HFMWEEK
SPECIAL REPORT

UCITS 2014

SHIFTING TIDES
Greater regulation and the industry-wide implications

OPPORTUNITY
A different outlook for alternative Ucits

INSIGHT
An inside track on the implementation of new AIFMD guidelines

FEATURING Avoca Capital // Independent UCITS Platform // Lyxor Asset Management // Man Group // ML Capital // Schroders // Sparkasse Bank Malta // Walkers Global

It has been a year of change for managers of Ucits funds. As firms attempt to understand the overlapping regulation of the AIFMD and MiFID, grapple with Emir and prepare for Ucits V, a host of new challenges, and opportunities, await this growing sector.

Now accounting for almost 85% of Europe's funds industry, Ucits have had a strong 12 months. Assets under management for alternative Ucits peaked at €155bn in 2013, a hike of €16bn on the previous year, underlying once more the ever-increasing popularity of these vehicles as investors increasingly search for onshore solutions.

Approval of the much mooted Ucits V has now arrived and, once passed by member states, will see significant changes to depositories, remunerations and sanctions across the industry. The blueprint for MiFlD II has also been released, and with plans to split Ucits into complex and non-complex categories, the industry is set to experience even greater challenges in the coming months.

As the Ucits industry embarks on another year of transition and shifting regulations, the *HFMWeek Ucits Report 2014* provides you with expert insights from some central figures in the arena and explores the key themes that are shaping the industry today.

Chris Matthews
Report editor

HFMWEEK

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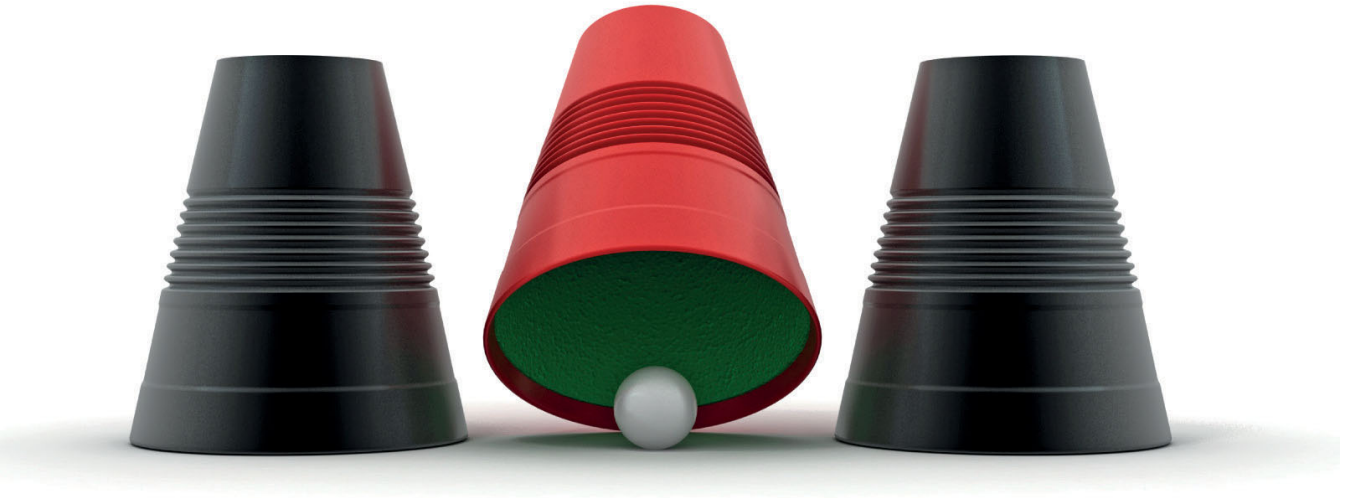


12 COMMON FICTIONS ABOUT UCITS AND UCITS PLATFORMS

DAVID ROBINSON OF **INDEPENDENT UCITS** DISCUSSES THE REALITIES OF OPERATING WITHIN THE UCITS FRAMEWORK FROM THE PERSPECTIVE OF BOUTIQUES AND HEDGE FUNDS

David Robinson graduated from Yale in 1988. He was a top-rated analyst covering Asia at Barings and HSBC, and a fund manager at Sofaer Capital. He established Prodigy Capital in 2003 and founded the Independent UCITS Platform with Hugh Hunter in 2012.

MYTH 1: ONLY LARGER-SCALE PLAYERS HAVE THE CAPABILITIES TO MANAGE THE COMPLEXITIES OF THE UCITS FRAMEWORK

The myth that Ucits is only for the big players is promoted most vigorously by (no surprises) the big players. Ucits adds another level of oversight to fund governance. But, by design, the oversight is independent of the portfolio manager and does not need to add to the costs of the investment manager.

Any additional costs to the fund can be more than offset by innovative structuring, especially if managers opt to test and grow their strategies on a platform.

MYTH 2: AS A BOUTIQUE I DON'T HAVE A CHANCE OF CONVINCING INVESTORS TO INVEST IN MY UCITS

Ucits is in fact a lifeline for smaller managers. Since 2008, fund buyers have faced pressure to perform more rigorous due diligence on investment managers. Due diligence of Ucits funds by the regulator in the approval process and ongoing independent risk management addresses many of the key issues covered in the buyer's due diligence process, especially operational issues and questions of adherence to stated investment policies ("style drift").

The level of comfort increases immeasurably in credible jurisdictions like Ireland and Luxembourg. Consequently, it is often the case that larger buyers can invest in smaller funds only if they are Ucits.

MYTH 3: UCITS IS ONLY FOR LONG-ONLY FUNDS

While Ucits was originally a long-only fund format, the guiding principle was protection of investors through diversification, independent oversight and close monitoring of the ownership of fund property, especially cash assets, by a depository. In recent years, EU policy makers have been keen to extend these principles to alternative strategies.

The reality is that it has been possible to replicate most hedge fund strategies since Ucits IV in 2009 allowed the use of derivatives to simulate single stock short positions.

While still a subset of Ucits assets, alternative Ucits have grown dramatically faster than traditional Ucits, their AuM increasing by 450% versus 49% for traditional strategies in the past five years.

Alternative Ucits strategies now include event-driven, relative value, equity and debt long/short, macro/CTA, commodities, multi-strategy and volatility arbitrage.

MYTH 4: UCITS RULES ARE TIRESOME AND ONEROUS

Ucits is not a straitjacket. The regulations often appear irritating to managers accustomed to the freedom (anarchy perhaps) of the unregulated funds. Few managers have not bristled at alerts informing them of rule breaches, especially any caused by outperformance of stock positions.

The offsetting benefits are profound: Ucits protects investors against the most frightening risks associated with unregulated schemes. Investors know this, sleep well at night and might in fact add to their investments in the morning.

Ucits can also be surprisingly forgiving. Provided managers are transparent about how they will manage their portfolios, and do as they say, Ucits is no different from a disciplined approach in other formats.

MYTH 5: UCITS WILL DAMPEN RETURNS BY RESTRICTING LEVERAGE

Contrary to perceptions, there are no absolute limits on gross exposure, although naked borrowing is prohibited. If exposure might exceed 200% of NAV, managers can opt for the VAR approach, specifying volatility limits for the portfolio.

MYTH 6: MORE FREQUENT VALUATIONS WILL ADD COSTS TO MY FUND

The market for fund services in Europe is competitive and there are economies of scale. Often, onshore administration services with more frequent valuations are less expensive than services with less frequent valuations in offshore jurisdictions. Daily portfolio reconciliations performed by the administrator may also reduce operating costs for the manager.

MYTH 7: MORE FREQUENT DEALING ALLOWS INVESTORS TO TRADE MY FUND OR ENCOURAGE THEM TO SELL MY FUND FIRST TO RAISE LIQUIDITY

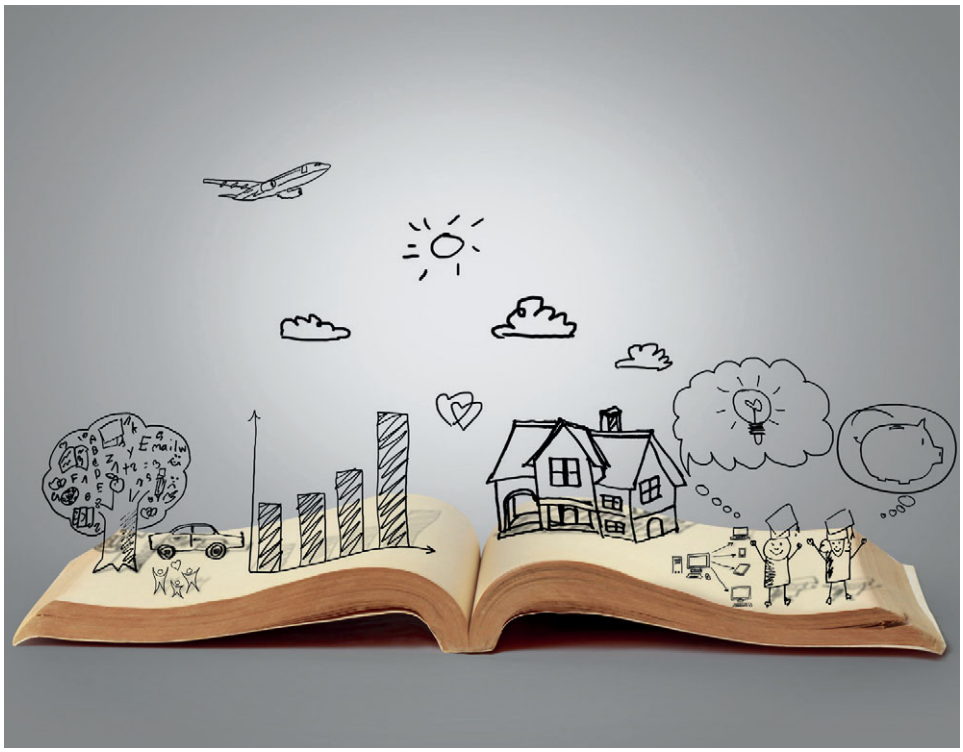
Fund buyers set their own holding periods and fund buyers with underlying retail clients are restricted by rules to prevent 'churning'. Investors seeking to leave a fund will do so anyway, and daily dealing can make redemption (and subscription) flows smoother.

MYTH 8: SETTING UP A UCITS FUND IS EXPENSIVE, WILL COST MANAGEMENT TIME AND MAKE MY HAIR GO GREY

Establishing a Ucits fund can be highly cost-effective on a platform and take less than three months. There are fur-

ther economies of scale through sharing of infrastructure and access to platform-level arrangements.

A good platform provider will develop grey hairs on your behalf, providing personalised help to tailor your strategy to Ucits and guide you through the fund formation and implementation process.



MYTH 9: I DON'T NEED UCITS BECAUSE I CAN SELL AN UNREGULATED FUND USING PRIVATE PLACEMENT REGIMES OR EXEMPTIONS UNDER THE AIFMD

Relying on reverse solicitation to sell alternative strategies under private placement regimes is a risky strategy. Sanctions against firms pushing the limits of the rules are likely to be severe. In addition, investors who have been sold funds through reverse solicitation could be more tempted to sue if there are losses.

Using private placement regimes is, in any event, not a long-term solution as the regimes will likely be phased out by 2017. In the meantime, private placement rules will become stricter across European jurisdictions and related permissions may not be passported between jurisdictions.

Exemption to the AIFMD applies only to managers with AuM under €150m – and of course to Ucits. Non-Ucits funds must still be sold under private placement rules.

Crucially, European investors are increasingly limiting investments to regulated vehicles anyway.

MYTH 10: ON A PLATFORM, I WILL HAVE TO OPERATE UNDER THE PLATFORM'S BRAND NAME

Most platforms insist on branding rights in the sub-fund name. The independent platform approach is intended to provide a new solution for entrepreneur managers who value their freedom and independence.

The approach acknowledges that many new managers have struck out on their own to escape the constraints (and costs) of operating under large firms and their brand names.

MYTH 11: ON A PLATFORM, I WILL BE FORCED TO USE SERVICE PROVIDERS ALREADY SELECTED BY THE PLATFORM

Many platforms exist to leverage and provide captive clients for fund marketing firms, prime brokerages and administrators. Managers are attracted by promises of distribution which are often unfulfilled.

The independent platform approach encourages managers to use a variety of service providers, depending on the exact needs of their funds, especially for marketing and trade execution.

In relation to marketing, the independent approach recognises there are no shortcuts to hard work and performance, and that getting the chemistry right between the manager and distributor is the key to success.

Independent platforms avoid conflicts of interest and work with the manager to develop unique, effective distribution strategies tailored to the fund.

> "THE MYTH THAT UCITS IS ONLY FOR THE BIG PLAYERS IS PROMOTED MOST VIGOROUSLY BY (NO SURPRISES) THE BIG PLAYERS. UCITS ADDS ANOTHER LEVEL OF OVERSIGHT TO FUND GOVERNANCE"

An independent platform can set up multiple relationships at the platform level, allowing managers to operate from day one with a choice of service providers.

Smaller managers in particular have access to a range of services whose providers, particularly prime brokers, might not consider them to be viable counterparties if they were operating standalone funds.

MYTH 12: THE PLATFORM WILL TAKE A CUT OF MY FEES

A good independent platform provides quality infrastructure and helps managers to build their own brands and businesses. The fee for doing this is linked to the size of the assets – and does not come from the pocket of the manager. ■

THE ATTRACTION OF LONG/SHORT CREDIT

ANDREW DREANEEN OF SCHRODER GAIA AND SIMON THORP OF AVOCA CAPITAL MANAGEMENT DISCUSS THE COMPANIES' RECENT PARTNERSHIP AND THEIR LAUNCH OF A NEW LONG/SHORT CREDIT STRATEGY

Simon Thorp
is the CEO of Avoca Capital Management LLP and is responsible for managing long/short credit. Simon has 31 years' investment experience in senior fixed income roles with Akroyd and Smithers, S G Warburg, Salomon Brothers, NatWest Markets, Ilex Asset Management and Liontrust.

Andrew Dreaneen
is head of Schroder GAIA product and business development involving manager selection, product development, product management, sales and marketing. He was previously head of product development for a number of Schroders Ucits and alternative fund ranges.

Schroders has teamed up with Avoca Capital – a specialised credit manager – and launched a long/short Ucits credit strategy. *HFMWeek* spoke to Simon Thorp, fund manager of Schroder GAIA Avoca Credit and Andrew Dreaneen, head of Schroder GAIA product and business development, to find out more about the investment strategy and proposition to clients.

HFMWeek (HFM): Why has Schroders launched a long/short credit strategy?
Andrew Dreaneen (AD): This decision was driven by demand from our existing client base. We are seeing strong demand for alternative Ucits funds and in particular credit long/short strategies. This is because many investors are overweight fixed income in particular high yield which, relative to investment grade, comes with increased default risk. We believe a long/short credit strategy, in particular one run by a high-pedigree investment team with a proven track record of participating in credit market rallies while at the same time protecting on the downside, will resonate very well with our clients.

> "WE ARE SEEING STRONG DEMAND FOR ALTERNATIVE UCITS FUNDS AND IN PARTICULAR CREDIT LONG/SHORT STRATEGIES"

HFM: Why did Schroders select Avoca Capital as the investment manager?
AD: Schroders is very selective of who we are prepared to partner with, ultimately we are seeking to find the best managers for each strategy on Schroder GAIA. After an extensive search Avoca was selected as our preferred manager as they are a leading European credit manager with a highly experienced investment team dedicated to credit long/short investing. In addition, Avoca's long/short credit strategy can be comfortably implemented within the Ucits framework as it is liquid, diversified and doesn't depend on excessive leverage.

HFM: Can you tell us a bit about Avoca and the team involved with this fund?
Simon Thorp (ST): In 2014 Avoca was acquired by KKR to become KKR's European credit platform. Avoca is a specialised European credit manager with about $8.4bn[1] in assets under management. There are 67 employees in the firm and we have offices in Dublin, Stockholm and London. I'm the CEO for Avoca's long/short credit strategy, and together with my co-portfolio manager James Sclater and our four dedicated analysts, we have delivered strong risk-adjusted returns over a decade, preserving investor capital and generating the bulk of our returns from alpha.

HFM: What is the fund's investment universe?
ST: We invest in liquid corporate, financial and sovereign credits either via bonds, credit default swaps or indices. We do not invest in structured credit or private placements. The European corporate credit markets have grown rapidly over the last few years (the HY market has doubled in size since 2010 to $337bn[2]) as banks have withdrawn from lending to corporates, resulting in many inefficiencies. In addition, increased regulatory scrutiny on banks' capital requirements has brought the $550bn[3] of 'financial' paper to the centre stage of our universe, providing extremely fertile ground for long/short credit investing. Finally, the ongoing European peripheral crisis has added a lot of volatility and therefore opportunities, not only in peripheral corporates and banks, but also in the sovereign debt of those countries.

Our focus has always been on Europe where we feel we have a competitive advantage and where our analysts spend a lot of time on the ground meeting with management. Running this strategy over the last 13 years means we are familiar with every high-yield credit. The bulk of our alpha is generated by our 'core' book, what I call 'the engine room', such as idiosyncratic or thematic longs and shorts. In addition to our core positions and depending on where we are in the credit cycle, we will look to generate alpha from event-driven ideas (M&A-related), capital structure arbitrage or relative value.

HFM: How do you generate new ideas and what is your investment process?
ST: Our ideas can come from a number of sources, including macroeconomic themes, specific company research, valuations or events. We believe there is no substitute for excellence in credit research and we strive every day to improve the quality of this production and be at the cutting

edge of credit analysis as it develops over time. Technology also plays a key role in helping to make the investment process as efficient and successful as possible, while helping us identify trends and momentum inflexion points in sectors or countries. Each idea is presented and discussed at our thrice-weekly investment meeting. James and I will decide whether the idea has significant value and, crucially, whether we can see it fitting into the overall portfolio framework. If the idea is validated then the relevant analyst will go and publish a full credit paper that analyses the company according to the three pillars of our research philosophy:

1) As a bond holder where do you sit in the capital structure and what cushion do you have below you?
2) What is the volatility of that cushion(through the cycle is this cushion likely to be more or less eroded)?
3) What will trigger that erosion and does the company have sufficient liquidity to withhold cushion erosion?

The credit paper is then circulated to all the team, discussed and voted upon. I have the final veto. James and I, together with the relevant analyst, will then select the optimal credit instrument, size the position, discuss hedges, set a stop-loss and profit-taking target and time to realisation of the thesis.

HFM: How is the portfolio structured?

ST: Our analysts are constantly generating interesting long and short ideas, and my job is to set a framework for what I want the portfolio to look like and which of those ideas will populate it. This overall portfolio framework is very much a function of the credit cycle and the liquidity in the market. Relative value and event-driven positions, for example, require liquidity and spread convergence and so there is no point in populating these buckets when liquidity is being withdrawn from the market and spreads are widening.

At other times during the cycle, credit will trend nicely driven by macroeconomic news, company financial performance and technical factors. If these planets align positively or negatively, we will lean the portfolio either long or short in aggregate to benefit from such a market move. The scale of that beta is limited to ensure that over the cycle the bulk of our returns are generated from alpha. We often express this view using indices. We are always on the lookout for cheap optionality to 'insure' the portfolio against tail risks and this has helped us enormously over the years. These hedges can be in the form of equity index options, credit options or interest rate options.

HFM: Why should investors consider investing in this strategy?

AD: Schroder GAIA Avoca Credit is a strong proposition for clients in the Ucits space:

- The fund is run by Avoca Capital who is one of the leading European credit managers.
- The fund is based on a very successful hedge fund with a proven track record since 2002 (see table below).
- The investment team is led by a seasoned credit portfolio manager in Simon Thorp who has more than 31 years' investment experience.
- The fund stands out amongst the peer group especially in terms of delivering high yield type returns with lower volatility and less downside participation than the market.
- The fund is available exclusively on the leading Schroder GAIA platform with a strong focus on manager selection, due diligence, risk oversight and client service. ■

$530m
Strategy AuM

+195%
Cumulative net return since 2002

8.4%
Annualised return

ZERO
Annual periods of negative returns in the last 12 years

IMPORTANT INFORMATION

Past performance is not a guide to future performance and may not be repeated. The value of investments, and the income from them, may go down as well as up and investors may not get back the amount originally invested. Exchange rates may cause the value of investments denominated in currencies other than sterling to fluctuate, and the income from them, may rise or fall.

1 Avoca Capital as at 31 March 2014
2 Avoca Capital estimate as at 31 March 2014
3 Avoca Capital estimate as at 31 March 2014

ALTERNATIVE UCITS: THE EVOLUTION OF A GROWING SOLUTION

CYRUS AMARIA OF **LYXOR ASSET MANAGEMENT** DISCUSSES THE MAIN CONSIDERATIONS SURROUNDING ALTERNATIVE UCITS FUNDS AND HOW THEY FIT INTO TODAY'S HEDGE FUND MARKET

Cyrus Amaria
is deputy head of the alternative investments at Lyxor Asset Management.

HFMWeek (HFM): Why is there a growing interest in the alternative Ucits space?

Cyrus Amaria (CA): In the current market environment, characterised by low yields for fixed income investments and well-priced equity markets, a greater number of investors are looking towards alternative investment funds as both a performance enhancer and diversifier to what they currently hold.

Traditional asset classes responded well to the onset of central bank liquidity in 2009 but with the start of tapering – which can work as a form of monetary tightening – it seems much of the tailwind that was provided by liquidity is starting to dry up. Alternative Ucits are being used by an increasing number of investors to improve the risk-return profile of their portfolios and to navigate a more difficult market environment.

When looking at alternative investments, most investors are mindful of the liquidity problems that hedge funds, in particular offshore funds, faced in 2008 as well as the concerns surrounding transparency. Ucits funds go a long way in addressing some of these concerns as they have to offer at least bi-monthly liquidity, and reporting requirements can also enhance the transparency provided to investors.

Ultimately, the demand from the investor side to diversify their portfolio and the ability to access hedge funds in a more regulated format seem to be two of the largest reasons for an increase in the demand for alternative Ucits funds.

> "THE MOST SUITABLE STRATEGIES UNDER UCITS AT THIS POINT REMAIN EQUITY LONG/SHORT, EVENT DRIVEN (INCLUDING MERGER ARBITRAGE), MANAGED FUTURES, GLOBAL MACRO AND LIQUID CREDIT"

HFM: Do investors have enough choice with alternative Ucits funds?

CA: Alternative managers are relatively new in Ucits format. The growth of the market has expanded from around €40bn at the end of 2008 to more than €150bn by the end of 2013. This growth rate is very impressive and significantly stronger than the offshore hedge fund industry. The number of funds in existence is estimated to be more than 1,000 with plenty of opportunity for investors to select differentiated managers. Importantly, there has also been an increase in strategies that many hedge fund managers have been willing to offer. The most suitable strategies under Ucits at this point remain equity long/short, event driven (including merger arbitrage), managed futures, global macro and liquid credit.

In 2013, Lyxor launched three new Ucits managers across different strategies: merger arbitrage – Lyxor/ Tiedemann Arbitrage, liquid credit – Lyxor/ Canyon Credit, and a CTA – Lyxor/ WNT (Winton). Each fund has generated excellent investor interest due to the unique opportunity the strategy brings. For example, in the case of Tiedemann Arbitrage the manager has shown ability to profit from complex merger and acquisition deals while consciously limiting losses through actively hedged protection.

Canyon Credit is a manager that has great experience trading debt markets mainly in the US and is focusing on the more liquid credit trades that do not necessarily go into their longer horizon offshore hedge fund. Some of the themes include: special situations, liquidations, refinancing arbitrage, merger arbitrage and capital structure arbitrage. Along with the manager's skill these are strategies that investors can rarely access outside of the hedge fund spectrum.

Finally, WNT is a CTA that excludes commodities and certain equity positions from its strategy. Lyxor was able to create something unique with the manager that is able to profit from the strong quantitative capabilities of the manager's organisation.

All three funds certainly fill a purpose for an inves-

tor's portfolio and one of the most interesting aspects is the length of time we have known each of these organisations. Winton and Tiedemann have been part of Lyxor's managed account platform since 2002 and Canyon since 2005. Our positive experiences with these managers, especially during the liquidity crisis in 2008, helped with our selection process in creating a regulated Ucits version for investors.

HFM: A Ucits fund is a regulated fund. Does that eliminate a lot of the risk associated with hedge funds?
CA: I would not say that at all. Sometimes there is a common misunderstanding that the Ucits framework eliminates all risks in hedge funds. A Ucits hedge fund is still a hedge fund, and remains exposed to all traditional hedge fund risks including liquidity mismatch, portfolio style drift or reputation risks. For this reason, it is very important that investors seek out an asset manager with established experience in selecting and monitoring hedge funds, in order to evaluate and mitigate such risks. In addition to the Ucits filters of liquidity and governance, it will provide them with greater expertise and protection to invest efficiently.

HFM: What works well in the Ucits space?
CA: Some of the most important considerations for an investor remain the quality of the organisation, the recognition of the manager being an expertise in their field and a preference for very good liquidity. The strategy the manager employs is of course vital for an investor as they are looking for a tool in portfolio construction.

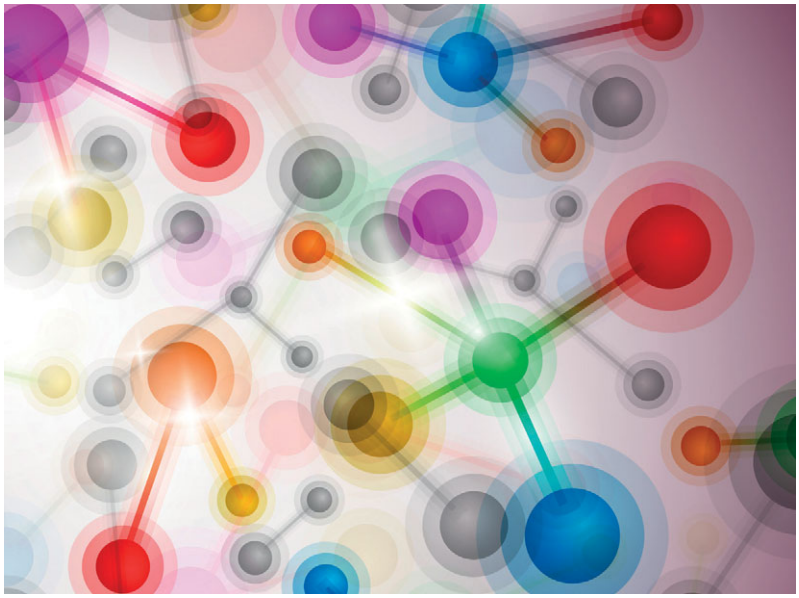
Aside from this there are important nuances when it comes to launching a hedge fund in the Ucits space. Fees tend to come high on the list of requirements. Most investors want to see a low management fee and possibly capped service provider fees on the over fund level. The idea is to get the TER as low as possible and less than the offshore fund, especially if certain assets are restricted from the investment universe.

With many "star" hedge fund managers, fees can be a difficult negotiation but one of the recognised methods to achieve this is through a Ucits provider that has experience in negotiating with premier funds.

Finally, one of the successes of the three Lyxor Ucits funds launched in 2013 was the creation of an 'early bird' share class. Investors were offered this share class with reduced management fees in perpetuity of their initial investment. While the low fee benefited the investor, the initial allocation was a benefit to Lyxor as it helped the Ucits funds quickly get up to scale and it meant that other investors were more able to meet their holding ratio requirements.

HFM: In the past 12 months a lot of offshore hedge funds have closed to capacity. Do you see the same with alternative Ucits or is this less of an issue because of the better liquidity?
CA: It would be fair to say that liquidity and capacity have some correlation but are not mutually dependent. Suffice to say that the alternative Ucits world tends to share similar experiences with the offshore hedge fund world.

Many hedge funds close their funds to additional investor capital as they believe they have reached the maximum amount they feel confident allocating based on their resources. In many instances, a hedge fund may have a small team and if they were to grow their fund beyond a point where they do not have time to fully research an idea, this is to the detriment of investors, but also to the detriment of the manager. If the returns of the fund decline due to the inability to efficiently put capital to work, then investors will vote with their feet and redeem from the fund.



Capacity is certainly one of the more important topics again for both managers and investors. From our research there are maybe close to 20 Ucits funds that are closed to accepting investor's capital with the vast majority of cases coming in the last 12 months.

HFM: How do alternative Ucits now fit in with the regulation of the AIFMD?
CA: The AIFMD is certainly still in the implementation phase for many hedge funds although those that benefited from the grandfathering provision will need to act soon. At Lyxor we are embracing the new AIFM Directive and have received our licence in France but while both the AIFMD and Ucits represent an onshore access to hedge fund strategies, the AIFM Directive actually has a very distinct target. The AIFMD is exclusively intended for professional investors, whereas Ucits offerings are also accessible by fund distributors and private investors, with very different limitations of liquidity, diversification and leverage. The AIMFD on the other hand allows for more illiquid and leveraged strategies, without constraints to exclude any financial instruments or risk parameters (leverage, concentrations, etc.). This is why we see these two offerings as very complimentary, rather than conflicting. We are in the process of launching a new AIFMD-compliant managed account platform in Luxembourg, alongside our offshore and Ucits platforms, and each will be managed and developed, to appropriately respond to their respective investor segment. ■

DISPELLING THE MYTHS ABOUT ALTERNATIVE UCITS

IAN SWALLOW, HEAD OF UCITS MANAGEMENT AT **MAN GROUP**, DISCUSSES THE FRAMEWORK OF UCITS, THE PROBLEM WITH LIQUIDITY MISMATCHES AND ALTERNATIVE UCITS STRATEGIES

Ian Swallow
is head of Ucits management at Man Group and responsible for product development management both onshore and offshore for the group's GLG content.

A FRAMEWORK, NOT AN ENDORSEMENT

The popularity of the Ucits 'brand' is beyond question and this continues to be one of the fastest-growing segments of the fund management industry. Indeed, our own anecdotal experience suggests that investors outside Europe often prefer to invest in a fund under the Ucits banner.

One of the issues associated with the ability to label a product as Ucits-compliant is that this status alone can influence the perspective of investors over its potential suitability. For example, a risk-averse investor may incorrectly consider that each and every Ucits vehicle is effectively approved by local and international regulators as being suitable for all.

The Ucits framework should indeed ensure that the relative risks undertaken by investment managers are commensurate with their published strategy and that the potential returns justify the absorption of such risk. However, the regulations do not aim to ensure that all Ucits-compliant products have the same risk/return objectives or offer similar levels of downside limitations.

A separate but related point is that some strategies that are not specifically excluded under the Ucits Directive are not wholly compatible with it. This means there is a moral responsibility – that may not always be strictly adhered to – on the part of providers to only wrap appropriate strategies within a Ucits format.

Consequently, we believe that a perception that all Ucits funds are made equal has led to some strategy or provider-specific issues being afforded myth-like status and blanketed across the entire universe. Clearly, objectivity demands that the following commonly quoted myths are dispelled.

> "WE BELIEVE THAT A PERCEPTION THAT ALL UCITS FUNDS ARE MADE EQUAL HAS LED TO SOME STRATEGY OR PROVIDER-SPECIFIC ISSUES BEING AFFORDED MYTH-LIKE STATUS AND BLANKETED ACROSS THE ENTIRE UNIVERSE"

1. Ucits funds carry a performance drag

Some investors believe that the performance of an alternative Ucits fund will, by definition, lag that of the offshore strategy on which the offering is based because significant re-engineering of the portfolio is required in order to satisfy the Ucits Directive. However, the rationale behind a number of alternative product offerings being made available under the Ucits banner is that the underlying offshore strategy is largely, or even completely, aligned with Ucits regulations. Consequently, where no major modifications are required, the offshore and Ucits funds will often trade pari-passu.

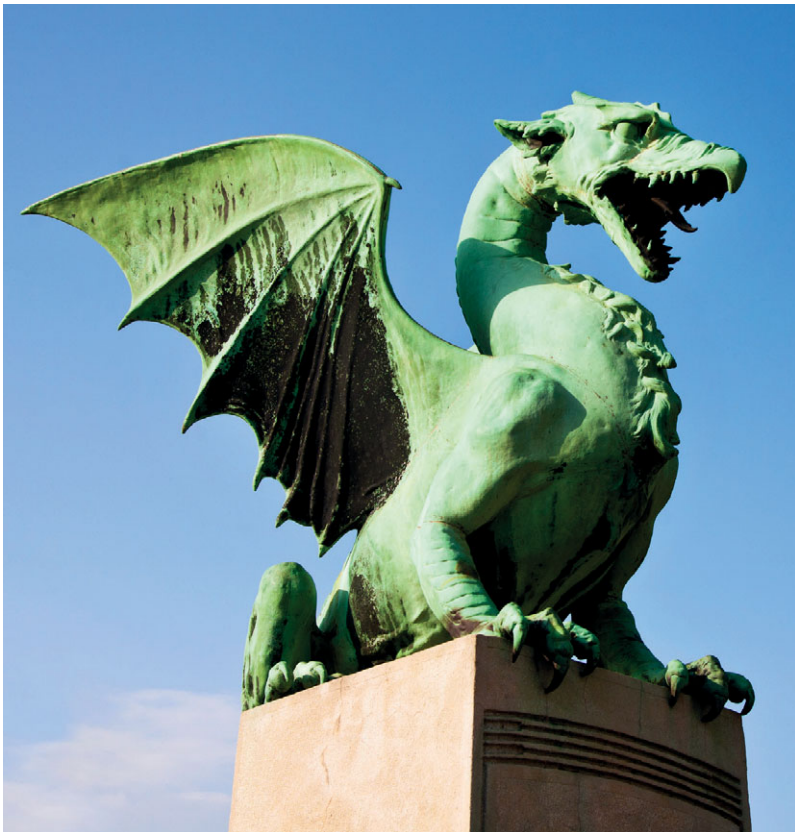
2. A liquidity mismatch could cause redemption difficulties

Liquidity mismatches arise when the terms of redemption offered are different to the rate at which the portfolio could be unwound in the event of a flood of redemptions. Some investors fear that where the redemption terms of the offshore product differ from that of the Ucits offering, managers will not be able to provide the advertised liquidity.

It is true that some hedge fund strategies, such as certain offerings falling within the event-driven category, require additional time to unwind a portfolio because the underlying assets themselves are relatively illiquid. However, many hedge fund providers stipulate a longer redemption period in their non-Ucits offerings than that specified by the Ucits Directive simply because they have a small number of very large investors. Consequently, in the event of a significant redemption, they wish to protect the interests of other investors by unwinding positions over a longer period to avoid slippage. It is often the case that the assets could, in practice, be crystallised in line with the Ucits specifications.

3. A large number of alternative strategies are not replicable under the Ucits provisions

A number of investors have noted that, for example, the Eligible Assets Directive (EAD) prohibits holding physical commodities. Consequently, strategies that harness commodities-related earnings streams, such as managed futures and global macro, are not fully replicable.



Cleary, there are a number of issues related to holding physical commodities, such as storage, potential damage, insurance and transport costs. However, alternative Ucits providers can gain commodities exposure through, for example, index options, which are highly liquid and meet other Ucits rules relating to diversification and collateralisation. Therefore, the ability to deliver commodities-related return streams is not only highly desirable for investors seeking investment performance that is uncorrelated to traditional assets, it is also perfectly permissible under the EAD.

4. Ucits rules prohibit short selling

A popular misconception is that some of the best hedge fund strategies are not available in a Ucits format because they rely on short selling, which is not permitted under Ucits regulations.

Evidently, short selling is one of the most powerful tools in the armoury of a hedge fund manager, as it allows investment professionals to express a negative view on an asset. This provides a further potential source of alpha and the short book can also be used to hedge the performance of the long positions. However, the practice has often come under the scrutiny of regulators because it can be dangerous if not conducted prudently. Consequently, stock exchanges have periodically banned 'naked' short selling, which is a form of speculation that involves selling stock that is not owned with a view to buying it at a lower price in time for settlement.

Under the terms of the Ucits Directive, even 'covered' (where stock is legitimately borrowed before selling) shorting is prohibited. However, synthetic shorting can be achieved through the use of cash-settled derivative instruments, which are perfectly permissible. As such, the regulations are not a barrier to operating a long/short strategy that is aligned with its offshore counterpart.

5. It is expensive to bring an alternative Ucits strategy to the market so fee loads are greater

The costs associated with structuring a Ucits offering are very much dependent on both the scope of the issuer and the compass of the strategy offering. There is no doubt that economies of scale apply and some small alternative investment houses could find that the following points are barriers to cost-effective implementation for both manager and investor:

- Platform size (fixed costs can be large for small platforms)
- Complex compliance monitoring requirements can be difficult to monitor and are thus labour intensive
- Production of additional materials (e.g. KIID)
- Passporting/registration, upfront and ongoing maintenance costs (including translation costs)
- Maintenance of, or contracting with, an onshore management company to manage funds
- Lack of experience in dealing with regulators (both directly and via legal counsel).

The last point is not a question of expense in monetary terms, but it can be a drain on human resources and regulatory inexperience frequently leads to unforeseen delays in proposed launch dates (and thus fee-income accumulation).

RESOURCES AND INNOVATION

As is often the case with myths, there is usually some substance to the misconceptions that are frequently applied to alternative Ucits strategies. However, these issues may be specific to either the issuer, the specific approach pursued or both. It is unquestionably the case that some of the most popular Ucits products, such as managed futures and equity long-short, are naturally aligned to the liquidity provisions of the Ucits Directive.

Consequently, adhering to the principles of the offshore strategy on which the offering is based, and producing returns that are closely aligned to it within a Ucits framework, is seldom a barrier. This is especially the case for large-scale players who are able to devote time, expertise and resources to uncovering innovative methods of mirroring the offshore strategy within the Ucits regulations. ■

UCITS V: A WELCOME INITIAL RESPONSE

CATHERINE FITZSIMONS OF **WALKERS GLOBAL** DISCUSSES THE RECENTLY APPROVED UCITS V DIRECTIVE AND THE POTENTIAL IMPACT OF ITS REMUNERATION POLICIES ON THE INDUSTRY

Catherine Fitzsimons
is based in the Investment Funds Group of Walkers Ireland, where she advises some of the world's leading investment managers, investment banks and service providers in relation to the structuring, establishment, authorisation and operation of Ucits and alternative investment funds.

Although much will depend on the technical guidance to be issued by Esma on the remuneration provisions contained in Ucits V, the asset management industry is cautiously optimistic that the agreed form of Ucits V will provide fund managers with a sufficiently flexible regime to enable them to continue to provide attractive compensation packages for top performing staff, while ensuring managers keep investors' interests as a key consideration when making portfolio management decisions.

BACKGROUND

On 15 April 2014, the final version of the Ucits V Directive was formally approved by the European Parliament. Ucits V was designed to bring some key elements of the Ucits regime into line with the new provisions governing alternative investment funds contained in the AIFMD. It focuses on the three concepts of depositary liability, remuneration of fund managers and administrative sanctions that may be imposed by regulators.

Across Europe and beyond, fund managers have been particularly concerned with the proposed remuneration provisions of Ucits V. While investor protection has been the overriding objective of the remuneration rules, managers feared that the introduction of an impractical or overly restrictive remuneration regime would impact their ability to attract the best portfolio management professionals to manage their European Ucits fund products.

> "ACROSS EUROPE AND BEYOND, FUND MANAGERS HAVE BEEN PARTICULARLY CONCERNED WITH THE PROPOSED REMUNERATION PROVISIONS OF UCITS V"

REMUNERATION POLICIES AND PROCEDURES

Ucits V requires that all Ucits management companies put in place remuneration policies and procedures for all staff whose activities may affect the risk profile of either the Ucits management company or any Ucits under management. The objective of these policies and procedures must be to discourage Ucits taking disproportionate risks, by effectively requiring fund managers to have a personal interest in the performance of the Ucits over time.

This requirement is broadly similar to that in place for alternative investment funds, as contained in the AIFMD.

While Ucits V relies heavily on Esma to implement technical rules which will provide full details of the applicable remuneration regime, the text of Ucits V itself contains some core requirements.

Disclosure of fixed and variable remuneration received by management is now required to be included in the annual reports of the Ucits, providing investors with the comfort of greater transparency.

The point that has been of particular interest to fund managers relates to the variable component of their remuneration. The key requirements, which apply only in respect of the variable portion of their remuneration, are:

- 50% must consist of units in the Ucits concerned, unless the Ucits accounts for less than half of the portfolio managed by the management company; and
- At least 40% must be deferred over a period of three years. This amount is raised to 60% in cases where the proportion of variable remuneration is particularly large.

These agreed provisions represent months of negotiation and lobbying on behalf of the asset management industry. Over the course of the drafting of Ucits V, it was proposed at one point that a cap on bonuses for asset managers be introduced so that bonuses paid to individuals, who are in a position to influence the risk profile of a Ucits, would always be limited to an amount equal to their fixed remuneration. This proposal was met with much consternation across the industry and deep concerns over the impact on current employment arrangements and the ability to properly reward asset managers based on performance of Ucits investments. Thankfully, this proposal has not been included in the final agreed text of Ucits V. As a result, it does not appear that Esma has been given the remit to introduce any form of this type of rule in its technical guidance.

The remuneration provisions are broadly consistent with those contained in the AIFMD and it has been specifically noted in Ucits V that the technical guidelines to be prepared by Esma will, where appropriate and to the extent possible, be aligned with the AIFMD. After much negotiation of the Ucits V text, wording was included in the preamble noting that remuneration rules should apply in a proportionate manner to any third party who takes investment decisions affecting the risk profile of the Ucits.

The industry is cautiously optimistic that this wording highlighting the need for proportionality will be taken into account by Esma in the formulation of its technical guidance. This could limit or reduce the effect of the Ucits V remuneration rules on third party investment managers to whom portfolio management of a Ucits has been delegated.

The possibility Esma may permit a proportionate view to be taken in applying the requirement that half of the amount of variable remuneration received must be invested in units of the Ucits under management has been particularly welcomed by portfolio managers appointed to Ucits who are based in the US. The initial concern was that any requirement for US staff to hold units of a Ucits could result in US registration being imposed on the Ucits and its management company. As these registration requirements are costly and administratively burdensome, there may be scope for Esma to all Ucits managers to take the view that the requirement for such individuals to hold units in the Ucits would not be proportionate to the protection afforded to investors and on that basis not require it.

> “DISCLOSURE OF FIXED AND VARIABLE REMUNERATION RECEIVED BY MANAGEMENT IS NOW REQUIRED TO BE INCLUDED IN THE ANNUAL REPORTS OF THE UCITS, PROVIDING INVESTORS WITH THE COMFORT OF GREATER TRANSPARENCY”

NEXT STEPS

Following its approval by the European Parliament, Ucits V now moves to formal approval by the European Council. It is not proposed that any further amendments be made at that stage. Once approved by the Council, it will then be translated and published in the *Official Journal of the European Union*. Ucits V will come into force 20 days thereafter. Member states are then required to introduce implementing legislation within 18 months.

CONCLUSIONS

The level of anxiety surrounding remuneration rules was greatly reduced with the European Parliament's approval of the final Ucits V text. However, much will depend on the technical guidance to be issued by Esma. While the industry is obliged to once again 'wait and see' what rules will be applicable to them, it is widely felt that the text of Ucits V was a good first step on the road to the formulation of a regime that balances the objective of investor protection with the realities of attracting the best talent to European fund management.

As Ireland allows the establishment of Ucits self-managed investment companies, this will continue to be the most attractive option for US fund managers seeking to establish a regulated mutual fund in Europe, as the remuneration requirements will initially apply at fund level, with the proportionate approach applying thereafter. ■

UCITS – THE KEY CONSIDERATIONS

RICHARD DAY OF **ML CAPITAL** DISCUSSES THE KEY QUESTIONS MANAGERS SHOULD BE ASKING THEMSELVES PRIOR TO LAUNCHING AN ALTERNATIVE UCITS FUND

Richard Day
is chief operating officer of ML Capital, investment manager to the MontLake Ucits platform. Prior to joining ML Capital in 2010, Day spent the first ten years of his career at Morgan Stanley working within asset management, international equities, operations and technology.

It is important before embarking on a Ucits fund launch that hedge fund managers ask themselves the following key questions:

Do you have committed seed capital?
The 'build it and they will come approach' is likely to lead to a lot of expense and wasted time – before embarking on any significant amount of work, it is important to have a firm idea on where the seed capital is coming from. Generally, we find that existing hedge fund managers consider launching a Ucits structure as a response to investor demand, however, in order to be a viable option managers need to have $25-$50m in committed seed capital.

Do you have a clear strategy on how you are going to increase assets under management once launched?
Approximately 90% of alternative Ucits funds are sub-$100m, however 90% of the allocators to alternative Ucits funds are looking at funds in excess of $100m. Therefore, having a strategy to reach that sum is very important and having a cornerstone investor is invariably not enough. The ongoing total expense ratio (TER) of a fund can have a huge impact on asset raising so it is important to have a clear strategy on how you will grow AuM to reduce the TER. A further consideration is that the 2/20 fee model doesn't fly; a lot of allocators are simply not willing to pay this.

> "THE ONGOING TOTAL EXPENSE RATIO (TER) OF A FUND CAN HAVE A HUGE IMPACT ON ASSET RAISING SO IT IS IMPORTANT TO HAVE A CLEAR STRATEGY ON HOW YOU WILL GROW AUM TO REDUCE THE TER"

Does your strategy work within Ucits rules?
Specifically, what changes if any will you need to make to the strategy to make it work and how will this affect performance – both on a backward-looking basis in terms of your track record and on a forward-looking basis in terms of your ability to generate returns?

You need to work out how to gain the sufficient knowledge to understand the rules in detail, as this will have a direct impact on your ability to run the strategy within the Ucits framework.

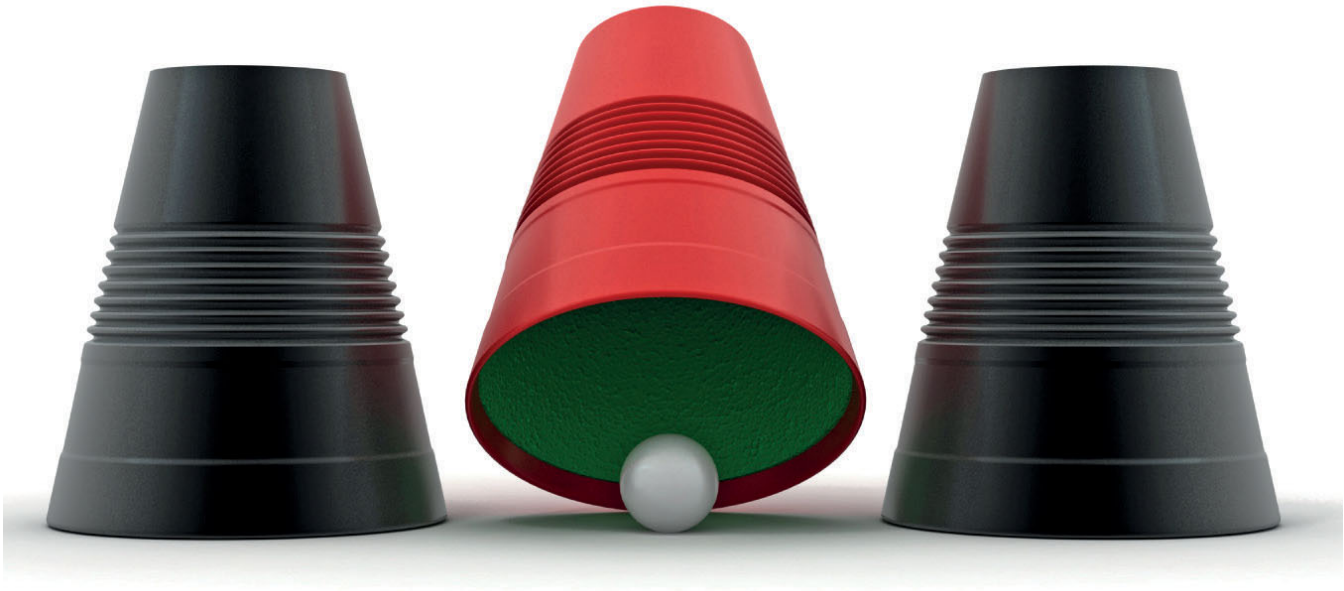
Are you equipped operationally to manage a Ucits fund – either on a standalone basis or as part of a platform solution?
Ucits funds are typically managed on a daily NAV basis and there is a raft of new regulatory considerations that need to be taken into account. It is often a custody-led model as opposed to a PB-led model, so managers need to understand the difference between the two offerings.

If the answer to any of the above questions is 'no', you are likely to fail before you have even started. If the answers are 'yes', then the question is how do you proceed to ensure the greatest degree of success?

Should you go it alone or seek help from a partner?
There are a plethora of organisations that will offer to help you figure out the best Ucits solution for your organisation (while often positioning their own services in that very solution): independent consultants, onshore and offshore fund lawyers, PB consulting teams, administrators, custodians, the list goes on. Ultimately, the decision to either go it alone and launch an independent fund, or partner with a Ucits platform and launch a sub-fund on an existing umbrella should be driven by the need to build a successful distribution strategy and to cater for the operational demands of running a Ucits fund. If a manager considers those two core areas, they will be better placed to come up with solutions that work for them and give them the best opportunity to be successful.

What does it take to get a fund up and running and become successful?
Simply put, it's time, money and expertise, with the latter driving how long it will take, what it will cost you and how successful you will be.

How do you build a successful distribution strategy?
It is important to understand from the onset what you are ultimately targeting. Something that is core to us at ML



Capital is the opportunity set: are you looking to penetrate the $200bn and rising alternative allocators to Ucits or is the $7trn mainstream Ucits allocators what you are really after? The latter is where the bigger opportunity is, but it is also typically harder for the average hedge fund manager to penetrate.

Before you even begin to sell your Ucits fund, there are many operational areas to consider. A common misconception of many hedge fund managers is that by launching a European onshore regulated fund you are immediately open for public sale in the key markets in Europe. The reality is far from this and a lot of work needs to be done to get yourself operationally ready. Consideration needs to be given to country registrations, tax reporting in key markets and access to the key platform providers that control so much of the investor flow, for example.

Once ready operationally, you need to have the resources at your disposal to sell the fund – resources that understand the intricacies of each of the core European markets (such as the UK, Germany, Switzerland, Italy, France), have the ability to converse in the native language and have access to the key decision makers.

Selling Ucits funds is very much a long game; it takes a lot of time and effort.

How do you cater for the operational needs of running a Ucits fund?

Are you sufficiently regulated to manage a Ucits fund with discretion? Do you have permission from your home regulator? And are you able to get yourself authorised either in Luxembourg, Ireland or Malta?

Service provider selection is key – Ucits funds require operational expertise that is alien to many of the traditional hedge fund services providers. It is very much a case of long-only meets hedge, and avoiding the car crashes in the middle is crucial. In many instances, hedge fund managers will be moving from a monthly or quarterly NAV cycle to a daily NAV cycle, so they need to get themselves operationally prepared for this in order to be successful.

> “SERVICE PROVIDER SELECTION IS KEY – UCITS FUNDS REQUIRE OPERATIONAL EXPERTISE THAT IS ALIEN TO MANY OF THE TRADITIONAL HEDGE FUND SERVICES PROVIDERS”

As mentioned on page 21, it is important to understand the difference between a PB-led model and a custody-led model – both in terms of fees and the level of support you receive. The PB model is often very hands-on, offering a lot of support, and while the custody-led solution is significantly cheaper, the level of hand-holding provided is greatly reduced. Many managers have struggled to get to grips with the operational intricacies of running a Ucits fund without the high level of PB support.

It is essential to get to grips with the Ucits rules; not just understanding them but also appreciating the consequences of getting it wrong, for example understanding the differences between advertent breaches and inadvertent breaches. Advertent breaches can end up costing managers a lot of money if they make a trading mistake that leads to a breach of the Ucits rules and causes the fund to make a loss; it can also lead to regulatory sanctions. The operational burden of running a Ucits fund on a small/mid-sized hedge fund manager is significant and should not be underestimated.

CONCLUSION

Hedge fund managers looking to enter the Ucits space should do so only after doing their homework. The opportunity is clear for all to see with $7trn of assets to be tapped into, however opening up that pool of capital is not without its challenges. If you can successfully navigate your entry point and build a long-lasting strategy, you can be very successful. ■