



Innovation

ARTHUR COX

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Asset Management and Investment Funds Briefing

Alternative strategies in UCITS funds

In recent times an increasing number of Irish funds authorised by the Financial Regulator have been launched employing alternative strategies rather than the traditional long only or fixed income funds. The purpose of this client memorandum is to examine the key reasons why a UCITS vehicle is now regarded as a suitable product for alternative strategies. It focuses on the reasons behind the trend, the particular characteristics of the UCITS brand that make it attractive for the alternative strategy managers and specifically the need to put in place the risk management process for UCITS that use derivatives. The formalisation of this process is likely to be a new requirement for these managers.

Investor demand

The launch of alternative strategy UCITS funds has been driven by investor demand for regulated product. The imposition of redemption gates, lock-in periods and the suspension in dealings in unregulated funds during the recent liquidity crisis - often without any advance notice to shareholders - meant that investors were unable to realise their investments and then found that they were unable to obtain any meaningful information about a fund's strategy or holdings. As a response to this frustration investors are now looking to invest in products with greater liquidity and improved transparency and which adhere to corporate governance practices which the unregulated product appears not to provide.

Promoters' interests

From the promoters' perspective, a UCITS fund is attractive for a variety of different reasons. As a consequence of the UCITS III changes and the widening of the range of eligible investments it is now possible to replicate alternative strategies within the UCITS framework. Alternative managers are seeking to access a wider investment community as a consequence of the loss of assets under management generally in recent times and the UCITS, as an internationally recognised brand comprising approximately 70% of all EU investment funds, provides a new and significant opportunity for growth for these managers. Also, the current uncertainty surrounding the scope of the Alternative

This document contains a general summary of developments and is not a complete or definitive statement of the law. Specific legal advice should be obtained where appropriate.

Investment Fund Managers Directive means that until such time as the Directive is finalised UCITS (which are outside the scope of the Directive) provide a tried and tested alternative for those wishing to create new product.

Advantages of the structure of a UCITS

The UCITS structure provides certain key elements of protection attractive to all investors, whether institutional or retail.

There must be at least fortnightly dealing in a UCITS fund. Many UCITS provide daily or weekly dealing providing investors with a ready opportunity to realise their investment.

A UCITS fund must appoint a custodian whose duties and responsibilities are twofold - the safekeeping of assets and the supervision of those charged with administering the fund. The Madoff fraud has focused attention on the benefits of the custodial function. The assets of a fund (other than cash and derivative positions) are held by the custodian separate from its own assets, thereby avoiding custodian counterparty risk. In the cases of certain unregulated funds, there is no requirement to appoint a custodian to safekeep the fund's assets.

The UCITS vehicle offers greater transparency for investors in a number of ways. The price of a UCITS must be published as frequently as the fund deals. Shareholders are entitled to receive annual and semi-annual reports which detail, among other things, the significant portfolio holdings (albeit on an historic basis), the investment risks, the conflicts of interest, fees, the size of the fund and significant events affecting the fund. In addition, shareholders may on request obtain access to the risk management statement which is required to be prepared annually on the use of financial derivative instruments and may obtain additional information on the use of derivatives on request.

Also, the UCITS regulatory framework provides certainty with regard to the way in which a UCITS fund is managed. Investment restrictions dealing with, for example, the spreading of investment risk, issuer concentration limits, leverage and limitations on borrowing are all set by EU legislation. These restrictions are then monitored by the fund's custodian. The fund is also responsible for putting in place a risk management process in relation to its use of financial derivative instruments and a business plan dealing with corporate governance standards imposed in certain key areas of management of the fund itself.

Distribution opportunities

The passport available for a UCITS fund allows it to be marketed publicly in the EU member states (and many other non-EU member states) following a filing process. Such registration then provides access to a far greater universe of potential investors such as individuals, pension

funds, insurance companies, private banks, private wealth managers and other funds. The passport process is also relatively straightforward and similar requirements apply across most countries compared to the disparate private placement regime which varies considerably between jurisdictions. UCITS have also been registered for public sale in over 60 jurisdictions including Switzerland and Hong Kong and throughout Asia and Latin America.

Eligible investments

The list of eligible investments for a UCITS fund is wide-ranging. It includes:

- » transferable securities
- » financial derivative instruments
- » deposits with credit institutions
- » money market instruments
- » other funds

There are, however, additional criteria relating to liquidity and valuation which need to be met in the case of many of these investments so as to ensure that the UCITS is sufficiently liquid to meet redemption requests. Although listed securities will be presumed to be liquid there are circumstances in which the liquidity risk will need to be assessed. These rules need to be considered on a case by case basis.

Significantly, the list of eligible investments does not include direct investment in property, commodities or in private equity or hedge funds and prohibits short selling, but exposure to these may be achieved through derivatives to achieve synthetic shorting and/or the use of indices. Exchange-traded and over-the-counter derivatives can be used for investment purposes as well as for efficient portfolio management. The underlying must consist of one or more of the eligible investment (such as transferable securities, money market instruments or collective investment schemes), must not expose the UCITS to risks that would not otherwise assume (such as investment in property or commodities) and it must not cause the UCITS to diverge from its investment objectives.

Where a UCITS uses over-the-counter derivatives, there are rules that apply relating to the type of counterparty and the percentage of the fund's value that can be placed with the counterparty. In addition, there is position exposure limit where the combination of all the positions with the particular counterparty in terms of counterparty derivatives exposure and all other eligible investments relating to that counterparty cannot exceed 20%. However, the Financial Regulator acknowledges that cover can be put in place in order to reduce the risk of exposure with a counterparty by the fund holding certain forms of collateral in order to mitigate the risk of loss to the fund as a result of the counterparty failure.

Alternative strategies

The range of alternative strategies possible within the UCITS framework include:

- » long/short equity
- » convertible bond
- » commodity index fund
- » multi strategy
- » fund of UCITS hedge fund
- » exchange-traded funds
- » long/short credit
- » absolute return
- » managed futures
- » event driven
- » structured/guaranteed products

Many alternative strategy UCITS fund track the performance of an index and the UCITS III regime provided greater flexibility for these funds allowing diversification of up to 20% per issuer (rather than the usual 10%) and 35% in exceptional circumstances. An index must be sufficiently diversified, constitute an adequate benchmark for the market to which it refers, be published in an appropriate manner and be independently managed from the management of the UCITS. If a particular index can meet the 5/10/40 diversification rules that apply to a UCITS and a UCITS could invest directly in the constituents of the index, the index does not need to be approved by the Financial Regulator. The Financial Regulator approves other indices on a case by case basis and has approved a wide range of indices, including fund of hedge fund indices and commodities indices. The Financial Regulator expects an index to be constructed on pre-determined rules and objective criteria and it must not provide for payments to the index provider from the index constituents.

Flexibility

A UCITS can include many of the attributes that are used in other types of funds. Performance fees, calculated by reference to a benchmark or net new highs, can be applied in addition to management fees. A UCITS can have any number of share classes with differing management fees, minimum holding requirements, hedging strategies and distribution policies. Anti-dilution levies can also be imposed on the entry and exit from the fund.

Promoter approval

Any entity wishing to establish a UCITS fund must be approved to act as the promoter by the Financial Regulator. This requires the completion of a prescribed form with details of the promoter's regulatory status, ownership, financial situation and experience of managing collective

investment schemes. The promoter must have a minimum capital of €635,000 and the proposed administrator and custodian in Ireland will need to confirm separately to the Financial Regulator that it has carried out due diligence on the promoter.

Timing

Once the promoter is approved by the Financial Regulator, the approval process for the establishment of a UCITS fund involves typically three drafts of the fund documentation being submitted to the Financial Regulator for review. The approval process should take approximately 6 weeks from the date of submission of the documents for the authorisation to issue.

Risk management process

A risk management plan must be put in place for all UCITS funds using derivatives and the need for a formal risk process that is reviewed by the Financial Regulator and reported on a yearly basis is not a requirement that the hedge fund managers would be used to. The purpose of this plan is to ensure that the risks relating to these instruments are identified, measured, managed and monitored. The risk management plan sets out the controls, systems and personnel involved in the monitoring and management of these risks. A fund must classify itself as either being "sophisticated" or "non-sophisticated" for the purposes of addressing risk relating to the use of derivatives.

Typically, a non sophisticated fund will choose to value the fund's exposure to derivatives using the commitment approach. This measures the incremental exposure and leverage through the use of derivative instruments by converting the derivative instrument position to the equivalent underlying asset position. In this case, the total risk exposure (namely the net asset value and its risk exposure) of the fund must not exceed 200% of the net asset value i.e. 1 to 1 leverage. The UCITS commitment approach is typically used for those funds using straightforward derivative instruments.

The alternative approach adopted by the funds using derivatives extensively is the value at risk model. Arguably the value at risk methodology provides a more precise measure of leverage and market risk. With the value at risk methodology the probability of the risk of loss is measured rather than explicit leverage parameters set as in the commitment approach. It calculates the worst expected loss at a given confidence level (or probability) over a specific period of time in normal market conditions. The value at risk methodology can be relative – measured using a benchmark portfolio of assets which does not use a financial derivative instruments or absolute. In the case of relative value at risk the risk must not be greater than twice the value at risk of the benchmark portfolio.

The absolute value at risk methodology limits the percentage value at risk relative to the fund's net asset value and must not exceed 20% of the fund's net asset value. The value at risk methodology uses stress testing and back testing to ensure that the volatility of the fund is measured in a way that is not addressed in the commitment approach.

Conclusion

The range of funds now being established as UCITS illustrates the flexibility of the UCITS framework and the value of the UCITS brand. There are detailed and complex

rules that need to be considered when formulating the UCITS policy and fund managers need to be aware of the additional reporting and governance requirements required when establishing a UCITS.

More detailed information on the establishment of UCITS funds and the use of indices can be obtained in our client briefings and on our website or by contacting any one of the partners listed below.

Contacts



Carl O'Sullivan Partner
+353 (0)1 618 0525
carl.osullivan@arthurcox.com



Kevin Murphy Partner
+353 (0)1 618 0515
kevin.murphy@arthurcox.com



Sarah Cunniff Partner
+353 (0)1 618 0508
sarah.cunniff@arthurcox.com

Dublin

Earlsfort Centre, Earlsfort Terrace, Dublin 2, Ireland
tel: +353 (0)1 618 0000 | fax: +353 (0)1 618 0618
email: dublin@arthurcox.com

London

12 Gough Square, London EC4A 3DW, England
tel: +44 (0)20 7832 0200 | fax: +44 (0)20 7832 0201
email: london@arthurcox.com

Belfast

Capital House, 3 Upper Queen Street, Belfast BT1 6PU, Northern Ireland
tel: +44 (0)28 9023 0007 | fax: +44 (0)28 9023 3464
email: belfast@arthurcox.com

New York

300 Park Avenue, 17th Floor, New York NY 10022, USA
tel: +1 (1)212 705 4288 | fax: +1 (1)212 572 6499
email: newyork@arthurcox.com