

UCITS FUNDS



Ucits III funds have swelled in popularity with investors looking for more liquidity and less risk in turbulent times. *HFMWeek* has gathered three industry experts to provide an insight into the benefits of the Ucits brand and take a look at how EU regulation, and the introduction of Ucits IV next year, will affect the vehicle's growth

HFMWeek: What, in your opinion, are the main reasons for the growing appeal of Ucits funds among hedge fund managers?

John Bohan (JB): The migration towards Ucits funds is driven by demand from institutional investors or fear of their demands from investment managers. Hedge fund managers in the current environment can appreciate the value of a liquid, transparent and regulated product as a way to attract investors, while also allowing the manager access to increased distribution channels not only across the EU but in other regions such as Asia, the Middle East and Latin America. The new simplified notification procedure provided by Ucits IV (to be in force by 2011) will also attract the attention of hedge fund managers since it will speed up the cross-border distribution of their funds.

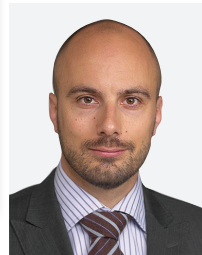
Dominique Lecocq (DL): Ucits ease marketing and distribution efforts. The post-financial crisis has led investors to consider regulated collective investment schemes, rather than unregulated or less regulated investment vehicles. Some hedge fund managers have converted their investment strategies into Ucits-compliant strategies to benefit from this marketing trend. While Ucits funds are designed for conservative, diversified, liquid and less risky strategies, hedge fund strategies may be leveraged, volatile, aggressive and more concentrated. The Ucits Directive is clear on eligible investments and leveraging limits, and was not initially designed for hedge fund strategies. Many 'Ucits hedge funds' require the use of OTC swaps and/or total return swaps to implement their strategies with unacceptable Ucits underlyings. However, this creates counterparty risk. The Total Expense Ratio (TER) may increase drastically compared to the TER of a hedge fund structured as a Professional Investors Fund (PIF), such as the Luxembourg Specialised Investment Fund, the Maltese Professional Investors Fund, or a Cayman Exempted Segregated Portfolio Company.

Andrew Hutcheon (AH): A lot of investors like regulated products and the recent market turmoil has added to that enthusiasm. Ucits already represent about 75% of the EU investment fund market with assets under management amounting to around €6trn (\$8trn) (Source: EFEMA: 2008).



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is based in Gibraltar and works as an analyst for Barclays Wealth. Hutcheon read politics at the University of Stirling, and acquired commercial experiences at Axa and HSBC CIBM before moving to Barclays Wealth in January 2008.

That said, they also potentially offer regulatory cost savings and reduced costs for investment managers. The spectre of increased regulatory scrutiny has heightened Ucits' appeal to alternative investment managers because, in theory, the imminent AIFM Directive should simplify the regulatory environment, create cost savings through economies of scale and reduce costs for investment managers that can be passed onto consumers. Ucits IV will chip away at many of the barriers in the European fund management market. Ucits funds must be available for investors dealing at least twice a month as opposed to unregulated funds that are available to investors dealing usually monthly and quarterly.

What are the key benefits offered by Ucits funds? How do they compare to other regulated funds?

JB: Since the global financial crisis, the advantages of Ucits funds have become paramount to the more cautious and conservative investor. Investors are seeking more liquidity and transparency in their portfolios and are looking to reduce their appetite to risk by investing in a more diversified portfolio. The main advantage of Ucits funds over regulated funds is the Ucits global brand and its ability to freely market across Europe.

DL: These are questions a promoter should ask him/herself when structuring a collective investment scheme. A fund is only successful if investors invest and remain invested. Accordingly, a promoter should address two main issues when setting up a fund: regulatory issues; and marketing and current trends. Currently, the trend is for Ucits funds. However, a Ucits has a much higher total expense ratio (TER) than a PIF. This is partly due to the extensive monitoring duties of the custodian bank and the Commitment II/Value at Risk approach which requires more work, expertise and complex IT tools.

AH: Disclosure and regulation are the incorporated protections attached to Ucits, both of which benefit investors. The 2008 amendments to Ucits III have already given investors regulated access to alternative strategies such as leverage and synthetic shorting for investment purposes.

The internationalisation of Ucits has also delivered benefits to investment managers: it has permitted them to develop a single branded investment product, attractive to both retail and institutional clients from diverse fiscal settings.

Non-harmonised investment funds are permitted by several EU member states, despite the fact that they do not comply fully with the rules of the Ucits Directive and



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investors are left to make their own decisions about their level of regulation and suitability (these types of funds may not necessarily be offered to retail clients and may be offered on a private placement basis). In comparison, Ucits funds come with a regulatory framework that is clear and straightforward and easily understood. Ucits funds should ideally be available without the necessity of local registration for distribution in all EU countries, but in fact most countries still require local registration to be available for their retail market; in theory, the process is supposed to be simpler.

What are the main differences between Ucits III and Ucits IV?

JB: The Ucits III Directive extended the range of permitted investments allowable in Ucits funds and allowed fund managers to move from the traditional long-only type space to more hedge fund-like strategies. Ucits IV will allow for Ucits master/feeder structures, cross-border Ucits mergers, a management company passport and simplified fund information for investors. Ucits III will be replaced by Ucits IV in 2011 and the modifications introduced should allow Ucits managers to trade cross-border more easily, drive down the costs of management and improve investor protection.

DL: The new rules of the revised Ucits IV Directive are set to be transposed into the national law of member states by 1 July 2011. Ucits IV will modernise the existing Ucits

Directives under a single law, and is expected to consolidate a fragmented European investment fund industry by reducing administrative barriers for the cross-border trading and management of funds. This will reduce costs by allowing economies of scale and increase the choice of investment products available to European investors, while ensuring that they are provided with clear information on their investments. The major developments in Ucits IV relate to: (i) the Key Investor Information (KII) which will replace the simplified prospectus, (ii) the Ucits Fund Mergers, (iii) an eased notification and passporting right, (iv) a new EU passport for the management company, and (v) the ability to create master/feeder structures.

AH: The main changes are:

- Simpler and accelerated notification procedure.
- A new standardised Key Investor Information (KII) document, giving clear and understandable information to investor - supposed to be more user friendly than the current simplified prospectus and limited to two pages;
- A procedure for cross-border Ucits Mergers and the creation of more cost-effective 'megafunds';
- Master/feeder structures, allowing funds to delegate investment to other funds;
- Co-operation between Member State Supervisory Authorities; and
- Management Company Passports, allowing management companies to manage funds cross-border.

Ucits IV is the latest step in the European Commission's Ucits project to fashion an indisputable pan-European single market for investment funds. It will significantly enhance the current growth trend of Ucits global sales, and will extend the product and investment flexibility currently afforded under Ucits III.

What challenges will the move to Ucits IV present to managers and how can these best be dealt with?

JB: A management company that is using the passport

facility will encounter significant hurdles in relation to the different rules that exist across the various EU jurisdictions. Differing local accounting rules and policies, financial reporting and regulation, and rules on investment valuation across the EU will present a number of challenges for companies utilising the Management Company Passport. Companies will need to streamline operations and take advantage of economies of scale and this will pose challenges to managers.

DL: Ucits IV will modernise and codify the existing Ucits Directives. Accordingly, there should be no challenge for managers, but only additional flexibility. In particular, Ucits IV makes the cross-border management of Ucits possible. Under the new Directive, any management company which has been authorised by its home member state may manage Ucits in other member states, either through the establishment of a branch or the use of freedom to provide services, after having notified its home authorities and supplied the requisite information to home and host authorities as prescribed by the Directive.

AH: Fund costs are not linear to fund asset size. Small funds as a consequence will have disproportionately higher costs than larger funds. Geographically and fiscally, the level of cost difference between the US and Europe is therefore very significant. This equates to lower return for the European saver. There is an argument for cross-border mergers and mega-fund structures to negate this non-alignment.

The present market environment will also speed up the movement towards consolidation, as managers go about economising funds and their structures. Further, with fewer replicated strategies investor investment selection should become easier.

Do you anticipate that the EU AIFM Directive will lead to increased demand for Ucits funds?

JB: The AIFM Directive will apply to fund managers that manage or market non-Ucits funds with assets under management exceeding €100m (\$134m). That leaves a

huge amount of investment managers out of scope, so despite the rumblings, the demand for offshore products in Cayman or Bermuda will remain intact. While the Directive has certainly spread fear, ultimately, the global industry will need to move towards a common standard of regulation. The offshore centres will certainly retain a lot more flexibility but nevertheless need to increase the level of regulation.

DL: The AIFM Directive should not lead to increased demand for Ucits funds. These are two different topics. The Ucits Directive aims at regulating Ucits-compliant collective investment schemes, while the draft AIFM Directive (if and when it enters into force) focuses only on hedge fund and private equity managers. The increased demand for Ucits funds was led by a market demand for fully regulated schemes. Should the AIFM enter into force and should it harmonise the management of hedge funds, this should give sufficient comfort to investors that the hedge fund industry is properly regulated and subject to regulatory surveillance. Why go Ucits then, except for paying an increased TER and using expensive OTC swaps to execute certain investments that would otherwise not be eligible under the Ucits Directive? Hedge fund managers are interested in managing a flexible vehicle that provides sufficient comfort to investors as to its regulatory status and surveillance.

AH: For investors, Ucits offer choice, service and value for money. Investors can choose from a broad range of investment strategies produced by reputable managers with a good track record of return, with full transparency and backed by strong governance, risk and control systems – underpinning the aim of the EU AIFM Directive – a harmonised, comprehensive, regulatory framework.

Looking ahead, do you expect the movement toward Ucits to be a permanent shift?

JB: Ucits funds offer solutions for mitigating hedge fund volatility and risk, however, the Ucits structure can be too limited with regards to investment strategies and returns, therefore will not replace or instigate a permanent shift away from traditional hedge funds. The immense flexibility of offshore products along with significantly lower costs of set-up and ongoing maintenance means that the demand for offshore funds will remain. The Ucits product has firmly established itself as a key product for the medium to large investment management companies that have the resources and strategic desire to market openly in Europe or simply provide the reassurance to investors that they have been through the approval process with a premium-tier regulator.

DL: Ucits became a real label of quality. There are many investors that do not necessarily capture that Ucits are only designed for a conservative investment universe; however, there is this general feeling that a Ucits fund is more secure and supervised than other funds. Therefore, I am confident that the number of Ucits funds will evolve positively.

AH: The stakes are high but I believe the consolidation of a fragmented alternatives industry will have a lasting impact on the fund market in Europe and beyond – mergers and master/feeder structures will drive significant change, increasing both competition and efficiency. Hedge fund managers with less liquid strategies will not want to be left behind and distribution professionals will be sought to bring Ucits retail knowledge to hedge funds. ■