main features of UCITS. It all sounds complicated and laborious but a competent partner will be able to take most of the initial and ongoing burden away so that the fund manager can concentrate on managing money in as uninterrupted and unmodified a fashion as possible.

Fund Structures:

There are several fund structures available to UCITS. These include Unit Trusts, which are familiar vehicles and preferred by certain Asian investors such as Japanese, Variable Capital Companies, which are the OEICs and SICAVs and will look similar to a hedge fund structure with additional segregation of assets ex prime broker and Contractual Funds which are niche structures which are more complex to administer and market.

Management Companies:

The structure and indeed the existence of a management company is based on the tax planning of the investment manager. A Management Company brings with it minimum capital requirements, oversight and accounting and consolidation requirements. Roughly speaking, a UCITS Management Company needs to have 125,000 EUR of capital as a minimum plus 2 basis points per EUR of AUM over 250 million. This capital cannot be held on the group Holdco balance sheet and must be invested in liquid investments.

Sponsors:

There are some onerous capital requirements on Sponsors.

- In Ireland the capital requirement is 635,000 EUR.
- In Luxembourg the capital requirement is 7.5 million EUR.
- These are largely unwritten rules.
- A sponsor can be rented.

Legal Documentation:

- There are rules for the prospectus
- There is a simplified prospectus
- Constitutional documentation, memoranda and articles.
- Legal contracts:
    - IMA
    - Administration Agreement
    - Custody Agreement
    - Distribution Agreement
- Business Plan and Substance Application
- Risk Management Process

The Business Plan and Substance Application:

- Constitutional documents
- Capital requirements
- Probity and competence of directors
- Suitability of qualifying shareholders and organizational structure
- Conduct of business
    - Board meetings – Frequency and content – minimum of 4 in the domicile.
    - Managerial functions
        - Frequency and content of reporting
        - Exception reporting
        - Escalation measures

The managerial functions require at least 2 Conducting Officers or Dirigeants.

These can be:

- Employees (usually not)
- Directors of the UCITS can assume these functions
- UCITS can appoint consultants.
- In Ireland a board can be collectively appointed. In Luxembourg individuals have to be named.

The managerial functions include:

- Appointment of Chairman
- Frequency of board meetings
- Distinguishing between decisions for the board versus the conducting officers
- Compliance monitoring.
    - Investment breaches
    - Pricing errors
    - Complaints
    - AML issues
- Risk Management
    - Investment risk
    - Use of Derivatives
    - Pricing issues
    - Reconciliation
    - Failed trades
- Performance Monitoring
    - Performance metrics
    - Benchmarks – especially if VaR relative to benchmark is used as a formal exposure metric
    - Explanation of unusual performance
    - Outlook
    - A bi annual detailed commentary for inclusion in

    - the financial statements
- Finance Control
    - Management company and fund financial statements
    - Annual audit process
    - Monthly management accounts of Management Company and Fund
- Monitoring Capital
    - Monthly review of capital adequacy.
- Supervision of service providers
    - UCITS requires regular ongoing due diligence on the Administrator, Custodian, and other service providers.

Eligible Markets and Securities:

<u>List of Eligible Assets</u>

- Transferable Securities (TS)
- Money Market Instruments (MMI)
- TS and MMI with a derivative element (example Convertible Bonds)
- Financial Derivative Instruments (FDI)
- Open ended Collective Investment Schemes (CIS)
- Deposits with credit institutions
- Ancillary liquid assets
- Financial indices
- Repos, reverse repos, stock lending

<u>List of non eligible assets</u>

Direct or indirect investments in

- Commodities
- Real estate
- Private equity

- Hedge funds
- Non financial indices
- Short selling of MMI
- Anything that circumvents the investment limits of the UCITS directive

Note that exposure to the above can be gained through financial indices on the underlyings.

<u>Transferable Securities:</u>

Generally:

- Max loss limited to cost
- Liquid
- Regular, accurate reliable pricing
- Negotiable

Closed end funds:

- Corporate governance has to be robust
- Asset manager subject to national regulation

Money Market Instruments

Generally:

- Normally dealt in on the money markets
- Liquid
- Can be accurately valued

If not dealt in on a regulated market:

- Meet certain issue/issuer criteria

- Information available for a credit assessment
- Freely transferable

<u>Derivatives:</u>

- Underlyings consist of:
    - TS, MMI, CIS, FDI, deposits, financial indices,
    - Interest rates
    - FX rates
    - Currencies
- Do not expose UCITS to risks it could not otherwise assume
- Does not cause deviation from investment objectives
- Does not result in the delivery of underlying which is not an Eligible Asset

Shorting comes in under derivatives on TS and financial indices. It will allow shorting equities and bonds via CDS.

OTC derivatives are allowed. There are requirements on the counterparty.

- The counterparty must provide valuations
- The counterparty must provide unwind

<u>Collective Investment Schemes:</u>

UCITS funds can invest in Collective Investment Schemes provided

- The underlying CIS does not itself invest more than 10% of NAV in another CIS (UCITS or otherwise)
- The CIS is diversified
- The CIS is liquid
- There is a 30% limit on exposure to non UCITS CIS even

if they comply with the above

- Non UCITS CIS must be subject to some form of supervision equivalent to UCITS, with sufficient investor protection

Financial Indices:

- Automatically eligible if the constituents are themselves eligible
- All other indices require separate regulator approval
    - Requires sufficient diversification
    - Be an adequate benchmark for the reference market
    - Appropriately published
    - Must have independent management from the management of the UCITS

A number of bespoke indices have emerged that appear to game this rule. The indices resemble bespoke, alpha optimized portfolios instead of an index representative of some class of assets.

Hedge fund investable indices are eligible provided:

- No backfill used in their construction
- No payments are made to the index provider from the index constituents
- Index construction is objective and systematic
- UCITS must perform adequate due diligence on the quality of the index

Repos, Reverse Repos and Stock Lending

- UCITS can enter into repos and reverse repos and stock lending. Conditions apply.

- Collateral must be posted.

Diversification:

Unsatisfied with the almost universal concept of diversification, UCITS has adopted the term Risk Spreading.

Unlisted Securities:

- Limit of 10% of NAV in unlisted securities.
- Additional 10% of NAV in recently unlisted securities destined to list in less than 12 months
- Limit does not apply to certain 144A securities provided they list within a year
- Bonds with a liquid market traded between regulated broker dealers and are subject only to general limits

5/10/40 Rule:

- 10% NAV issuer limit across capital structure.
- For positions exceeding 5% NAV issuer limit, the aggregate shall not exceed 40% of NAV.

For bonds issued by EU credit institutions subject to special public supervision

- 25% NAV issuer limit across capital structure.
- For positions exceeding 5% NAV issuer limit, the aggregate shall not exceed 80% of NAV.

For Index Trackers, there are looser limits.

- Max 20% NAV issuer limit. 35% in exceptional circumstances. (e.g. 0005 HK in the HSI Index)

- Index must be:
    - Sufficiently diversified
    - Represent an adequate benchmark
    - Published appropriately
    - Independently managed of the UCITS

Control Limits:

- Max 10% of non voting shares of any issuer
- Max 10% of debt securities of any issuer
- Max 10% of money market instruments of any issuer

Government Securities:

- 35% NAV issuer limit (from 10%) for TS and MMI issued by:
- EU member state and their local authorities
    - Non Member State
    - Public international body of which at least one member state is a member
- Exempt from 5/40 rule

Up to 100% of NAV may be invested in TS, MMIs issued by a member state or their local authority, non member state or public international body if:

- Held over 6 or more different issues
- Limit 30% per single issue
- Intention to use these limits and target issuers is disclosed in constitution and offering docs
- Limited to OECD / Investment Grade (quite independent of each other these days)
- Gilt Funds for example can be UCITS compliant and invest in 1 single issuer. (not quite investment grade these

days)

Investments in Other Collective Investment Schemes:

- Max 20% of NAV in a single CIS
- Max 30% of NAV aggregate in non UCITS CIS (to remain ourselves UCITS)
- Underlying CIS limited to no more than 10% in other CIS in aggregate (prevents FOFOF layering)
- Max 25% of units of a single CIS (control issue)

General:

- 20% NAV limit in issuer exposure across their capital structure, net. Includes TS, MMIs, cash, OTC counterparty, exposure via derivatives

- Max 5% in warrants

- No uncovered short sales

- Limits do not apply to the exercise of subscription rights

Borrowing Limits:

- The Fund can borrow up to 10% of NAV for temporary purposes.
- Credit balances may not be offset against borrowing in calculating the percent borrowed.

- Leveraged is achieved through derivatives.

Risk Management:

Risk Management Process:

- A fund using Derivatives must submit to the Regulator a detailed Risk Management Process (RMP)
- The RMP will set out the list of derivatives that will be used, the controls, processes, systems and personnel involved in the management and monitoring of risk relating to these derivatives.
- Material changes to the RMP need regulator re-approval.

Level of Sophistication:

- The Fund may self classify itself as Sophisticated or Non-Sophisticated.
- The Regulator may disagree
- Sophisticated funds are required to implement VaR
- Non Sophisticated funds can use commitment or (delta) notional exposure
- Self classifying as Non Sophisticated exempts a fund from the use of VaR but can impose restrictive notional leverage limits
- Self classifying as Sophisticated allows more latitude in definition of leverage within a VaR framework

Global Exposure:

Total gross exposure including derivatives is limited to 200% NAV

Synthetic shorting is allowed

Physical shorting is not allowed

Commitment Approach:

- Notional value
- Global exposure is NIL for funds using derivatives purely for hedging or risk reduction purposes
- Options can be treated on delta adjusted basis
- Purchased and sold derivatives can be netted only if there is explicit netting arrangements with the Custodian or counterparties

VaR:

VaR model based on:

- 99% confidence interval
- Max 1 month holding period
- Min 1 year historical observations
- Stress tests and back tests must be applied
- Adequate internal controls, staffing and experience are required
- Description of VaR model and 3^{rd} party verification
- VaR may be specified as a multiple of a benchmark. That multiple is limited to 200%.

Position Exposure:

- Limits are defined on total exposure aggregating direct, indirect and derivative exposure.
- Except for certain Index based derivatives.

Counterparty Exposure:

- Counterparty risk is limited to 5% of NAV for OTCs and

10% for EU or equivalent credit institutions.

- All derivative exposures to the same OTC counterparties must be aggregated and an “add on” for future credit exposure based on Market Value (Ireland) and Notional (Luxembourg).
- Counterparty risk can be reduced by the fund receiving collateral from the counterparty.
- Positive and negative positions can be netted but only if there are formal netting agreements with the counterparty.

Liquidity:

- A UCITS must re-purchase or redeem its units at the request of the unit holder.
- Minimum frequency is twice a month. (Note that there is no specification on when in the month.)
- Maximum notice until payout of cash is 14 days.
- A UCITS can have a 10% gate per redemption date, thus a maximum 20% gate per month.

Feasible Strategies:

The following strategies are feasible under UCITS:

- Long short equity
- Long short credit – liquid markets only
- Convertible arbitrage
- Global Macro
- Fixed income arbitrage – definitions of leverage need to be addressed
- Commodity index funds – there is no question of physical of derivatives on underlying commodities. Only commodity indices are eligible.
- CTA and Managed Futures

- Event Driven
- Funds of UCITS Funds
- Structured and guaranteed products
- ETFs

The following are not recommended for UCITS and fall foul of UCITS liquidity and valuation requirements: Less liquid credit strategies, distressed debt, mezzanine, private equity strategies, small and micro cap strategies.

A Final Word:

For the hedge fund manager, UCITS provides a delivery channel to a different investor base diversifying business risk. It also addresses investor concerns about the operational and fraud risks that plagued parts of the offshore unregulated industry in 2008. In addition, it provides a potential means of dodging the AIFM directive. There will be managers who see UCITS as a convenient dodge and an easier path to raising capital, and there will be those who see it for what it is; the evolution of European mutual fund legislation to ensure better investor protection while providing investors more choice. It is important that managers comply with the spirit of the law as well as the letter. The risk to UCITS as a brand is that it is abused by some managers which abuse the market uncovers in the usual discontinuous fashion and the fallout tars all UCITS with the same brush.

UCITS is designed for liquid strategies. Shoe-horning illiquid strategies into UCITS is a very bad idea. Not many people are aware that UCITS has a gating facility. This is an emergency feature for when normally liquid markets seize up. To run an illiquid portfolio in a UCITS in the hope that the gate provision is never needed is irresponsible on the part of the manager and the service providers who help to bring that UCITS to market.

UCITS is designed for low to moderate leverage strategies. The Sophisticated Fund classification which measures leverage in terms of VaR allows liquid strategies where delta notional exposure is not an appropriate measure of leverage admission as a UCITS. It is not there so that a highly levered and risky strategy can be slipped into a UCITS.

UCITS is designed for portfolios of eligible assets which are eligible by virtue of their liquidity, price discovery and transparency. It is designed so that the UCITS can feasibly supply the represented liquidity, provide an accurate and representative valuation of assets and not carry surprisingly large liabilities on the balance sheet which unexpectedly erode the value of the Net Asset Value.

Use with care.