MACFARLANES

ALTERNATIVE UCITS – EXPANDING YOUR INVESTOR UNIVERSE

INVESTMENT MANAGEMENT

The success of the UCITS brand is undeniable. The trademark characteristics of liquidity, transparency and copious regulation associated with it continue to prove seductive to European, Asian and South American institutional investors. Consequently, in order to exploit this interest and to access a wider pool of investors, we are seeing an increasing appetite from hedge fund managers to adapt their strategies for use within a UCITS wrapper.

We consider here why a manager of a traditional offshore hedge fund might decide to establish a UCITS, techniques used by hedge fund managers to conform their strategies to become UCITS compliant and the options available to get a UCITS to market in the most agile and cost effective way.

WHAT ARE THE BENEFITS OF OPERATING A UCITS?

There are typically two reasons for a hedge fund manager to add a UCITS product to its range:

- key investors are exerting pressure on the manager to offer a UCITS; or
- the manager would like to attract the increasing number of European, Far Eastern and South American investors, particularly pension funds, who do not want to invest in (or wish to reduce their allocation to) an offshore unregulated fund, and are consequently exploring regulated fund investments.

Of course a UCITS can be offered to retail investors – its original purpose – however, we do not typically see hedge fund managers looking to exploit this possibility.

Reputation

In both of the above cases the UCITS product is likely to be appealing to investors because it offers greater liquidity and transparency than that offered by hedge funds. UCITS have been available to investors for almost three decades and therefore have longevity and familiarity in their favour. The level of regulatory oversight offered by a regulated fund is also appealing to investors. They are perceived as being safer, more reputable products than similar offerings. Of particular value is the protection offered by having a depositary safekeeping the fund's assets, a concept which has now been replicated in the Alternative Investment Fund Manager's Directive (AIFMD) for some unregulated funds. These positive characteristics did not entirely shield UCITS investors from the effect of the Madoff fraud however and therefore this additional protection does not mean they are immune to trouble in the market but the perception is there.

Marketing

Whilst it may be possible in the future to market a Cayman hedge fund to European investors under the passport available under AIFMD, this is not likely to become a reality until 2016 at the earliest (if at all). Until that time the only way to market such a fund in Europe is by observing the diverse local private placement regimes in each relevant jurisdiction. Some hedge fund managers have determined that it is too cumbersome to market in Europe and so have decided that they will no longer do so, thus disengaging a large pool of potential investors. In stark contrast the marketing of a UCITS fund throughout Europe is a familiar and well trodden path; the manager makes a notification to the fund's home state regulator which in turn notifies the regulator in the host state in which the manager wishes to market the UCITS. Provided the manager has a robust distribution network, offering a UCITS in Europe is far simpler than marketing an unregulated fund in Europe.

Fees

The manager of a UCITS can receive both a management fee and performance fee from a UCITS and a UCITS will typically bear the same types of costs as a Cayman fund. Thus the structure of fee arrangements in a UCITS fund does not necessarily need to differ from that of a Cayman fund.

A manager of a UCITS is required to express fees and expenses in a two page "Key Investor Information Document" using an "on-going charges figure" (OCF). The OCF represents all of the costs of managing the fund (for example, the management fee, performance fee, depositary fee, administration fee, and auditor's fee) but does not include dealing costs. This is part of the regulatory trend to ensure that all fees relating to the management of a fund investment are disclosed to investors, not just the management fee.

ARE THERE ANY DISADVANTAGES?

Infrastructure

The infrastructure required to operate a UCITS is significant. Both the operator of the fund and the fund itself must be authorised and regulated by a European regulator (unless the fund is established in a jurisdiction which offers a "self-managed" product for example, Luxembourg in which case no separate operator is required). If an operator is required it needs to be a "UCITS manager" under the UCITS Directive which brings with it substantial systems and controls and regulatory capital requirements and brings such manager under the scrutiny of the regulator of the jurisdiction in which it is established. The operational infrastructure for a self-managed fund is similar. However there are a number of service providers able to assist in providing solutions to ease the compliance and regulatory burden.

Investment and borrowing powers

The investment constraints (as described below) that are fundamental to offering a UCITS product are not for everyone. It is certainly easier to offer a UCITS product based on a "plain vanilla" strategy which sits easily within the UCITS restrictions. However others are willing to be more creative and there are techniques available which, with a shift of emphasis in the strategy, may enable a manager to replicate, to a greater extent, their strategy within the constraints of a UCITS manager.

Cannibalisation

Some managers have expressed concerns that they may "cannibalise" their existing Cayman fund if they establish a UCITS; that is, investors from the existing Cayman fund may redeem and instead invest in the UCITS. However in our experience this is not necessarily the case. Usually investors wishing to invest in a UCITS product are different investors expecting different returns to those investing in a Cayman fund.

However, cannibalisation is a possibility. For example, if investors in a manager's UCITS product can access a similar strategy to those investors in the manager's Cayman fund and yet the UCITS investors receive benefits such as disclosure of the fee arrangements in the form of an OCF and daily liquidity, the manager may come under pressure to offer the same to the hedge fund investors. A hedge fund manager may find that all fund products offered need to be operated to the highest common denominator set by UCITS in such respects.

Liquidity

A UCITS must offer investors redemption rights at least every two weeks. Most UCITS offer daily or weekly liquidity. Gating is not permissible (deferrals of redemption requests are permitted where redemption requests exceed 10 per cent of the fund's value but only until the next valuation point, which is typically the next day).

INVESTMENT CONSTRAINTS

A UCITS is limited to investing in transferable securities (generally this means listed securities although up to 10 per cent of net asset value may be invested in unlisted securities), money-market instruments, other UCITS or regulated funds, warrants, derivatives and deposits, in accordance with prescribed restrictions and spread limits.

A UCITS is not permitted to invest in unregulated funds, commodities, gold or real property. The use of borrowing is very limited. There are significant influence and concentration rules such that a UCITS is not permitted to acquire so much of an issuer such that it can exercise significant influence over it.

These constraints may appear, at first glance, to be a significant roadblock to many strategies but there are techniques available which will enable exposure to some of the investment classes which are "off limits" whilst maintaining compliance with the UCITS restrictions.

Shorting

A UCITS is not permitted to undertake physical shorting. However, a UCITS may take short positions synthetically through derivatives. These though are also subject to restrictions, as follows:

Derivatives

A UCITS is generally only permitted to enter into a derivative transaction (either OTC or exchange-traded) if the underlying assets from which the value of the derivative is derived, are themselves UCITS eligible assets. This is known as the "look through rule".

The exposure under any derivative transaction must be suitably covered from the property of the UCITS. Therefore a UCITS is required to hold property sufficient to match the exposure arising from all of its derivative transactions.

For OTC Derivatives, exposure to any one counterparty must not exceed 10 per cent of the net assets of the UCITS where the counterparty is a credit institution, or 5 per cent in any other case. However, this can be offset by collateral. As such, standard OTC derivative arrangements where collateral is exchanged between the parties based on exposure will mitigate this to some extent.

In addition, OTC derivatives must be subject to reliable and verifiable, verification on a daily basis, and must be capable of termination at fair value, at any time.

Exchange-traded derivatives must be traded on a "regulated market", and the posting of collateral to the UCITS fund's futures broker should be taken into account for counterparty exposure limits.

Indices

The "look through rule" described above does not apply if the UCITS invests in an index based derivative provided the index meets the detailed requirements set out in the rules. Broadly, the index must be sufficiently diversified, it must represent an adequate benchmark for the market to which it refers, the index must be published in an appropriate manner and it must be managed independently from the UCITS. It is therefore possible to create an index which provides indirect exposure to ineligible assets such as hedge funds or commodities via a total return swap referenced to an index of those assets. The UCITS will hold primary investments in eligible assets (such as equities and bonds) and will swap the return on the assets with a counterparty for a return based on the reference index.

Collateral

Any collateral received in connection with the above is also subject to restrictions principally that it should be sufficiently liquid.

Borrowing

A UCITS may only borrow on a temporary basis for liquidity (generally for no longer than three months) and this is subject to a limit of 10 per cent of net assets.

UCITS VI

In 2012 the European Commission published a consultation paper regarding the UCITS regime to seek the views of stakeholders regarding whether changes are needed to certain aspects of the UCITS regime. The consultation paper did not contain any specific proposals, rather it was a list of questions for the consideration of stakeholders. Some of the points for consideration related to whether the UCITS regime had "gone too far" in permitting more exotic techniques to be implemented by UCITS which are products originally designed with the retail market in mind. Notably the Commission asked whether the list of UCITS eligible assets should be reviewed (i.e. to prevent investment in otherwise ineligible assets such as commodities via the use of derivatives) and whether the counterparty exposure rules should be reviewed (i.e. to avoid the existing possibility of a UCITS being permitted to have substantial exposure to one counterparty through the receipt of collateral). Stakeholders replied to the consultation, but nothing further has come of this and there was no reference to UCITS VI in the Commission's Business Plan for 2014/2015. Hedge fund managers will need to "watch this space" but it seems unlikely, given that the list of UCITS eligible assets was only expanded to include derivatives in 2001, that the Commission would go back on this decision and now reduce the list of eligible assets. It is perhaps more likely that the Commission would implement a regime for "plain vanilla" UCITS being offered to retail investors and a co-existing similar regime for UCITS making use of more exotic derivatives which are being offered to institutional investors.

ESTABLISH A FUND OR JOIN A PLATFORM?

If a manager decides to offer a UCITS in Europe, it needs to decide whether to establish its own UCITS manager to operate that fund, establish its own self-managed fund, or engage a third party service provider to assist. There are many different types of service offered by third parties so it is important to consider what kind of service provider best fits with requirements.

Establishing a UCITS manager/self-managed fund

If a manager would like to operate its own UCITS then it will typically need to establish an entity in Europe to be the operator and seek authorisation from the relevant regulator for that entity to be a "UCITS manager". The UCITS manager will need to:

- have a robust risk management system in place to monitor risk exposure of the UCITS;
- establish systems and controls to ensure compliance with the conduct of business rules in the jurisdiction in which it is established as well as to ensure compliance with the investment and borrowing power restrictions;
- hold regulatory capital (the rules relating to the level of regulatory capital are detailed but very broadly the amount required is likely to be the greater of: (i) €125,000; and (ii) a quarter of annual expenditure); and
- establish relationships with a depositary, administrator, auditor and lawyers in the relevant jurisdiction.

This will be costly in terms of both time and money. It is key to recruit the right calibre of person from a compliance, risk, investment management background and implement the IT architecture appropriately. The UCITS manager will if not the original manager itself, usually be a group subsidiary and is likely therefore to have a taxable presence in Europe. The consequences of this will require careful consideration.

In terms of time, it typically takes between nine months and one year to establish a UCITS manager and get a fund to market.

Some European jurisdictions do not require the establishment of a UCITS manager; rather a fund manager could establish a self-managed fund which does not need a separate manager. However the board of such self-managed fund would need much of the infrastructure described above and would also need to hold an appropriate amount of regulatory capital (in Ireland, for example, the figure is €300,000). There may be some cost savings to launching a self-managed fund but the operation and compliance burden is similar.

The benefit of a manager having its own fund is that the manager gets its own branded product over which it has complete autonomy (within the regulatory constraints). Once it has the infrastructure in place it can very easily scale up and add new products to the range.

Third party service providers

An alternative is to have a third party operator host a UCITS for the manager only. Such an operator will take the role of the UCITS manager, provide the risk function and/or will provide board members for a self-managed fund and deal with the operational and risk aspects involved. They will delegate investment management to the manager. This takes away some of the compliance burden and upfront cost of a manager establishing its own UCITS manager or self-managed fund and may allow a little more control than if the manager joins a platform (see below) because the fund has been established for that manager only. It also removes the reputational risk from association with other managers on a platform.

Some investors welcome the additional independent oversight which appointing a third party service provider brings.

Using a platform

Arguably the least burdensome model is to "rent a sub-fund" from an established UCITS manager/operator. This is a "plug and play" option. Such a platform operator will have an existing UCITS umbrella fund. They will establish a new sub-fund for a manager and delegate investment management to it. The manager is therefore plugging into their existing infrastructure so that it has no choice over service providers and has little independence and control over its product. For example, under the UCITS requirements the operator of a UCITS fund must be able to terminate the investment manager where it believes that to do so is in the best interests of investors. Some hedge fund managers do not like the thought of having control over their product eroded in this way. In addition, the name of the platform operator will need to be included in the name of the UCITS fund which can be unappealing.

However the benefit is that a manager can get a fund to market more quickly than if it establishes its own UCITS manager and its own UCITS fund or self-managed fund. A manager will not need the infrastructure, systems and personnel to deal with the risk and operational issues which come with operating its own UCITS. Using a platform such as this a manager may be able to launch a fund in as little as eight to ten weeks.

Platform providers often undertake rigorous due diligence on potential managers. A manager will need a strong story and a good track record to be permitted to join an established platform. Start-ups may find it difficult to find a platform to join.

Managers on the platform may not always be successful. Whilst all of the sub-funds in a UCITS are segregated from a liability perspective, a manager may run the risk of reputational contagion if one of the other managers on the platform is struggling.

Managers will be required to a pay a platform fee in order to manage a fund on the platform. This is usually based on assets under management. A manager will also need to consider whether the platform provider is going to charge it for exiting the platform. If the fund does well the manager may decide it wants to leave the platform and establish its own UCITS.

Managers should also consider the cost implications of establishing second and further funds on the platform and whether the platform provider will offer the manager the benefit of any economies of scale to do so.

REMUNERATION

The latest iteration of the UCITS Directive, UCITS V, imposes remuneration requirements on UCITS managers. These remuneration requirements must be transposed into the laws of each EU Member State by 18 March 2016. At the time of writing only the "Level 1" remuneration requirements which set out the basic principles for remuneration have been published. The next stage is for the European Securities and Markets Authority (ESMA) to produce a set of draft guidelines for consultation; expected in the second quarter of 2015. These guidelines will add the detailed requirements to the basic principles. It will therefore be a number of months until the details of the requirements are finalised.

However the Level 1 UCITS remuneration requirements are almost identical to Level 1 of the remuneration code which was implemented in each Member State in 2013 as a result of the AIFMD; so it is reasonable to assume its impact will be similar. On that assumption there are two relevant points to draw out: (i) the ESMA guidelines on the AIFMD remuneration code included a proportionality principal so that the more problematic deferral and claw back provisions of the code did not apply to the manager providing its size, internal organisation and the nature, scope and complexity of its activities justified the disapplication. The Financial Conduct Authority attributed maximum flexibility to the proportionality concept such that a number of managers were able to disapply these problematic provisions. It is likely that both ESMA and the Financial Conduct Authority will take a similar approach under UCITS V; and (ii) the ESMA guidelines on the AIFMD remuneration code required the code to be imposed on delegates where such delegates were performing investment management functions. If this is implemented similarly under UCITS V, the implication is that delegate investment managers of UCITS managers, for example a US SEC authorised advisor, will be contractually required to adhere to the relevant remuneration rules, albeit hopefully subject to the rules on proportionality.

The development of the detail of the UCITS V remuneration code is therefore a relevant consideration when establishing a UCITS.

DISTRIBUTION

Distribution of a UCITS throughout Europe is clearly key. Whilst there is often no legal requirement to do so, managers may wish to consider appointing a third party distributor to enable it to access EU investors. Some platforms and third party service providers do offer this service and therefore this may be an important factor in deciding what kind of third party assistance the manager retains.

In addition to the types of "plug and play" platforms described above other types of platform exist which do not assist with the establishment of the UCITS; rather the manager establishes a UCITS manager and a fund or self-managed fund itself but then it joins a platform to make use of distribution benefits which such a platform offers. Some of the large investment banks offering this service may have a wide institutional user base for their platforms but at the other end of the scale are platforms to which only financial advisers (and therefore indirectly retail investors) have access.

Otherwise the manager will probably rely on building relationships with third parties, such as pension fund consultants and private banks, in order to have its fund distributed more widely.

Once a manager has decided on its distribution strategy it is relatively straightforward to market a UCITS into other EU States using the UCITS marketing passport. The UCITS will not be subject to further regulation in any other EU jurisdiction is required. There is an established process which removes some of the uncertainties and challenges of marketing under the AIFMD regime. As the UCITS brand has been recognised for some time now, there are also well established and simple ways to market UCITS into non-EU jurisdictions, for example Hong Kong.

CONCLUSION

With a well thought through distribution model and the right service providers assisting, establishing a UCITS is likely to enable a manager to access European (and possibly Far Eastern and South American) investors thereby widening the universe of investors investing in the manager's strategy. There is however no "one size fits all" approach to establishing a UCITS and managers should consider the options carefully.

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