



UCITS and Hedge Funds

Fact, fiction, and the real opportunities

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In recent months there have been several much-heralded launches of UCITS platforms for hedge fund strategies. In addition there appears to be a renewed interest shown by European and US sponsors and managers of alternatives in regulated products such as UCITS.

Many considered the original UCITS Directive imperfect and, as a result, the various amendments to the UCITS Directive, together with the changes introduced by the Eligible Asset Directive – commonly referred to as UCITS III – were intended to facilitate a regulated investment fund product that could more appropriately invest in assets and use strategies matching evolutions in the financial markets. Although the changes introduced by UCITS III have been part of EU law for over two years, significant interest by European alternative-asset managers is relatively recent and for US managers very recent.

This article explores what is driving that interest, both in Europe and in the US, whether it reflects substantive possibilities and, if so, what the real opportunities for an alternative asset manager may be.

Why the interest in UCITS?

Given the events of last year in the hedge fund industry and more widely the Madoff saga and the apparent political imperative, institutional investors are under pressure to re-consider how they allocate investments to alternatives. As a result, many institutional investors are re-considering UCITS which are perceived by many as a more liquid and “transparent” investment vehicle when compared to hedge funds and fund of hedge funds.

Equally, in times of relatively low returns on investment, capital charge risk weightings are likely to become more significant and the prospect of a more efficient allocation of capital away from hedge funds to UCITS may, in some instances, reduce investor’s capital requirements. Regulatory requirements at the level of the fund as well as manager, together with non-affiliated custodial/administrative functions, also offer their attractions to investors.

If investors are looking to UCITS, then managers, looking to increase their assets under management, are likely to have an interest in exploring how their strategies can be made to fit into a UCITS product. Against the above background, there are, and it is likely there will continue to be, a wide range of legislative and regulatory proposals in Europe and the US affecting the investment management industry. Whatever shape these proposals finally take, it is a reasonable assumption that they will have a profound impact on the way investment

funds and financial institutions operate and carry on their businesses. Understandably, market participants – including hedge fund managers – faced with the prospect of increasing regulatory oversight are re-evaluating the advantages of managing products such as UCITS – which they would not necessarily have previously considered.

The fundamental investor and manager questions – why a UCITS?

The fundamental questions are two-fold.

1. From a manager’s perspective, can the performance returns and related fee structures be (at least in part) replicated in a more regulated environment with hard liquidity constraints?
2. From an investor’s perspective, under the present legal and regulatory regime applicable to UCITS, do UCITS offer greater transparency and liquidity in a way that is meaningful to investors?

UCITS and liquidity – can hedge funds be made to fit?

Although the eligible asset rules – which preclude exposure to commodities and property entirely, and typically restrict any other investment to a 10% NAV limit – restrict strategies available to a UCITS product, as a practical matter it is the liquidity requirements which present the greatest limitations on a manager’s ability to implement hedge fund strategies in a UCITS product.

The maximum redemption period (subject to limited exceptions) for a UCITS product is 14 days and redemptions generally must be made at NAV. Moreover, any investment made by a UCITS, even if within the categories of eligible investments set out in the UCITS Directive, is precluded from compromising the ability of a UCITS to meet redemption requests.

In summary, there is a fundamental regulatory requirement that liquidity mismatches are precluded – a requirement made more difficult by the fact that “gates” and other restrictions on redemptions (subject to limited exceptions) are not permitted and a UCITS is likely to be given only a limited time to cure “passive” (i.e. inadvertent market price driven) or “active” (i.e. culpable) breaches of its failure to meet redemption requests. A UCITS is also required to have adequate risk-monitoring and risk-management systems in place.

The burden of ensuring liquidity mismatches do not arise, and the applicable regulatory requirements are met, sits with the directors of the UCITS. Where a UCITS delegates investment discretion to an investment manager, the regulatory compliance burden remains with the UCITS, with back-to-

back obligations imposed on the investment manager. The legal and regulatory compliance risk of managing a UCITS therefore sits squarely with the investment manager and as a result any manager considering a UCITS product needs to both understand and be comfortable that it can meet the compliance burden imposed by a UCITS and the local regulations.

In addition to the liquidity requirements, leverage in a UCITS is generally limited to 100% of NAV (or two times) and short-term borrowings limited to 10% of NAV. Similarly, maximum OTC derivative counterparty exposure is limited to 10% of NAV with daily valuations and rebalancing of positions in accordance with a valuation methodology and risk monitoring systems acceptable to the local regulator.

To date, as a result of the various restrictions, UCITS with alternative strategies have generally been limited to long/short equity, credit/bond funds and managed futures strategies. A number of other strategies and asset-classes are capable of being accommodated in a UCITS structure where a manager is willing to hold a higher percentage of liquid assets than it might otherwise hold in an unregulated fund with the same strategy. A manager can also accommodate certain strategies by using a number of asset-structuring techniques.

For example, managers may use “financial derivative instruments” together with margin financing and “structured financial instruments” within a UCITS product. A manager can also diversify issuer or counterparty exposure via structured investment vehicles. That said, the rules relating to the use of such instruments are designed to ensure that the general UCITS eligible assets and diversification requirements are not circumvented and thus the scope for the use of such structuring techniques is not without limit.

Will investors receive the comfort they need via investing in UCITS?

One topic that has received renewed investor attention in relation to hedge funds is the appropriate level of disclosure by hedge funds. Generally speaking, hedge funds are not subject to UK rules dictating any particular diversification requirements, concentration limits or other conditions. Typically hedge fund managers are free to set the parameters of their investment strategy and portfolio composition and are given a reasonably wide discretion in how they generate returns.

Equally, whilst hedge funds may voluntarily provide investors with reasonably regular information about the performance of the fund, they rarely

provide detailed information about portfolio composition and positions held.

By contrast all UCITS are subject to obligatory eligible asset rules, investment restrictions and concentration limits. UCITS are also subject to obligatory disclosure requirements. In addition, conflicts of interest either arising via the management of the UCITS itself or via the management of a UCITS together with a hedge fund or managed account will need to be resolved within the context of a regulated fund environment.

Of course eligible asset rules, investment restrictions, counterparty exposure and concentration limits, together with conflicts rules do not in themselves necessarily provide investor protection. Equally, nor does a high level of obligatory disclosure relating to them.

Evidently effective investor protection is dictated by the presence of a number of factors, including compliance by the manager with the UCITS rules, how meaningful any information disclosed will be to investors, and what they can do in response to the information provided. No legal/regulatory framework can remove entirely the risk of fraud and obviously not the risk of loss of capital due to market conditions and/or inadequate management of assets. However, liquidity together with regular NAV disclosure at least offers an exit.

US managers/investors?

Like their European counterparts US fund managers are re-evaluating the benefits of UCITS products. Although under UCITS III an investment manager of a UCITS product is generally required to be domiciled in the same jurisdiction as the UCITS itself, local regulators have allowed derogations from this requirement. As a result, like a UK based manager managing an Irish based UCITS product, a US based manager may be allowed to manage a UCITS from the US with local regulatory approval.

To do so, a US manager will generally be required to be a registered investment advisor with the SEC. In addition, the manager – like all managers managing a UCITS product – will be subject to certain capital requirements and compliance with UCITS regulations including the risk monitoring requirements, the Eligible Asset Directive and any requirements imposed by the local regulatory authorities.

The key for any sponsor of a UCITS when managing a UCITS product is to understand that it must comply with US securities laws if it anticipates distributing interests in the UCITS to US investors. More specifically, it must realise that just because a UCITS can be offered to retail investors in the

EU does not mean that it can be offered to retail investors in the US. In fact, a UCITS offered to US persons will typically be offered to such investors on a private placement basis in the US, requiring investors to be ‘accredited investors’ under the US securities laws and severely restricting a UCITS’ solicitation efforts. As a result, if a UCITS is offered to US persons, it must be extremely careful with respect to any communications – both in the US and outside the US - that could be regarded as a ‘general solicitation’ or ‘general advertising’ of the UCITS.

In addition, a UCITS with US investors must comply with the US Investment Company Act of 1940. This will likely result in additional financial and other qualification requirements for US investors which must be pre-approved by the local regulatory authority.

Conclusion

It remains to be seen whether the present interest in UCITS will translate to significant UCITS launches by hedge fund managers and significant asset allocation by investors. The probability is that such products will be launched as complementary to core alternative strategies. However, in a rapidly-evolving regulatory landscape, the future is inevitably hard to predict. **THFJ**

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