Industry braces for EU decision on AIFM Directive

Fund managers rush to adopt Ucits structure

Critics question ability of Newcits to deliver
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European regulation holds key to future alternatives landscape

By Simon Gray

Nearly two years after the bankruptcy of Lehman Brothers brought home to the global financial industry the seriousness of the crisis that unfolded from the collapse of the US sub-prime mortgage market, the shape of the regulatory environment drawn up as a response to the past three years of turbulence is now taking shape, for better or worse. A major step came on July 21 with the signing into US law of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

For the alternative asset management sector in particular the Dodd-Frank Act, which covers a vast swathe of financial sector activity, promises significant changes in the way firms operate and are regulated. Few of the measures have been greeted with any great enthusiasm, but by and large there is acceptance in the US that this is the price required to restore confidence in the financial industry and that most investors support rules designed to introduce greater oversight and transparency in a previously loosely regulated and opaque part of the market.

Many managers from outside the US, especially in Europe, are likely to face double regulation as a result of the new measures, but this may be least of their worries. After well over a year of debate, the endgame is approaching for the European Union’s Alternative Investment Fund Managers Directive as the EU’s convoluted legislative process attempts to forge a definitive text out of two (maybe three?) conflicting and in some respects incompatible draft versions. A final decision might come as soon as September – but the legislators have missed plenty of deadlines already.

However, while US alternative investment firms has long accepted the inevitability of coming within the regulatory ambit of the Securities and Exchange Commission or state regulators, their counterparts in Europe are considerably less sanguine about many of the proposals embodied in drafts of the AIFM. 
The BVI... a leading jurisdiction for domiciling hedge funds.

Funds & Investments

The Securities and Investment Business Act, 2010 (SIBA), allows for three categories of funds (professional, private and public) to be established, whilst providing for investor protection commensurate with their level of sophistication.

SIBA enhances and contributes the regulatory framework supporting mutual funds and codifies many of the best practices already adopted by funds domiciled in the BVI.

SIBA also introduces laws to regulate a range of other investment business, the public issues of securities and market abuse.

The Territory attracts the full range of investment fund promoters, from first time hedge fund managers to large institutional sponsors of funds resulting in approximately 4000 hedge funds currently registered in the BVI.

Key Factors in choosing BVI:
- An appropriate system of regulation
- Innovative legislation
- Lower start-up costs and un-going fees and fees
- Concise and well-known fund classifications
- Zero rate taxation
- A commitment to a 48 hour approval process for the recognition of private and professional funds
A new statute for regulation of BVI funds

By Simon Schilder

On May 17, 2010, the Securities and Investment Business Act, 2010 (SIBA) came into force in the British Virgin Islands. As well as introducing the regulation of new areas of business activity undertaken by BVI entities, one of the principal objectives of the new legislation is to update the regulation of BVI funds by repealing the Mutual Funds Act, 1996, the statute that has underpinned the regulation of the BVI fund industry for more than a decade, and introducing a new statutory regime in tune with evolving industry standards.

Going forward, Part III of SIBA and its underlying secondary legislation, the Mutual Funds Regulations, 2010 – and, for public funds, the Public Funds Code – will therefore be the legislation regulating the BVI fund industry.

But how will this change in regulatory regime affect the BVI fund industry? The regulatory regime applicable to private and professional funds (the two categories of regulated funds that represent the overwhelming majority of BVI funds, particularly hedge funds) is not substantially changed as a consequence of SIBA.

Many of the ‘changes’ merely representing the codification of existing regulatory policies operated by the BVI Financial Services Commission that have evolved over time. The regulatory changes for such funds are therefore positive, as SIBA will provide certainty and enable greater regulatory transparency.

The regulatory regime applicable to public funds, a category of fund used for retail offerings by BVI funds (for which currently approximately 300 of the 3,000 licensed BVI funds are registered) will be changing under SIBA.

Most of the regulatory changes are introduced through the proposed Public Funds Code, which is still in draft but has just completed an industry consultation. Underpinning the Public Funds Code is the need for the regulation of BVI funds aimed at the retail market to meet Iosco principles.

To facilitate the smooth transition of existing funds into the new regulatory regime under SIBA and the Mutual Funds Regulations, transitional provisions exist during which various changes brought about by these new regulations are required to be implemented.

Consequently, for private and professional funds, the regulatory status quo has been maintained under SIBA, but some new regulatory obligations have been introduced, as well drafting changes required for existing funds’ offering documents and constitutional documents (which need to be made during the transitional period). The driver for these new regulatory obligations is to facilitate the supervision of BVI funds by the regulator, and therefore the effective management of systemic risk.

For public funds, the regulatory change is greater, although until the final version of the proposed Public Funds Code is published, the precise scope of the changes cannot be determined with complete certainty.

Overall, these are positive changes, which maintain the popular concepts of the BVI’s fund industry while making it more robust and in tune with the evolution of international regulatory standards.
Directive, including notably measures that would regulate how - or whether - managers and funds located outside the EU could access investors within the 27-nation bloc.

“The two versions [of the directive] approved by the European Council and the European Parliament are strongly at variance with each other in important areas,” says Andrew Baker, chief executive of the Alternative Investment Management Association. “We have issues around leverage, remuneration, use of depositaries and the scope of the directive around valuation and the ability to delegate sub-management in and out of the EU. All those issues remain unsatisfactory. But the most contentious issue relates to third-country access.”

This unresolved question, Baker notes, affects a broad cross-section of the industry ranging from EU-based managers that run funds domiciled in offshore jurisdictions such the Cayman Islands, British Virgin Islands and Bermuda, as well as the UK’s Crown Dependencies, to any manager based in a country or territory outside the EU such as Switzerland, the US, Hong Kong and Singapore.

The uncertainty is already prompting managers to examine other ways of structuring their business. Some are setting up new funds using structures designed for sophisticated investors in the two main hubs for fund domicile and servicing within the EU, Ireland and Luxembourg, as well as the up-and-coming financial services centre of Malta. A few are examining the redomiciliation of existing offshore funds to a European jurisdiction.

Rather more are seeking to circumvent the possible impact of the AIFM Directive by packaging hedge fund strategies within fund structures that comply with the EU’s series of directives on Undertakings for Collective Investments in Transferable Securities (Ucits), which govern funds that can be registered (relatively) freely for sale to the general public anywhere in the EU once they have been authorised in one member state.

At least the US regulatory changes offer the merit of certainty. The Private Fund Investment Advisers Registration Act of 2010, part of the Dodd-Frank legislation, will greatly broaden the requirement to register with the SEC among investment advisers to private equity, venture capital, real estate, hedge and other alternative funds, many of which previously benefited from an exemption to the registration requirement under the Investment Advisers Act of 1940.

Says US law firm Goodwin Procter: “The private adviser exemption is available to an investment adviser with fewer than 15 ‘clients’ that does not hold itself out generally to the public as an investment adviser and does not advise mutual funds or business development companies. Many private equity, venture capital, real estate, hedge and other private fund managers have been able to rely on the private adviser exemption because they count the funds that they manage as clients rather than counting the investors in those funds.”

The SEC attempted to close this loophole in December 2004 by introducing a new rule that would require investment advisers to count individual investors rather than funds in calculating their number of clients, but in June 2006 the rule was overturned by a US appeal court that decided the regulator had exceeded its powers and misinterpreted the law. The new legislation simply eliminates the private adviser exemption, although it introduces others, such as advisers to (as yet undefined) venture capital funds or private funds, and (also undefined) family offices.

The Registration Act sets thresholds that determine whether investment advisers should be regulated by state financial supervisors or the SEC, which generally is responsible for regulating managers of
...introducing a multi-jurisdictional group, providing investment fund administration services

www.ifina.com
Enquires: Derek Adler +44 (0) 1784 433034
dadler@ifina.com
In the front line of funds best practice

By Derek Adler

Ifina’s organisation in June of a networking evening at BVI House in London, featuring speakers representing the global hedge fund industry and the funds sectors in the British Virgin Islands and Switzerland, represent the latest step in an initiative launched last year to stimulate a debate on the future of the hedge fund sector in the wake of the financial crisis.

Amid knee-jerk reactions from many governments and regulatory authorities, as well as uncertainty about market trends and caution among investors, we felt it important to bring to the table industry members to examine how the market turmoil and other difficulties that had affected fund managers, investors and service providers could be avoided, or at least mitigated, in the future.

The issues weighing on the industry have not gone away. Drafted in extreme haste in spring 2009, the European Union’s Alternative Investment Fund Managers Directive still awaits final agreement between the EU’s three decision-making bodies. Although some of the aspects of the original legislation that most infuriated industry professionals have been moderated in subsequent drafts, there remain many points of contention, not least the question of whether and how the directive will permit non-EU funds and managers to access the European market.

The latter issue obviously remains crucial to the Swiss alternative fund industry, yet at the same time the country is benefiting from a certain degree of disillusion among hedge fund managers with tax and regulatory matters within the EU in general and in London in particular. Meanwhile, reports of the imminent decline of the BVI and other offshore fund jurisdictions have proved at the least premature as they benefit from a revival in new fund launches.

At seminars organised by Ifina last autumn at the Zurich and Frankfurt stock exchanges, we emphasised that the alternative fund industry needed to be proactive in getting its message out and to speak directly to members of the wider financial sector about its embrace of best practice, particularly the use of independent service providers, to provide reassurance to the investment community.

There’s also an ongoing need to address public authorities and tackle assumptions by politicians and regulators that are not borne out by market reality. Take the moral panic about derivatives, which has been going on in one form or another for years. Rather than standing by in the face of blanket restrictions, it’s up to industry members to make the case for derivatives as a risk management tool and to explain the difference between hedging and speculating.

Greater knowledge and understanding of what the industry does and how it works would be an enormous advantage in restoring trust among investors. For example, they would benefit from a better understanding of the role played by hedge fund administrators not just in ensuring that funds’ numbers add up but as an early warning system for problems at the funds they service, whether through poor decision-making, negligence or fraud.

Regulators certainly increasingly view service providers as an integral part of the checks and balances on the industry, whether their role is explicit or otherwise. Administrators are first in line to spot any untoward events, such as sudden changes in the volume of activity, because they see the trades from the investment manager and reconcile them with the bank or broker. That’s why the fund administrator is the crucial element to the safety of any fund.
assets exceeding USD100m. The legislation also redefines what constitutes a private investor accredited to invest in sophisticated funds as an individual or couple with a net worth of at least USD1m excluding their primary residence.

The new rules will restore the obligation on many non-US managers of funds with US investors to register with the SEC, as happened temporarily in 2004. According to consultancy Kinetic Partners, in addition to regular filings this will involve require measures such as developing a compliance manual, code of ethics and policy on personal investment dealings by employees for their own account, setting up a monitoring programme that meets with SEC requirements and industry best practice, an annual review and testing of the compliance programme, and annual compliance training.

Managers must register with the SEC within a year of the passage of the legislation.

In order to be exempt from the requirement to register with the SEC, a non-US asset manager will have to meet all of a series of criteria: it must have no place of business in the US, have fewer than 15 US-based clients and investors in the hedge funds or private equity funds they manage, have less than USD25m in aggregate assets under management attributable to US clients, and not hold itself out generally to the US public as an asset manager.

The expanded authority of the SEC will have a far reaching effect on the alternative investment industry, both in the US and in Europe," says Kinetic Partners member Andrew Shrimpton. "Not only will asset managers who handle significant assets in the US now be required to register, they will also be faced with more onerous compliance and monitoring obligations. Managers in the UK and Europe need to consider whether they are obliged to register with the SEC and respond appropriately to the heightened scrutiny and new demands."

The prospect of being caught up in the US regulatory net is an added complication for managers with a global investor base that are already grappling with how to respond to the requirements of the AIFM Directive once it has been finalised. Baker cautions that alternative investment firms would be ill advised to take hasty decisions about changes of domicile or fund structure, with the legislation not yet agreed and the actual implementation date still a long way off.

"It is too early to do anything like changing business model, moving jurisdiction or even closing down," he says. "Even if the legislation were passed tomorrow, there would still be a two-year transposition period. That means that in the very worst of outcomes, there will be two years to do something about it. Whatever decisions you were going to take before this started, you should stick with those decisions until we have greater clarity."

Baker was a speaker at a recent networking evening organised by fund administrator Ifina at BVI House, the London office of the government of the British Virgin Islands, bringing together fund managers and other members of the industry. The discussions focused extensively on the AIFM directive and the outlook for jurisdictions outside the EU, which fear that the introduction of measures widely viewed as protectionist will ultimately damage the industry worldwide.

"We could end up with a bloc of European investors and European managers," he says. "If the EU starts kicking away the foundations of global capital flows, it will affect global markets. For example, any thoughts that what the EU is doing represents an opportunity for Asian countries to take advantage of what looks like a European own goal have quickly been dispelled. The Asians see it as nothing but a threat because of the risk of fragmentation of the markets into regional blocs, which would be a severely retrograde step."

The current deadlock has arisen because in May the EU’s Council of Economic Affairs and Finance Ministers approved one version of the directive while the Economic and Monetary Affairs Committee of the European Parliament adopted another version. Representatives of the Parliament and of the Council, which represents EU member states, together with the European Commission, which – officially at least – is still backing the original, much derided draft it produced in April 2009, are currently involved in a process known as a dialogue to reach a compromise on the final version of the legislation.
The continuing evolution of Ucits in Ireland

By Peter Stapleton & Pádraig Brosnan

Market commentary and discussion on the merits and limitations of alternative Ucits funds continue to generate considerable interest for hedge fund managers and their investors. The interest is backed by recent statistics from the European Fund and Asset Management Association showing continued recovery and overall net inflows for Ucits since the turn of the year. At the end of May, total net assets within Ucits stood at EUR5.58trn, representing about 76 per cent of all European investment fund assets.

While the alternative Ucits sector is currently a small fragment of the Ucits market, it is growing rapidly.

This trend is not new, and there is now widespread awareness of the opportunities for repacking traditional hedge fund strategies within Ucits funds. The ‘Newcits’ combination of regulation, diversification, liquidity and international distribution with the ability to replicate hedge fund strategies has proved a strong draw.

Product innovation continues apace with Ucits being structured, for example via indices or exchange-traded certificates, to provide investors with access to a multitude of sophisticated asset classes including hedge funds, life settlements, commodities and credit. This growth may in turn lead to an expansion in secondary investment as the universe for fund of funds-type investment into other Ucits hedge funds multiplies.

However, the liquidity constraints, investment restrictions, diversification rules, borrowing and leverage limits imposed by the Ucits directives will not fit the strategies of all alternative managers, nor do all have the resources to add the additional substance and risk-monitoring layers required to run a Ucits fund.

Nevertheless, overall market sentiment and interest remains positive and, for managers considering where to locate new Ucits funds or expand existing platforms, Ireland continues to be recognised as the domicile of choice for alternative Ucits. This stems not only from the country’s reputation for innovation on legal and regulatory issues but also its long history of providing administration, listing, legal and audit services to hedge funds located in the traditional domiciles of Cayman and the BVI. As a result, it is a natural fit for managers seeking to add a European regulated product to their existing hedge fund offerings.

Against this backdrop, industry members should take note of a number of significant recent developments for Ucits funds both in Ireland and the EU as a whole.

Irish developments

We expect some alternative managers with certain types of European investor to look at adding fund platforms in EU member states, particularly Ireland. Our experience to date is that most are seeking European-regulated products that complement rather than fully replace platforms in traditional hedge fund domiciles.

In this regard, the Irish Companies (Miscellaneous Provisions) Act 2009 provides a clear regime for managers who would like to move part of their existing corporate structures to Ireland by way of...
This will aid UCITS managers wishing to use synthetic prime brokerage arrangements to support their strategies.

**UCITS IV implementation**

At EU level, the funds industry stands on the cusp of its next major evolution as the UCITS IV Directive enters the final stages of Committee of European Securities Regulators (Cesr) recommendations and industry consultation ahead of its scheduled implementation in EU member states by July 1, 2011.

As most readers will be aware, UCITS IV comprises a series of reforms aimed at enhancing the distribution and efficiency of UCITS funds rather than creating new strategy capabilities, which were addressed in UCITS III and the Eligible Asset Directive. The key legal and regulatory principles of UCITS IV already set down in the recast UCITS IV Directive (2009/765/EC) consist of a working management company passport, merger options, master-feeder structures, electronic cross-border notifications, key investor information documentation (KIID) and a framework for improving co-operation between EU supervisory authorities.

However, the UCITS IV Directive only sets out the general framework and legal principles behind the UCITS IV concepts. As a result, since its publication there has been an extensive process of industry consultation and the provision of technical advice from Cesr to cover the details, that is level 2 measures and level 3 guidelines covering the practical implementation of UCITS IV.

This process resulted in the adoption on July 1 this year of further detailed requirements by the European Commission in the form of two directives and two regulations, which cover key investor information and publication issues, electronic notification procedures, mergers and master-feeder and management companies.

Commission Regulation (EU) No 583/2010 focuses on the KIID and the conditions to be met when providing key investor information or the prospectus of a UCITS in a durable medium other than paper or by means of a web site.

Commission Regulation (EU) No 584/2010 details the form and content of the standard notification letter and UCITS attestation, the
use of electronic communication between competent authorities for the purpose of notification, and procedures for on-the-spot verifications and investigations and the exchange of information between competent authorities.

Commission Directive 2010/42/EU provides further clarification on the requirements for UCITS mergers and master-feeder structures, such as the content of the merger notification document and procedures between EU member state regulators and the relevant service providers.

Commission Directive 2010/43/EU expands on the procedural requirements for the management of UCITS, particularly cross-border activities, and organisational requirements, conflicts of interest, conduct of business, risk management and content of the agreement between a UCITS depositary and a management company in that context.

In addition, CESR has published its final guidelines on risk measurement and the calculation of global exposure and counterparty risk for UCITS, which will be of particular interest to hedge fund managers using derivative instruments as an integral part of their strategy.

Now that the final measures are in place at EU level, attention is turning to the reform of existing rules in EU member states in advance of the July 2011 deadline.

Ireland has consistently been among the first EU member states to adopt new UCITS measures and the process of domestic change ahead of UCITS IV is already underway. In this regard, both the Irish government and the Financial Regulator have committed to Ireland’s position as a leading centre for international investment funds.

For example, taxation measures announced in the Irish Finance Bill 2010 have already brought welcome clarity to the fraught issues of cross-border taxation for UCITS management companies – an Irish management company will not bring the profits of a foreign UCITS within the charge to Irish tax - and stamp duty relief for asset transfers under UCITS mergers or reorganisations.

In a recent address to the Irish industry, Matthew Elderfield, head of financial regulation at the Irish Central Bank, highlighted the “potential benefits of this legislative initiative”, while making clear that the changes must be achieved from an operational point of view with minimal risk to investors. He confirmed that the Irish Financial Regulator will continue working closely with industry to ensure the smooth transition of UCITS IV into the Irish regulatory sphere.

It is expected that revised Irish UCITS notices, guidance notes and policy papers will be issued before the end of 2010.

**CESR guidelines on money-market funds**

Also of significant interest to the Irish market considering its share of European money-market funds are CESR’s latest guidelines, which propose a common definition for UCITS and non-UCITS money-market funds. The move follows criticism of the labelling of certain funds resulting in investors suffering unforeseen losses. They were found not to appreciate fully the risks and asset classes these funds could invest in, which differed from the generally accepted concept of money-market funds as investing in relatively liquid, short-term investments.

The CESR guidelines aim to improve investor protection by establishing a definition that will provide a more detailed understanding of the distinction between money-market funds that operate in a very restricted fashion and those that follow a more ‘enhanced’ approach. The guidelines create two categories, Short-Term Money-Market Funds and Money-Market Funds.

The CESR approach recognises a distinction between Short-Term Money-Market Funds, which operate a very short weighted average maturity and weighted average life, and Money-Market Funds, which operate with a longer weighted average maturity and weighted average life.

The guidelines come into effect on July 1, 2011, the same date as the transposition deadline for UCITS IV, with an additional six-month period for existing money-market funds to comply. While other money-market-style funds outside the two categories can continue to be authorised as UCITS, they will not be able to use the Money-Market Fund label following the introduction of the guidelines. In addition, only Short-Term Money-Market Funds will be permitted to use a constant NAV.
"But the parliamentary version has gone down a much more dirigiste path and contains some extremely onerous restrictions that could reduce investor choice. If third-country managers or offshore fund domiciles cannot satisfy certain criteria, EU investors will not be permitted to invest with funds or managers from those jurisdictions. This version raises the spectre of an outright investor lockout, which is not in the interests of European investors and certainly not in the interests of the European asset management industry. It would leave the industry having to struggle very hard to continue to exist in its current form."

The BVI, along with its Caribbean near-neighbour the Cayman Islands, is one of the jurisdictions in the firing line if the industry’s worst fears come to pass, but Sherri Ortiz, executive director of the BVI International Financial Centre, the government-sponsored body that promotes the territory’s financial sector, is relatively confident that the jurisdiction can meet any equivalency standards the EU imposes.

"Many of the islands’ fund practitioners are convinced we can meet the forthcoming regulations," Ortiz says. "First, from every account the BVI can quite easily meet the level of regulation that will be required. Then once it has passed, the legislation will take at least another two years before it comes into full effect, which gives the BVI and any other country an opportunity to get its ducks in a row. However, for the most part we have already met the requirements that are currently mooted in order for funds to obtain a passport."

But there is as yet no mechanism in place for the passport, and the EU regulatory body that would oversee it, the planned European Securities and Markets Authority, does not yet exist. Many industry members fear that many existing offshore funds might be shut out of the EU if the jurisdictions in which they are domiciled are deemed not to meet European standards. And the legislation is equally vague about how managers based outside the EU could gain certification that they were subject to equal regulation.

"If the Council version gets through, that could be OK," Baker says. "We can probably live with that. There’s a big question mark about what co-operation arrangements between regulators would look like – there are none in place today. The memorandums of understanding that regulators have already put in place are to assist with misconduct and fraud investigations, and do not relate to information-sharing.

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Sherri Ortiz, BVI IFC

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Nevertheless, even offshore jurisdictions that are ready to meet international standards are concerned about the implications of being constantly under pressure to adapt to rules they have little or no influence in shaping. This is not just about the Organisation for Economic..."
Are you ready to capitalise on convergence?

By Phil Masterson

Due to the combination of bruising market losses, high correlation among asset classes, unexpected illiquidity and epic scandals, the investment management industry faces a restless, empowered investor base.

In addition to a focus on transparency and liquidity, retail investors and their advisors — as well as smaller institutional investors — are increasingly focused on absolute returns and investment strategies uncorrelated with long-only equity and bond indices.

Consequently, asset allocation trends are accelerating demand for products that combine access to non-correlated strategies and asset classes with the liquidity and transparency of registered investment products.

With more than 50 per cent of European hedge fund managers planning to establish Ucits products, the number of alternative Ucits (or Newcits) offered will continue to grow. Ucits attracted inflows of USD35bn into hedge fund-like strategies, absolute return benchmarks, commodity exposure, and other non-traditional approaches in 2009, and currently total more than 1,000 funds with USD200bn in assets. As hedge fund managers adopt retail distribution best practices and as comfort levels grow, we see some emerging as robust competition for traditional products.

However, while the industry welcomes a broader selection of innovative strategies in a regulated and retail-available vehicle, the possible damage to reputations if they fail to deliver is of concern.

In addition, not all strategies fit within the Ucits format, and firms must first determine whether offering an alternative mutual fund fits their branding and long-term strategy. There also are several other factors that need to be addressed: filing any gaps in skills and expertise, regulatory considerations, operational considerations and distribution considerations.

To be successful selling Ucits, firms must have an educated sales force and the infrastructure necessary to support advisor and investor education effectively. Firms should also position their strategies first as diversification tools and second as alpha generators, since our research shows that investors generally use alternative strategies primarily for diversification purposes.

Traditional firms, leveraging their existing distribution relationships and advisor support infrastructure, have had the greatest success to date.

Demand for alternative or non-correlated strategies in European Ucits is real, as reflected by net inflows into existing products, the growing accommodation of such strategies in model portfolios of intermediaries, and increased investor demand for a broad set of diversification tools.

Given their experience in educating investors and advisors and their existing distributor relationships, we believe that traditional fund managers will continue to enjoy the most success in the retail alternative fund business in the near term.

Initially, alternative managers’ best opportunity may be to sub-advice or partner with an existing retail manager. Such an approach can also be a win for traditional firms that might lack the requisite investment skill or expertise.
“We are conscious of being a non-EU member and we cannot do more than bring up arguments that we believe are sensible.”

Matthäus den Otter, Swiss Funds Association

Co-operation and Development’s initiative on harmful tax practices, a process in which offshore territories have now been invited to participate actively, but earlier episodes such the EU Taxation of Savings Directive, which was all but forced on dependent territories of EU states and certain completely independent third countries. Where will this end, they ask.

Switzerland, which gave birth to the first fund of hedge funds more than half a century ago and whose managers today account for almost a third of the global alternative fund of funds business, also has a strong interest in seeing the creation of a level playing field in the European marketplace. Matthäus den Otter, chief executive of the Swiss Funds Association, reminded participants at the BVI House event that the country has always taken a liberal stance because it is in the interests of its wealth management industry for clients to enjoy access to the funds that best suit their investment goals, regardless of their domicile.

“More than 6,000 foreign-based funds are admitted for sale in Switzerland, compared with 1,300 Swiss-domiciled funds,” he notes. “We are a fund-importing country, although a large proportion of the 6,000 foreign-based funds have been set up by Swiss banks in other countries, from where they re-import them. Our view on the AIFM Directive is that everyone who wants to serve the European institutional investor, as long as they have sound business principles, investor protection, quality and solid regulations, should have the chance to be part of this market.

“Of course, third countries like Switzerland cannot expect to be treated like EU member states, but at least treatment similar to that under the UCits directive would serve our industry very well. Moreover, EU professional investors should not be restricted in their choice of fund managers and products. If they have access to the most suitable products, we will all benefit in the end. I don’t think we are asking too much when we say that the AIFM Directive as it stands does not offer better protection for investors within the EU. Right now we are working to rebuild trust in our industry, but we do not think the current thrust of the directive is the right way to achieve this.”

Den Otter acknowledges that there is a limit to what his organisation, or indeed the Swiss government, can do to influence the EU’s deliberations, especially at this late stage. “We are conscious of being a non-EU member and we cannot do more than bring up arguments that we believe are sensible,” he says. “We want to do everything we can contribute toward investor protection, sound business principles and quality. But we shouldn’t be excluded from servicing our customers in the EU just because we are not a member state.”

If the deadlock in the trialogue negotiations is broken, a vote on the directive in the European Parliament could come in September, keeping the directive on course for final approval at the beginning of next year. And there have been tantalising although as yet unconfirmed hints that a compromise could be gaining favour that would slice through the Gordian knot represented by the third-country access issue.

The mooted compromise would allow third-country managers and funds to seek access to European markets through an equivalency certification and a passport if they wished and the regulatory and legal framework of their home jurisdiction allowed, but leave open the option of continuing to distribute their funds to qualifying EU investors through private placement arrangements and country-by-country approval.

That would beg the question of why the EU’s various decision-making bodies have spent more than a year wrestling with this issue. Says Baker: “If we go back to the status quo, what have we been doing for the past 12 months? While Rome burns, who’s been fiddling?” But many industry members would probably settle for a solution, however imperfect, that does not slam the doors of a Fortress Europe shut, leaving the rest of the world’s managers and funds outside.
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51, route de Thionville
L-2611 Luxembourg
Tel: (+352) 26 25 90 30
Fax: (+352) 26 25 83 88
www.cs-avocats.lu
Traditionally Luxembourg hedge funds and funds of hedge funds have been set up under part II of the law of December 20, 2002 on UCIs and, more recently, Specialised Investment Funds governed by the law of February 13, 2007. However, today many hedge fund managers are considering launching Ucits structures that can be freely marketed within the European Union and enjoy widespread acceptance elsewhere in the world.

The Ucits framework is attracting hedge fund managers mainly because of increased demand from investors for regulated products, transparency and liquidity – especially in the aftermath of the Madoff scandal – as well as broader eligible asset rules for Ucits, the strong risk management framework and the future benefits of Ucits IV after 2011. In addition, many institutional investors are restricted in the proportion of assets they can invest in less regulated funds but may invest relatively freely in Ucits vehicles.

The European passport makes distribution easier for fund promoters since they no longer have to be reviewed for substance in other EU member states but only with respect to formal compliance. The new simplified notification procedure under Ucits IV should speed up the cross-border distribution of funds.

An important factor in the emergence of ‘Newcits’ is the Eligible Assets Directive of March 19, 2007, which provided EU member states with a common understanding as to which assets are eligible for Ucits investment, together with the Eligible Assets Guidelines issued by the Committee of European Securities Regulators (Cesr). These rules were transposed in Luxembourg by the Grand-Ducal Regulation of February 8, 2008 and the CSSF circular 08/339. Previously, alternative Ucits were limited to long/short equity strategies. The main innovation was to extend the range of eligible assets to enable Ucits III funds to invest in OTC derivatives such as total return swaps and contracts for difference, to adopt synthetic shorting strategies and to permit investments in hedge fund indices.

These strategies are, however, subject to counterparty exposure restrictions, in that global exposure through the use of derivatives should in principle not exceed 100 per cent of the net asset value of the assets, limiting the funds’ overall risk exposure on a permanent basis to 200 per cent of their net asset value.

According to article 42 (1) of the 2002 Law, Ucits must implement a risk management strategy that enables them to monitor and measure the risk of the positions and their contribution to the overall risk profile at any time. The Luxembourg regulator, the CSSF, has classified Ucits on the basis of their risk profile into sophisticated Ucits and non-sophisticated Ucits.

A sophisticated Ucits – generally those set up by hedge fund managers – is defined as mainly using derivatives and/or making use of more complex strategies or instruments. According to the CSSF, a sophisticated Ucits must entrust to a risk management unit independent of the investment management function the task of identifying, measuring, monitoring and controlling the risks associated with the portfolio’s positions.

In addition, several European regulators are pondering whether Newcits should be treated differently from long-only Ucits in other ways – for example, by insisting that they can be sold only with advice, whereas currently all Ucits can be sold on an execution-only basis. Cesr has not yet taken any formal action but the issue remains firmly on its agenda.
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...
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Contact: Kjell Norling, Head of Global Fund Distribution, kjell.norling@seb.se

* Source: SEB Asset Management S.A. Average annualised performance, net of fees, NAV to NAV, from inception date 03/10/2006 to 30/04/2010. Full and simplified prospectus are available at BNP Paribas Security Services. Management company: SEB Asset Management S.A.
How the ‘ultimate fund’ was created

By Hans-Olov Bornemann

Today alternative UCITS III structures are very much in vogue, but the SEB Asset Selection Fund traces its origins back more than five years, to a train journey to northern Sweden in March 2005. My team of five spent the seven-hour journey on a brainstorming session to devise what we called the ultimate fund, the one into which we would put all our own money.

The team came up with a hybrid between a traditional hedge fund and a mutual fund, combining the best features of each in what later would become known as a ‘Newcits’. Our goal was to seek absolute returns, always trying to make money whatever the market conditions – while recognising that this is not always possible – and using both long and short positions. From the mutual fund world we took the idea of transparency, with valuation and liquidity on a daily basis. To provide access to investors anywhere in the world, we opted for the UCITS framework rather than an unregulated fund structure.

The final element was the fund’s strategy. Between 5 and 20 per cent of the returns of any portfolio can be attributed to security selection decisions, whereas 80 to 95 per cent is down to allocation decisions. At the time, about 99 per cent of all mutual funds were relative return products that followed a benchmark and whose managers spent their time making security selection decisions. We thought there should be great scope for a fund focusing on allocation.

Although our discussion started out as a fantasy exercise, by the time the team got off the train we were convinced we should launch this fund. Once this eventually happened in October 2006, we discovered it had a high correlation to managed futures and found factors that other managed futures players had been playing for a while. Although it wasn’t what we originally intended, in effect we invented the first CTA UCITS fund. With USD1.9bn in net assets, it’s the largest CTA fund in the UCITS world. Compared with unregulated hedge funds, it would rank among the largest 1 per cent of hedge funds globally, according to Bloomberg.

Our vision was vindicated by events in the market since the fund’s launch. At that time there was a roaring bull market, but in mid-2007 there was a massive shift in fortunes between equity- and bondholders. That allocation is the most important investment factor has been proven very clearly over the past three years.

Since then the concept has evolved and expanded. The original SEB Asset Selection fund is a medium-risk product that targets 10 per cent average volatility over three to five years. However, some potential clients wanted a lower-risk product, so we launched a 5 per cent target volatility product, SEB Asset Selection Defensive, in June 2009, and subsequently added SEB Asset Selection Opportunistic, a 20 per cent target volatility fund particularly favoured by funds of hedge funds seeking more high-octane investments.

SEB Asset Selection now has distribution approval in countries including the UK, Italy, France, Germany, Switzerland, Netherlands, Spain and the Nordic nations, and is now seeking authorisation in Asia and Latin America. The fund born years ago on a train in northern Sweden has crossed Europe and embarked on a journey to more distant regions. Competitive performance and UCITS made it possible.
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.

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 the 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...
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**INVESTING IN ALTERNATIVES IN A FAST CHANGING WORLD**
Managed accounts –
the Newcits solution

By Simon Hookway

Hedge fund managers were never going to stay away from new distribution channels for long, especially ones with the promise of onshore distribution – historically the area they had been unable to access with their tax-efficient offshore fund structures and trading strategies deemed inappropriate for unsophisticated onshore investors. The convergence of hedge fund strategies and the Ucits regulatory structure have led to what have been termed Newcits.

The growth in hedge fund strategies offered through Ucits wrappers has grown significantly in the past 12 months, together with their assets under management. This growth has been driven by investors’ need for the much-debated diversifying properties of hedge fund strategies, delivered in a regulated investment structure by trusted providers (meaning with operational and financial stability), and the potential impact of the EU’s Alternative Investment Fund Manager Directive on the investment landscape.

Possibly the biggest draw card of Ucits funds for investors in hedge fund strategies is the perceived liquidity they offer. There are caveats to this hedge fund distribution utopia. There is nervousness that investors are buying into a regulatory smokescreen and that sophisticated hedge fund strategies are being distributed to investors who may not fully grasp the strategies but believe they are protected by the regulator. Hence they feel they no longer need to understand fully the assets being traded and how they are being run by the manager.

EU supervisors are no doubt nervous, too, regarding the use of hedge fund indices and swaps as eligible assets in order to deliver hedge fund strategies that would ordinarily not be permitted or be too complicated to structure within Ucits products.

There is a feeling that investors are being blinded by the format used to deliver the strategy, and not taking enough care and due diligence when determining how suitable it is to their investment needs.

The Ucits brand has an excellent reputation for delivering products based on very strict criteria such as liquidity, leverage, credit and counterparty risk, and eligible asset definition. These might be a little burdensome and expensive to maintain, but Ucits delivers products across regulatory boundaries in an efficient manner – and this reputation needs to be maintained.

One of the most effective methods of marrying this regulatory framework with complex hedge fund strategies is to require any Ucits products based on alternative strategies to use managed accounts as the underlying basis for the investment.

Managed accounts are the only independent way of assuring the regulator that full transparency is available from an independent provider and that the asset eligibility criteria are adhered to completely. The perceived liquidity offered can be measured and any uncertainty over time to redemption of any asset in the portfolio can be stress-tested. Perceived liquidity could then be seen as certain liquidity.

A managed account infrastructure would deflect accusations that Newcits are nothing more than complex investment banking techniques and instruments that disguise the true nature of the products. Managed accounts are a cost-effective means of delivering certainty and transparency – independently.

The outlook for managed accounts has again been strengthened by the ease with which they provide simple solutions to complex regulatory frameworks. The architecture is ideal for alternative fund of funds managers to distribute their strategies onshore without having to resort to complex arrangement that raise alarm bells with investors, regulators and industry members alike.
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 new UCITS 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.

“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 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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andrew.bates@dilloneustace.ie
donnacha.oconnor@dilloneustace.ie

Dillon Eustace
Ireland is seeing the establishment of an increasing number of ‘Newcits’ – UCITS funds that pursue alternative investment strategies. Hedge fund managers are interested in UCITS because it is a means to regain assets from high net worth private banking clients and institutions that have not yet returned to alternative investments and that place greater emphasis on liquidity, transparency and regulatory protection.

UCITS is a pan-European fund product that, once established in Ireland, can be sold cross-border within the European Union or European Economic Area under a harmonised legislative framework without any requirement for additional authorisation. The recently adopted UCITS IV Directive, which is expected to be implemented into Irish law before July 2011, will dramatically simplify the cross-border notification process within the EU and EEA.

In addition, UCITS is a global brand recognised worldwide as a robust, well-regulated product attracting investment not only from within the EU but from a wide range of outside markets. For example, Hong Kong, Japan, Taiwan and many South American jurisdictions, as well as non-EU European countries such as Switzerland readily accept UCITS for inward sale.

Finally, the UCITS structure can facilitate many alternative strategies, and it is a welcome alternative given the uncertainty over the EU’s proposed Alternative Investment Fund Managers Directive.

The continued strength of interest in UCITS is evident. According to the European Fund and Asset Management Association, UCITS enjoyed net inflows of EUR51.7bn in the first quarter of 2010. At the end of May, UCITS accounted for 76 per cent of the total European fund market, with net assets of EUR5,517bn.

Currently there is more interest in establishing single UCITS hedge funds than UCITS funds of hedge funds, principally because managers consider the current UCITS hedge fund universe too narrow.

The vast majority of hedge fund UCITS strategies are long/short equity, long/short credit and global macro, whereas some strategies with the highest potential returns, such as distressed securities and convertible arbitrage, are difficult to transpose within a UCITS because of liquidity and leverage constraints.

However, it is possible to gain exposure synthetically to a greater variety of strategies, for example through a total return swap covering an index of hedge funds, provided the index meets certain regulatory criteria.

Although UCITS hedge fund products are expected to underperform their equivalent offshore funds because of investment and implementation challenges of the regime such as issuer concentration rules, liquidity and eligible assets requirements, hedge fund managers are still interested in establishing UCITS because of their distribution potential.

From a distribution perspective, UCITS are viewed as more attractive than offshore funds. One reason is increased liquidity – UCITS are required to provide for the redemption of shares at least twice a month. They also offer greater transparency through the publication of annual audited and semi-annual unaudited accounts.

Regarding regulatory oversight, all assets must be held for safekeeping by an independent custodian, which must ensure legal separation of non-cash assets held under custody. In addition, a UCITS must provide on request supplementary information to investors about the risk management methods employed.

Given the distribution potential and the advantages of a UCITS product, the Newcits trend is expected to continue.
Critics question long-term appeal of ‘Newcits’ funds

By Simon Gray

Even as the growth of ‘Newcits’ funds in the marketplace accelerates, concern has been growing about their limitations and potential dangers. These fears cover issues such as the potential for investment by retail customers that do not understand the products or for whom they are unsuitable, the possibility that investors may be disappointed if returns fail to match those of offshore hedge funds, and the need for higher volumes of assets under management to meet increased set-up and servicing costs.

But most potent is the fear, expressed by a number of prominent representatives of the asset management industry, that any hedge fund-style blow-up could cause long-lasting damage to the reputation of Ucits, built up over more than two decades, as a trustworthy fund vehicle for retail investment.

They include Jean-Baptiste de Franssu, chief executive of Invesco Europe and president of the European Fund and Asset Management Association, who recently described Newcits as “a traffic accident waiting to happen”. Speaking to a conference organised by the Association of the Luxembourg Fund Industry (Alfi) earlier this year, he argued that the Ucits structure was not designed for funds aimed at sophisticated investors and that hedge fund managers had taken advantage of rules defining eligible assets for Ucits in ways not intended by the legislation’s authors.

“It is a great concern,” De Franssu said. “These funds are pushing the Ucits rules on eligible assets to extremes. Can we afford to let Newcits develop? They could damage 20 years of work and success up to now. This is an opportunity for the industry to demonstrate we are ready to call for action when past legislation – in this case the rules governing Ucits eligible assets – has gone too far.”

Claude Kremer, a partner with Luxembourg law firm Arendt & Medernach, chairman of Alfi and vice-chairman of Efama, has also warned that the offering of more sophisticated and risky strategies through Ucits could endanger the acceptance of EU-authorised retail funds by regulators elsewhere in the world, such as Asia. “There
is legitimate concern about the scope of the European regulation,” Kremer said. “Asian countries are not bound by European rules. We need to be aware of the issue and ensure that the UCits brand, which has been highly successful in Asia, is not damaged.”

Brian Kelliher, a partner in the asset management and investment funds unit of Dublin law firm Dillon Eustace, adds: “The danger is the UCits brand could be tarnished if something went wrong. We’ve seen that as a result of the Lehman crisis, the Hong Kong regulator has become very cautious about alternative funds, even domestic ones. If UCits funds are open to potentially very high levels of leverage, not to mention volatility or market risk, it may be difficult for these funds to be registered in non-European jurisdictions.”

Olivier Sciales, a partner with law firm Chevalier & Sciales in Luxembourg, notes that Newcits come with drawbacks as well as advantages compared with other alternative fund structures. “UCits is quite a complex product, which some smaller promoters may not be aware of, and it’s often more costly than a SIF. Except in the case of the self-managed UCits, you need a management company that currently needs to be approved and regulated in Luxembourg. You also need a promoter with at least EUR8m in net assets on its balance sheet, unless the regulator agrees to a lower amount.”

He observes that the scope of Newcits may be constrained in the future by action on the part of the continent’s regulatory authorities. In fact the Committee of European Securities Regulators helped to pave the way for the growth of UCits funds using alternative investment strategies in 2004 when it introduced a distinction between sophisticated and non-sophisticated funds.

Recently, however, senior regulatory officials in France and Ireland have expressed willingness to re-examine the way sophisticated UCits funds are dealt with under European legislation, and in particular whether they should be treated as complex rather than non-complex products, as is the case currently for all UCits. Under the EU’s Markets in Financial Instruments Directive, while non-complex products can be sold on an execution-only basis, the distributor of a complex product must ensure it is being sold appropriately, which in practice tends to mean with advice.

Dermot Butler, chairman of Custom House Administration, is an avowed sceptic about the qualities of UCits as a structure for hedge fund strategies. “I’m none too convinced it’s anything but a short-term fad,” he says. “People seem to be setting up UCits because they think they’ll get better distribution, because the investors perceive that they’re better protected because they’re regulated, and because it helps avoid the AIFM Directive, which will apply to non-UCits funds. I think there are fallacies with all of these.

“UCits fund may be open to a broader band of investors, but you’ve still got to sell it to them. That requires distribution, and the average hedge fund manager doesn’t have retail distribution. If you’re a Marshall Wace or Brevan Howard that can conjure up USD300m in seed capital for a UCits fund, you’d be stupid not to do it. If a big pension fund manager offers you USD100m for a UCits structure, you’ll open one up the following day. But many managers are launching funds with less than USD50m, and some funds are already being closed because they have failed to attract a sufficient volume of assets.”

Butler cautions that it would be a grave error for investors to skimp on their due diligence into the manager just because the fund is a UCits structure. “I fear that some investors may be relaxing their due diligence efforts because UCits are widely touted as being strongly regulated,” he says. “That may mean they are not looking closely enough at the actual manager of the money. There’s nothing regulation can do to stop an incompetent manager, and regulation wasn’t much use to the investors in UCits feeder funds that invested with Bernie Madoff.”

Recently, he argues, the extra costs involved may represent a significant drag on performance. “A UCits costs a lot more to set up than European Cayman-style funds such as a QIF in Dublin or a SIF in Luxembourg or Malta,” Butler says. “The structure costs a lot more to operate because you must have a custodian, compliance with the regulations is expensive, and you will always have a quarterly bill from a lawyer for attending board meetings because the laws and EU regulations change so often.”
But he concedes: “If the cost of operating the UCits fund doesn’t crucify its performance in comparison with the group’s offshore Cayman vehicle, or if investors are happier to be in a UCits and are prepared to pay the extra cost, that’s fine.”

John Sergides, head of business development and strategy for alternative fund services in Deutsche Bank’s Trust & Securities Services business, points out that Newcits are often more complex, and therefore more costly, to administer than long-only UCits structures or indeed offshore funds. “Managers may not be aware of the differences in technology needed to do this and how much work will be involved,” he says. “When you try to make a hedge fund into a UCits, unless the assets are substantial, your servicing costs are increased, not decreased.”

Kelliher suggests that the cost issue might be mitigated if smaller managers join existing platforms - one of the most prominent is operated by Deutsche - rather than setting up their own schemes. “Platforms have been developed by certain promoters with existing administrators and custodians, where the fund is already up and running with a number of sub-funds, and they are adding third-party asset managers to it,” he says.

“That could enable start-up hedge fund managers to gain experience and develop commercially until they have an established track record as a UCits manager and may then be able to set up their own structure. An important factor is that these platforms may have existing distribution networks that new managers can avail themselves of.”

The jury is still out on how Newcits performance matches up with offshore funds run by the same managers according to the same strategy, mostly because few alternative UCits have a long enough track record to offer a meaningful comparison. A recent survey suggested that in the second quarter of this year many Newcits strategies only narrowly lagged equivalent offshore hedge funds, and equity long/short, global macro and event-driven UCits actually outperformed their offshore counterparts.

“There are certain things in an offshore fund which, for all the obvious eligibility, liquidity and concentration of risk reasons, should not and cannot make it into a UCits,” says Simon Hookway, managing partner of MAG Consultancy. “Unless you have correctly tested what your portfolio would have been under those conditions and how it would have performed, you don’t know what the tracking error will be between the offshore fund and the onshore regulated UCits, because when there is position-level disparity there will be tracking error.

“A number of firms that have rushed into this area haven’t necessarily gone through all these steps. This isn’t as serious a problem as a blow-up, but it still gives UCits a less than shining image in the eyes of investors if they think they’re getting an exact replica of the offshore fund when in fact they are getting something different. It should be obvious why this is, but if it is not explained correctly to investors it still comes as a shock.”

According to a recent survey conducted by the Edhec-Risk research centre, asset managers fear that structuring hedge fund strategies as UCits will distort strategies and diminish returns, because many strategies need to be altered to comply with the UCits regime, and liquidity requirements would put the liquidity risk premium out of reach. Sixty-nine per cent of participants in the survey believed that the liquidity premium of hedge fund strategies would disappear and performance would fall when strategies were structured within UCits.

Sergides suggests that smaller Newcits managers may not see the same level of support in terms of subscriptions that the larger managers are getting from institutional investors. “Managers are certainly looking for that money, but how much of it has actually materialised to date?” he asks. “The big shift for pension funds is in their allocation to alternatives. They’ve always had a huge...
they are attributed to the behaviour of the market rather than any inherent riskiness in the way the funds have been managed. Managers who proclaim their objective is to deliver absolute returns are more exposed, Bornemann argues, because investors harbour unrealistic expectations that such managers can and will make money in all market conditions. “People with that sort of expectation will be disappointed, no doubt about it,” he says. “But the important thing about a Ucits fund is that its liquidity enables investors to take their money out immediately if the fund starts to underperform.

“The potential risk to the reputation of Ucits lies in certain strategies, notably long credit and short volatility, especially if asset managers fail to explain the risks of the fund adequately. If they are too greedy and put on too much leverage, it may blow up in their face. Historic risk in such funds may not provide a good indication of future risk, because it’s a very fat-tailed kind of risk.

“This is a valid concern, but it shouldn’t result in investors being forbidden to use these tools. Instead there should be limits on how much leverage managers can use, and there must be proper disclosure to investors. If you explain how higher-risk products work, some investors will want to put their money in while others will shy away from them. That’s exactly the way it should be, both for traditional Ucits and for Newcits.”

### ALTERNATIVE UCITS: VALUABLE INNOVATION OR SHORT-TERM FAD?

**PRO**
- Tried and tested structure with strong global brand
- Regulation, transparency and liquidity meet investor concerns
- Avoids uncertainty over final form of AIFM Directive
- Suits institutions with limited ability to invest in offshore structures
- Passport for distribution throughout Europe and widely accepted by regulators worldwide
- Access to broader spectrum of individual investors
- Avoids discounts to NAV suffered by many quoted alternative funds
- Many hedge fund strategies are less risky than certain long-only funds
- Platforms can help start-up Newcits with service relationships and distribution
- If funds provide full information, investors should be free to make up their own minds

**ANTI**
- A blow-up could damage the Ucits image
- Investors may be disappointed if returns fail to match offshore funds
- Authorities abroad may restrict access to funds using leverage or derivatives
- Some strategies cannot be replicated effectively given Ucits investment constraints
- Start-up and ongoing running costs are higher than for offshore funds
- Some international investors, such as from the US, could be restricted from investing
- Newcits funds of funds may be less diversified than traditional funds of hedge funds
- Investors could rely on the Ucits brand and skimp on due diligence
- Could disappear as quickly as 130/30 funds, the big fad of 2006-07

Allocation to long-only structures, but it’s their allocation to the alternative space that is increasing.

“On the whole the institutional investors we talk to seem to have gone with institutional managers. People are looking for transparency, fiduciary responsibility and oversight of what’s going on at the asset level by investing via managed accounts. In the alternative space Ucits have been outweighed by managed accounts so far.”

However, managers who have been successful in developing Newcits business believe that some of the concerns are overblown. For example, Hans-Olov Bornemann, manager of the SEB Asset Selection Fund, counters the argument that Newcits could endanger the Ucits brand by noting that the regime emerged with its reputation intact from the stock market meltdown at the beginning of this century.

“Some Ucits funds investing in internet stocks dropped in value by 90 per cent without having a major impact on the brand,” he says, adding that long-only investments offered through Ucits funds in many cases carry significantly higher risk than hedge fund strategies. “You can invest 100 per cent of your money in Russian equities, and with leverage have 200 per cent exposure to Russia. Ucits can and do lose lots of money at times.”

He believes that these losses do not attach a stigma to the brand because...