Regulatory upheavals prompt alternative Ucits boom

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There are questions about their suitability for retail investment, their ability to deliver long-term performance has yet to be proven, and Europe's regulators could yet seek to rein in their freedom, but for now nothing seems capable of halting the onward march of 'Newcits', hedge fund strategies packaged into a structure compliant with the European Union's directives on Undertakings for Collective Investment in Transferable Securities.

Often known as Ucits III funds after the 2001 update of the directive that for the first time allowed managers to use derivatives to mimic hedge fund techniques such as short-selling, Newcits have been technically possible for most of the past decade. However, their momentum has only developed in earnest over the past 18 months as alternative asset managers have sought alternative structures to their traditional staple of loosely-regulated offshore mutual funds, mostly domiciled in jurisdictions in and around the Caribbean.

Since the spring of 2009 the move toward Ucits has gained further impetus from the EU's attempts to agree on a comprehensive piece of legislation laying down regulation of alternative and other funds aimed at sophisticated investors, the Directive on Alternative Investment Fund Managers. In addition to their horror at many of the provisions initially included in the directive, the EU's year-long wrangling over its final form has left many managers more ready to embrace a regulatory structure that may carry its own constraints but that is at least a known quantity, tried, tested and refined over more than two decades.

They see the Ucits framework as offering the reassurance demanded by many investors in the wake of the past three years' turbulence, delivering the transparency and liquidity that many traditional offshore hedge funds signally lacked in the darkest days of the crisis. Ucits-structured funds may also suit better the investment constraints of certain types of investor, such as pension funds, in some countries, and the fact that they come with a so-called EU 'passport' largely removes constraints on their distribution throughout the 27-nation bloc.

Meanwhile, some managers see in an embrace of the Ucits framework the opportunity to extend their potential client base beyond the traditional target markets of institutions and high net worth individuals and families to a broader spectrum of investors, perhaps not necessary true retail customers – although that possibility legally exists – but at least 'mass affluent' clients of wealth managers and higher-end independent financial advisers.

A recent survey of more than 400 traditional and alternative asset managers carried out by the Edhec-Risk Institute, part of the eponymous French business school, found that 60 per cent of alternative managers were concerned about the uncertainty over future distribution raised by the AIFM Directive, and that 65 per cent envisaged restructuring their funds as Ucits, compared with just 25 which had no plans to do so.

Hard and fast numbers on the volume of Newcits funds in existence are inevitably patchy, since official statistics do not necessarily distinguish between classic long-only retail funds and those employing alternative strategies – and in any case numbers evidently continue to grow week by week. One much-quoted industry estimate talks of around 250 funds with assets under management of USD50bn, but others go much higher, up to 1,000 funds or even more and assets of USD200bn and upward.

The higher numbers may include a broader range of so-called absolute return funds, as well as 130/30 and other variants of long/short fund that were the flavour of the month in the asset management industry three or four years ago but fared poorly during the recent periods of market turbulence and are seldom spoken of today.

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The vast majority of alternative Ucits appear to be domiciled in Ireland and Luxembourg, logically since they are already the principal domiciles for long-only cross-border retail funds, although Malta, which is setting out its stall as a lower-cost service centre for the European fund industry, both traditional and alternative, is also wooing potential Newcits business.

For Luxembourg, Newcits offers a potential boost for a sector that was slow to capitalise on the potential of hedge funds in he late 1990s, allowing Dublin to position itself as the service centre of choice for offshore hedge funds from jurisdictions such as the Cayman Islands and British Virgin Islands. Luxembourg's introduction of the Specialised Investment Fund as a sophisticated fund vehicle in February 2007 has been a resounding success, with more than 800 SIFs established to date.

However, Ucits vehicles offer various advantages over SIFs depending on the circumstances, notes Olivier Sciales, a partner with law firm Chevalier & Sciales. "The SIF does not provide access to the European passport, so for distribution purposes it sometimes makes sense to use a Ucits instead," he says.

"The growth in alternative Ucits is also driven by investor demand because some funds of funds and institutional investors must invest only or largely in Ucits vehicles. In many cases the proportion of their assets that they can invest in unregulated or lightly regulated vehicles is restricted, whereas investment in Ucits is less so. As a result, offering access to the strategy through a Ucits fund may enable the manager to gather more assets."

This view is backed by the Edhec-Risk survey, which suggests that institutional investors bound by quantitative restrictions will ask fund managers and distributors to repackage hedge fund strategies within Ucits structures. The report found that 62.5 per cent of insurance companies, for example, would consider asking promoters or managers to restructure hedge fund strategies as Ucits.

Peter Stapleton, a partner in the investment funds group at international law firm Maples and Calder in Dublin, notes: "Ucits funds will be exempt from the scope of the AIFM Directive, which removes some of the legal uncertainty posed by that directive, and there's the added benefit of a global distribution platform.

"While the Ucits passport is only legally effective in other EU member states, the brand is recognised far beyond Europe, on the basis of minimum standards or mutual recognition, which greatly increases the number of accessible markets. It is estimated that Irish Ucits are currently marketed to both retail and institutional investors in more than 60 countries worldwide.

"However, managers need to be careful that they're not rushing into a framework that doesn't fully fit their strategy just because they see investor demand from some sectors. They need to examine Ucits funds from many angles including regulation, liquidity, eligible assets, costs and the investment restrictions that apply. That's not to say it's not a very good option, as the remarkable growth of these products demonstrates, but it may not be a perfect fit for all."

One of the pioneers of the Newcits trend was Sweden's SEB Asset Management, which launched the SEB Asset Selection Fund in October 2006 as part of a Luxembourg-domiciled fund family. Hans-Olov Bornemann, head of SEB's global quant team, says that initially the fund attracted the majority of its assets from Swedish retail investors, although the proportion held by domestic and international institutions is now rising steadily, especially as the firm starts to exploit the full potential of the European passport for distribution throughout Europe and in other markets around the world where Ucits are welcomed by local regulators.

Bornemann cautions that the Ucits regulations make the structure useful for some but not all hedge fund strategies. "It suits various different strategies, including equity long/short, CTA and global macro, but less so any strategy that invests in very illiquid assets," he says. "Strategies that use a lot of leverage, such as credit hedge funds, could face a problem with illiquidity as well. Where SEB Asset Management has launched Ucits credit funds, we've made sure there is a lock-up period long enough to be consistent with the liquidity of the underlying assets.

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“Liquid strategies are already popular within the Ucits framework, because they don’t face the same constraints as more complex strategies. However, very concentrated long/short equity portfolios could run into the counterparty diversification rules. You need quite a number of investment ideas, because you can’t run positions that are as concentrated as those possible in the unregulated world.”

A more recent convert is specialist hedge fund manager Marshall Wace, whose conversion of its MW Tops fund, once a flagship for stock market-listed ‘permanent capital’ alternative funds, into a Ucits structure following a shareholder vote in August is something of a watershed for the industry. “Converting a listed fund into an open ended-investment company regulated under the Ucits regime is a recognised way of satisfying the desire of shareholders to regularly trade their shares at net asset value in a product managed by the same manager,” says Ronald Paterson, a partner at law firm Eversheds in London.

“Investors are having to accept some changes to the investment policy, including restrictions on the fund’s ability to invest in unquoted investments and to borrow, and the Ucits fund will only take short positions synthetically, not directly. Although the Ucits vehicle can be registered both inside and outside the EU (for example in Switzerland) there are restrictions on the ability of US investors to follow their investment into it. This is an interesting example of the extent to which a Ucits fund can be used to replicate other types of fund, although the regulatory and operational implications for the fund manager should not be underestimated.”

Brian Kelliher, a partner in the asset management and investment funds unit of law firm Dillon Eustace in Dublin, concurs: “The most common strategies are long/short, multi-asset and global macro strategies, which tend to be most compatible with the Ucits structure. Those less compatible include event-driven strategies where ordinarily the manager would focus on illiquid securities. Other strategies that involve market risk in excess of permissible value at risk limits would also be difficult to fit into the Ucits rules.”

Conventional wisdom has been that ‘Newcits’ are less attractive than traditional hedge funds for incorporation into fund of funds structures because the effect of Ucits restrictions on certain strategies constrained the universe of funds available to multi-managers and hence diminished their ability to achieve the level of diversification sought by investors.

However, this does not seem to be necessarily the case; funds of hedge fund managers are facing the same investor demands for greater regulation, liquidity and transparency, perhaps more so since they performed if anything slightly worse than single-manager funds during the annus horribilis of 2008 and in numerous cases had to suspend redemptions because of lack of liquidity in their underlying fund investments.

A report published in August by KDK Asset Management, based on a survey of 47 funds of hedge fund managers, found that 41 per cent of respondents have already launched Ucits-compliant multi-manager funds and a further 40 per cent plan to do so in the coming months. The survey found that a significant proportion of the new Ucits funds of hedge funds complemented direct investment in underlying funds with other techniques such as hedge fund index swaps, structured products or hedge fund replication products, but their number is falling as the universe of Newcits expands and direct investment becomes more popular.

Barry O’Rourke, managing director of SEI’s global fund services business in Ireland, says the emergence of Newcits is the latest example of a blurring of the dividing line between traditional and alternative managers over the past four or five years. “We have traditional fund managers using hedging techniques and perhaps investing in types of securities that could be regarded as alternatives, such as bank loans,” he says, “while alternative managers are putting together Ucits-eligible products.

“There is very little difference in terms of preparing daily or weekly net asset values for a company such as SEI that has the capability to service both traditional and alternative managers. The legal structure doesn’t make a huge difference, although Ucits III stipulates closer regulatory control over the product, so we provide various non-administration services such as ensuring that the directors

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have the information at their disposal to satisfy their corporate governance requirements."

O'Rourke says new alternative Ucits business is coming less from alternative managers seeking to package their existing strategies into the Ucits framework as traditional managers that are starting to use techniques previously limited to the alternative world. "It's not at all unusual for a Ucits III fund that in the past would be completely long-only to hold instruments such as swaps in its portfolio," he says.

While some managers are looking to exploit possibilities in the retail market, he says, others are mainly focused on traditional hedge fund investors. "It depends on where the manager targets their investor base," he says. "Many managers will not wish to engage with wealth managers or the retail market because they don't have the capabilities to handle that themselves, and ultimately the investors and managers may not be a good fit. They may prefer to target large institutional investors. For US managers that are coming to Europe for the first time, the first port of call is usually big institutions."

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