

HEDGE FUND MANAGER **HFM** WEEK **SPECIAL REPORT**

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UCITS III 2009

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UCITS funds set to grow in 2010

As investor priorities continue to change, so too does the structure of the hedge fund industry. Over the past two years, poor transparency, record losses and the widespread implementation of redemption gates and suspensions in a bid to stem mass fund withdrawals has meant that investor confidence in the industry has been severely shaken.

Today, as money slowly begins to flow back into the hedge fund market, the emphasis is less on performance and more on liquidity. The sting of the recent financial crisis is still being keenly felt by investors around the world and regulated funds that offer better liquidity have never been so attractive.

It comes as no surprise, then, that the popularity of UCITS-compliant hedge funds is continuing to soar. With investor protection already a main aim of the UCITS structure, the implementation of UCITS III in 2001 also allowed for more flexibility in terms of fund strategies. And, with investors becoming increasingly demanding in terms of the funds that they are willing to invest in, a rising number of hedge funds managers are opting to move into the UCITS space.

What's more, with the prospect of the potential impact of the implementation of the EC Alternative Investment Fund Managers (AIFM) draft Directive still looming on the horizon, it seems likely that ever-more hedge fund managers will choose to reap the benefits of UCITS funds going forward.

Those managers who do opt to combine the UCITS structure with hedge fund strategies should also ensure that they are fully aware of the implications of the proposed implementation of the next stage of UCITS: UCITS IV.

Designed to enhance the UCITS brand and make cross-border fund mergers and distribution more efficient, UCITS IV is set to be implemented in 2011 and it is likely to lead to yet a further increase in interest from hedge fund managers considering moving into the UCITS space.

There can be no doubt that the world of hedge funds has changed and these changes look set to be long term. If hedge fund managers are to be successful in the future, they will need to adapt to said changes and UCITS funds certainly appear to form a large part of doing so. There may be challenges involved in combining absolute return strategies with UCITS regulation but the potential benefits in terms of attracting investors make facing these challenges a more than worthwhile pursuit.

Shannon Hawthorne
 Report editor

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James Orme-Smith of **Deutsche Bank** believes that UCITS funds with their focus on liquidity and regulation can attract investors back to the hedge fund arena

UCITS funds are the way forward



James Orme-Smith is a director in Global Prime Finance within **Deutsche Bank's** Global Markets Division, which comprises traditional Prime Brokerage, Securities Lending and Synthetic Equity Finance. He is primarily responsible for Prime Finance sales into hedge fund strategies within the UCITS regulatory framework as well as synthetic equity flow product.

The events of the past 18 months have undoubtedly had a dramatic impact on the structure of the hedge fund industry. The discovery of Bernie Madoff's \$50bn Ponzi scheme in December 2008 has contributed to a substantial increase in focus on regulation, transparency and regular reporting requirements, while the recent financial crisis, which led a number of hedge fund to implement redemptions gates and suspensions in a bid to stem capital outflows, has resulted in a far greater investor focus on liquidity.

The desire and determination to meet these changing investor expectations has led a growing number of fund managers to look to UCITS-compliant hedge fund structures as a way of attracting investors who may have otherwise been wary about investing in hedge funds, and with the newfound emphasis on fund regulation and liquidity set to continue into the foreseeable future, and an ever-growing number of hedge fund managers entering the UCITS space in a bid to gain access to a wider investor base, the potential for the growth of these funds is huge.

Drawing upon his own substantial experience and knowledge of the topic, James Orme-Smith of Deutsche Bank, which will be releasing a white paper on UCITS funds in the near future, talks to *HFMWeek* about the benefits of the UCITS structure and the potential for growth in the future.

HFMWeek (HFM): How would you describe the current state of both the hedge fund and UCITS markets?

James Orme-Smith (JO-S): Both the hedge fund and UCITS markets have changed markedly over the past 18 months, specifically since late Q4 2008. For alternative strategies within UCITS, this has been as a result of the woes of the hedge fund industry and those underlying single managers, particularly with reference to investor transparency and investor liquidity. The hedge fund investor is nowadays more focused than ever on risk control, timely access to their assets and portfolio transparency against the backdrop of very strong performance

across almost all hedge fund strategies. In summary, we think both the hedge fund and the UCITS markets are in good health but believe the latter is showing stronger signs of growth at this present time which we expect to continue.

HFM: What is the process of setting up a UCITS fund? What are the main challenges and how might these best be faced?

JO-S: Once the UCITS structure has been approved by the relevant regulator, this umbrella can quickly and efficiently add on a single or multiple new sub funds, each containing different strategies and features. Once approved in a home state, a UCITS fund can then "passport" into any member state and be sold on an unrestricted basis to investors in that country, subject to local marketing rules. This opens a potential market of over 500 million investors globally and, in particular, allows access to markets which have traditionally restricted the sale of non-domestic funds. One of the main challenges of setting up a hedge fund is deciding the jurisdiction in which to locate the fund, the main choices generally being the UK, Ireland, Luxembourg and France. Also, it does take longer, and is more expensive, to launch a UCITS fund than a traditional offshore unregulated vehicle.

HFM: What are the main differences between a hedge fund and a UCITS fund?

JO-S: The first main difference is that, unlike a traditional hedge fund, there are certain control measures limiting what a UCITS fund may invest in. Eligible assets within a UCITS structure can be summarised as follows: transferable securities, money market instruments, units of UCITS, deposits and financial derivative instruments. Secondly, there are a number of limits for investments, operating on the principle of risk spreading, such as the maximum exposure to a single counterparty. In certain 'unsophisticated' funds, gross exposure is limited to two times NAV, whereas in 'sophisticated' funds some flexibility may be achieved. The latter is recommended to use Value-at-Risk (VaR) techniques to monitor risk, whereas the former may use accepted market-risk monitoring tools

“The desire and determination to meet changing investor expectations has led a growing number of fund managers to look to UCITS-compliant hedge fund structures”



such as the commitment approach. There are also liquidity constraints in that investors can only be offered daily, weekly or fortnightly liquidity which does hamper more illiquid strategies – by comparison most hedge funds will deal monthly, quarterly or even longer.

HFM: What kind of strategies would be suitable for a UCITS-compliant hedge fund?

JO-S: There are numerous strategies which are suitable for a UCITS-compliant hedge fund. Mainly, these are: equity long/short, market neutral, CB arbitrage, emerging markets, macro, managed futures and event-driven.

HFM: What are the advantages of UCITS-compliant hedge funds in terms of distribution?

JO-S: UCITS products are arguably the most broadly saleable fund product in the world and when UCITS IV is implemented in mid-2011, distribution will become even easier. Enhancements under UCITS IV will include creation of Master-Feeder funds to achieve cross-border asset pooling, a framework for cross-border fund mergers, a management company passport and a more simple

disclosure document to replace the simplified prospectus. Essentially, a UCITS-compliant fund is theoretically saleable globally, except to onshore North American investors.

HFM: Looking forward, what do you expect from UCITS-compliant hedge funds in terms of growth in the future?

JO-S: As a component of a total asset number under UCITS of about €5tn, UCITS-compliant hedge funds within this number are in the tens of billions. However, we expect very strong growth in the short to medium term as underlying investors search for alpha either as a replacement for traditional hedge funds or as a replacement for traditional long-only funds. We do not expect alternatives within UCITS to replace the traditional hedge fund investor base; rather, we expect growth in overall assets in these types of strategies from a broader and more diverse investor base.

HFM: Which markets do you think hold the most potential for these funds?

JO-S: We expect very strong growth from continental Europe and Asia. ■

Barry McGrath and **Elaine Keane** of **Maples and Calder**, Dublin, discuss the advantages that UCITS funds can provide hedge fund investors

The growing appeal of UCITS III



Barry McGrath is head of the Investment Funds Group in **Maples'** Dublin office. He is one of Ireland's top investment funds lawyers and specialises in financial services law. Barry advises on the promotion and operation of all types of mutual funds. He also advises many of the leading service-providers to funds, including global fund administrators, custodians and investment managers.



Elaine Keane is a senior associate in the Investment Funds Group in **Maples'** Dublin office. Elaine advises on the establishment, authorisation, operation and maintenance of Irish-regulated UCITS funds and open and closed-ended non-UCITS funds. Elaine also advises service providers to such funds, including global administrators, custodians and investment managers.

As the global financial storm appears to ease, investors and fund managers alike are taking stock of the new realities and priorities of the funds industry. Investor appetite for highly leveraged, illiquid, aggressive trading strategies has reduced and many are looking to more regulated products. Nowhere is this better reflected than in the booming popularity of UCITS.

Since the global financial crisis, the advantages of UCITS have come into even sharper focus. In the wake of the liquidity squeeze, where many investors felt the pinch of redemption gates, lock-up periods, lengthy notice periods and even suspensions, UCITS come with the guarantee of at least fortnightly liquidity. The UCITS requirements for robust, stress-tested risk management procedures; diversified investments; limitations on the use of leverage; and regulated service providers are also attractive propositions for investors.

The result has been a surge of interest in UCITS funds, with total UCITS assets under management now exceeding €6.4tn (£5.8tn). Fund managers have been enticed to the UCITS space by the unparalleled market access available through the UCITS passport. A UCITS authorised in one member state can easily and swiftly 'passport' that approval for marketing to the retail public in other member states, creating a genuine pan-European investor market. In recent years, the UCITS brand has also spread its wings beyond the EU and become accepted for retail distribution in numerous developing economies across Asia, Africa, South and Central America, to the point that it is now a truly global product offered in over 140 countries worldwide.

UCITS funds and hedge fund strategies

During the course of the past six months, the Irish funds industry has advised on and brought to market a number of new exchange-traded funds (ETFs) that bear the UCITS stamp of approval. This reflects the global trend towards ETF establishment and investment, with asset managers and investment banks capitalising on the inherent advantages presented by ETFs over traditional mutual funds, including lower costs, improved transparency and increased liquidity and diversification. The obvious benefits associated with ETFs have been directly reflected by the net inflows

into ETFs during this period, while other types of funds, particularly traditional mutual funds, have seen large-scale outflows. A recent development in the ETF space is the creation of ETFs which reference indices comprised of actual hedge funds. We have also seen an increase in interest in the establishment of long/short ETFs and carbon-focused ETFs. This expansion into new asset classes should open the market up to a new range of ETF product, which would appeal to an investor who wants something more than a "vanilla" index tracking investment, but still wants the benefit of liquidity.

A frequently voiced concern by hedge fund managers in respect of the UCITS wrapper is the constraints surrounding what constitutes an eligible asset for a UCITS fund. One technique used to address this issue is investing in exchange-traded certificates (ETCs). ETCs can be designed to reflect the performance of commodity indices or individual commodities (such as precious metals), hedge funds and any other technically "ineligible" asset classes and where the security or certificate provides an unleveraged exposure to the "ineligible asset", the ETC is considered to be an "eligible asset" under the UCITS Directive and can, therefore, be sold to UCITS funds. The certificate structure enables these debt instruments to match the daily trading flexibility of fund products through accessing platforms like Xetra or SETS. As long as the security or certificate provides an unleveraged exposure to the underlying asset, there is no apparent limitation on the type of asset class it can reference, which means that UCITS fund can legitimately invest in asset classes that were previously reserved for hedge fund products.

In addition, US managers, fund of hedge fund managers and the investment banks continue to develop UCITS products which reference hedge fund indices, bespoke and strategy-based indices and complex trading strategies (such as managed futures strategies), which have until now been the domain of hedge funds. The utilisation of indices and hedge fund strategies, and the myriad opportunities they present, has led to a new class of product which provides investors with access to asset classes as diverse and sophisticated as life settlements, credit and commodities with risk/reward appropriate for retail investors. Moreover, they combine robust and consistent levels of investor protection and regulatory compliance by

“Ireland, already the world’s largest domicile for hedge fund administration, is home to over 4,000 UCITS funds, totalling €540bn of assets under management,”



virtue of their status as UCITS funds.

We are now receiving enquiries from traditional fund of hedge fund managers considering the establishment of fund of UCITS hedge funds which will only increase this number of hedge fund type UCITS established over the coming months.

Ireland as a jurisdiction

Ireland, already the world’s largest domicile for hedge fund administration, is home to over 4,000 UCITS funds, totalling €540bn of assets under management. With over 9,000 professionals employed by the funds sector in Ireland, and over 20 years of experience as a leading international financial centre, the country boasts unrivalled European expertise in fund administration, custody, audit, tax and legal services.

The Financial Regulator in Ireland has also been praised for its strong regulation balanced with a pro-business, pragmatic approach. Coupled with the Financial Regulator’s constructive and co-operative relationship with the Irish Funds Industry Association (the industry’s representative body), this has created a regulatory environment which is pre-eminent in the EU, both in facilitating speed of product launches to market and exploring product innovation. Recent initiatives include an arrangement with China whereby Irish-domiciled UCITS can now be sold to the vast and largely untapped Chinese market.

Allied to the favourable tax regime, this combination of industry expertise and a reputation as a well-regulated jurisdiction monitored by a responsive and pro-active regulator has seen Ireland recently steal a march on its rival EU markets as the domicile of choice for UCITS structures seeking wide distribution.

Future developments

Acknowledging the significant rise of UCITS and the potential for further expansion, the EU has approved the UCITS IV Directive which is designed to iron out many of the remaining structural creases and to improve efficiencies. The Directive, due to be implemented in 2011, will allow for UCITS master/ feeder funds and cross-border mergers of UCITS for the first time. It will further streamline the bureaucracy involved in passporting a UCITS into other member states, and will simplify the fund information disclosed to investors. From a cost perspective, the introduction of a workable management company passport will allow for the cross-border management of UCITS funds and in turn allow an even more efficient pan-European distribution. So while UCITS IV will not broaden the product scope, it should render the operation of the current UCITS regime more efficient and therefore more appealing.

While there has been a significant increase in interest among hedge fund managers in the UCITS product, offshore jurisdictions such as the Cayman Islands remain the jurisdiction of choice for the establishment of hedge funds. The UCITS regime does, however, appear to be well positioned for further significant expansion. The distribution network available through the UCITS passport is attractive to asset managers seeking to extend their product range and diversify their client base. The heightened liquidity, transparency, risk management and regulatory scrutiny of the UCITS may appeal to investors while also meeting their demands for consistent returns, risk-adjusted absolute returns and competitive fee structures. ■

Paul Nunan of **Capita Financial Group** tells *HFMWeek* how investors are increasingly becoming more interested in the regulation and protection that UCITS funds can provide

A popular choice



Paul Nunan is managing director of the Dublin jurisdiction of **Capita Financial Group** and joined the company in March 2006. Prior to Capita, Nunan worked for Bisys Hedge Fund Administration. He has over 11 years' experience in funds administration.

While recent market performance suggests that the dark days of the financial crisis may be slowly moving behind us, for investors who were faced with poor transparency, redemption gates and suspensions and disappointing returns at the height of the downturn, the need for an increased focus on regulation and liquidity is a lesson that will not soon be forgotten.

Add to this the prospect of the potential implications of the EU AIFM Directive (still currently in draft format) and it is perhaps unsurprising that the hedge fund industry is experiencing an increasing number of managers expressing an interest in moving into the UCITS space.

Drawing upon a wealth of experience in both UCITS and hedge funds, Paul Nunan, managing director of Capita Financial Group Ireland speaks to *HFMWeek* about the growing interest in UCITS funds and what changes to the UCITS structure will mean for the hedge fund industry in the future.

HFMWeek (HFM): What, in your opinion, are the main advantages of UCITS funds?

Paul Nunan (PN): One key advantage of UCITS funds is the brand appeal and the comfort that they give to investors. UCITS are set up and regulated with investor protection as a prime concern. Controls are put in place that specify the asset classes UCITS may gain exposure to and also outline the level of risk-spreading and diversification limits that must be followed.

At the same time, (as a result of UCITS III introduced in 2001), flexibility in relation to the ability to use a certain amount of leverage and use synthetic shorting (subject to certain risk management limits and a risk management framework) has permitted UCITS managers to use strategies that would have been previously seen primarily in hedge funds.

It is this balance that has been found by the regulators between flexibility and investor protection that has led in my view to the growing popularity of UCITS funds. Latest figures show as much as \$6tn in UCITS funds as at the end of March 2009 (EFAMA).

UCITS also have the ability to be "passport" throughout the EU. This means that UCITS au-

thorised in Ireland can be sold in any other of the 27 EU member states without any requirement for further regulatory authorisation. The UCITS brand has also gained popularity outside of the EU and they are becoming more and more popular in many Asian and Latin American countries. In Capita, we have seen and worked with several US asset managers who have set up UCITS funds in the past 12 months and we see this trend continuing. UCITS has moved beyond just a European retail product and is now a global brand.

The fact that UCITS funds are required to offer at least fortnightly liquidity is also a major benefit, particularly in the current environment where liquidity is high upon investors' list of concerns.

HFM: To what extent have the events of the past 24 months contributed to the growing popularity of UCITS funds?

PN: It has certainly been a challenging time for the industry. While capital has started to return to the market over the past few months, it is still not to the same extent as it was prior to the economic downturn. Today, investors have a decidedly bigger influence in relation to how funds are set up and structured and, again, liquidity is a prime example of this as more and more managers are by necessity being forced to change the structure of their fund and move to provide daily liquidity to their investors.

Indeed, due to investor requests, we have seen clients change from weekly to daily liquidity within only a few months after launching the fund. This increase in the demand for daily liquidity, and also for more regulated fund products, has meant that the UCITS brand is indeed becoming increasingly popular.

HFM: What are the key differences between UCITS III and UCITS IV?

PN: The main differences are as follows:

- 1) The notification procedure has been simplified and accelerated, which hopefully will reduce administration requirements;
- 2) The procedure for UCITS mergers have been established to facilitate cross-border merging;
- 3) Master-Feeder structures can now be created;
- 4) A new standardised Key Investor Information (KII) document has been introduced; and
- 5) The management company passport will be implemented which will mean that companies can manage funds cross border.

“One key advantage of UCITS funds is the brand appeal and the comfort that they give to investors. UCITS are set-up and regulated with investor protection as a prime concern,”



HFM: How do you anticipate that these changes will affect service providers, and in particular, fund administrators?

PN: The increase in cross-border servicing will certainly increase the complexity involved – however, speaking from an Irish perspective, most Dublin-based administration providers already have expertise and experience in cross-border servicing, so it should not come as a surprise to many of them.

Ireland has built up significant experience in alternative funds and this experience greatly assisted in the move to UCITS III, particularly around the increased flexibility permitted for investment – I expect that we will experience something similar in relation to UCITS IV.

HFM: How will investors be impacted by the implementation of UCITS IV?

PN: Hopefully, it will have a positive impact. The whole purpose of UCITS IV is to increase competition and efficiency in the funds markets as well as increasing the distribution of UCITS funds – this will not only give investors a greater range of funds to choose from, but also hopefully reduce the actual cost. The mergers of funds – if there are significant fund mergers across Europe – will hopefully result in larger funds which will then drive down costs in relation to funds and this cost-saving should, in theory, be passed on to investors.

HFM: To what extent will UCITS IV be affected by the proposed EU AIFM Directive?

PN: It may end up driving more and more funds towards a UCITS platform; funds which may not have otherwise taken UCITS as their initial structure. However, it is still too early to know definitively how the draft Directive will actually impact upon UCITS – there is still a lot of discussion on the horizon with regard to the Directive so for now I think that the industry is watching developments very closely.

HFMWeek: Do you think the shift toward UCITS is a long-term shift?

PN: The recent shift towards UCITS is certainly in part a reaction to the events of the past two years. I do think, however, that the growth of UCITS funds will continue. There is a space for both UCITS and non-UCITS funds to sit comfortably together – there is a balance to be found and I don't think we're quite there yet. It is important that service providers, especially administrators, are able to service both types of funds for their clients.

HFM: Looking forward, how do you expect that the UCITS structure will evolve in the future and what impact do you think this will have on the hedge fund industry?

PN: The UCITS structure will continue to develop and mature and, going forward, I expect that UCITS will form part of more and more investment managers' product offering, in particular for the medium to large investment managers. We have seen this to be the case with an increasing number of hedge fund managers over the past year or so. As the structure continues to grow and evolve, the flexibility now permitted in regards to investment restriction criteria means that some hedge fund strategies can fit within a UCITS structure with minimal adjustment – UCITS will increasingly be seen as a potential tool for hedge fund managers to use.

That said, there are still some local requirements in various jurisdictions that have remained in place and this continues to add operational difficulties and costs to UCITS structures. Another issue that needs to be addressed at some point is the taxation implications of the changes.

UCITS has evolved at a controlled and steady pace and this needs to continue in the future.

In order to offer greater choice to their clients and help retain capital within their organisation, UCITS should be seen by hedge fund managers as a potential part of their overall product offering. ■

Padraig Kenny of **RBC Dexia Investor Services** discusses the opportunities available to alternative investment managers in UCITS structures, post the recent economic crisis

Alternative options



Padraig Kenny is managing director, **RBC Dexia Investor Services Ireland** and was appointed to the post on 6 October 2008. A law graduate of UCD, a solicitor and accredited by the UK SFA, he has been a financial services industry professional since 1984.

While investment market conditions continue to improve, the past 18 months have seen a seismic shift in attitudes to risk and regulation throughout the hedge fund industry. The financial crisis which struck in late 2008 triggered a major period of introspection for politicians, regulatory authorities and investment professionals which is yet to play out fully in terms of new regulation and financial oversight.

For alternative investment managers, the events of 2008 were particularly unfortunate. The run up to the financial crisis had seen a sustained surge in interest in alternative investments such as hedge funds, private equity and real estate and a growing convergence between alternatives and traditional asset classes. Alternatives looked fully poised to enter the mainstream.

The financial crisis put an immediate check on this growth, as redemptions soared and episodes such as the Madoff affair shed unfavourable new light on market regulation and the hedge fund industry in particular.

Maximising opportunities

Despite these events, the alternative investment industry is now determined to regroup, tackle the immediate challenges ahead and rekindle business growth. Looking beyond recent setbacks it is clear there is still strong investor appetite for alternative investments. Institutions such as pension funds continue to seek ways of generating index-beating returns – albeit with a heightened focus on risk management. Renewed interest in the retail hedge fund sector – notably in the UK – is a sign that the market still holds broad appeal.

This current climate presents a number of potential opportunities for alternative investment managers able to provide high yielding and well-regulated products that are subject to robust regulatory oversight.

From a jurisdictional perspective the market also creates significant opportunities for well-regulated and established fund centres, such as Ireland, which have a strong track record and the capability

to support both traditional fund structures such as UCITS and alternative fund structures. Ireland in particular offers specific advantages for promoters seeking to utilise alternative investment strategies within the UCITS wrapper. The market is a well-established UCITS domicile and administration centre. It also services over 40% of global hedge fund assets.

The convergence of alternative and mainstream investments has been reflected in Ireland via the growing use of alternative strategies and instruments within UCITS III-compliant funds.

While UCITS products were originally designed as ‘plain vanilla’ retail fund structures, the implementation of UCITS III in 2003 significantly expanded the range of investment structures which could be used within the UCITS wrapper. For the first time financial derivative instruments could be used within UCITS products subject to certain limits and tight regulation. Importantly, short exposure through the use of derivatives was also permitted, allowing for the creation of ‘sophisticated’ UCITS funds.

Sample instruments that can be used in UCITS III structures include total return swaps, futures and options, hedge fund indices, repos and other derivatives used in efficient portfolio management and, subject to criteria, OTC derivatives.

While many alternative investment managers initially approached UCITS III with caution, a growing number have since realised the benefits of placing their funds within a well-regulated structure which can be easily distributed cross-border and which enjoys a strong international brand reputation. High profile non-regulated hedge fund failures and regulatory lapses during the recent financial crisis have prompted a growing number of managers to reassess the potential UCITS III offers amid calls for more robust and transparent alternative investment structures.

At RBC Dexia, we have seen significant and growing demand from alternative investment managers to reconfigure their funds within a UCITS framework that offers better protection and a new level of transparency to end investors. Market events have, perhaps unsurprisingly, encouraged

“The alternative investment industry is now determined to regroup, tackle the immediate challenges ahead and rekindle business growth”



many investors to take a closer look at the instruments and funds they are actually investing in. In turn, this trend has increased more general calls for greater disclosure and transparency.

Looking ahead, other developing trends may hasten moves to convert existing alternative investment funds into sophisticated UCITS products. European Union proposals to regulate alternative investment managers under the controversial AIFM Directive may act as an added incentive to utilise well-regulated and reputationally strong UCITS structures.

While there are clearly defined limits to the type of investment structures and practises that can be applied within UCITS funds, there is scope to engage in dialogue with local regulators and explore conversion options.

In Ireland we have a very robust and responsive regulator in the Irish Financial Services Regulatory Authority (IFSRA) which has taken the approach of engaging closely with fund promoters interested in converting their alternative structures into UCITS funds. The regulator is keen to understand the strategies and needs of even the most complex asset management operations. Its responsiveness is also a major plus and the speed of execution when decisions are made to convert funds to UCITS III style structures is impressive.

There are many factors to consider when setting up sophisticated UCITS structures. Investment restrictions and risk management rules must be adhered to absolutely and the complexity of in-

struments used can create operational challenges in areas such as fund valuation and administration for companies used to dealing with more conventional UCITS structures.

In this regard, asset managers must ensure they have service providers and ancillary support partners they can rely on. As with other key fund centres such as Luxembourg, Ireland is extremely well blessed with a wide number of premier service providers, specialist law and audit firms and consultancies and boasts a national stock exchange which is well versed in fund listings.

Embracing UCITS structures

Looking ahead we anticipate that a growing number of alternative asset managers will seek to adapt their offerings to utilise UCITS structures. The benefits, in terms of regulation and ease of distribution, are clear. The anticipated implementation of UCITS IV in 2011 may also draw increasing interest from alternative asset managers attracted by the reputation and flexibility of UCITS structures.

The alternative investment market may have suffered a number of setbacks over the past year, but its potential to generate returns and attract investors remains intact. UCITS III structures, domiciled and administered in well-regulated centres such as Ireland and Luxembourg, could hold significant advantages for the market, which look set to be explored more widely and fully in the months ahead. ■

Christian Szylar of **Kinetic Partners** outlines how UCITS regulatory structures will provide the hedge fund industry with much-needed transparency and security

Raising the bar with UCITS III



Christian Szylar is head of risk monitoring solutions at **Kinetic Partners** and reports on areas such as investment restrictions, liquidity, counterparty risk and VAR. Christian holds a PhD in Management Science and a Masters degree in Banking Law.

The hedge fund industry has faced an unprecedented age of uncertainty in the 18 months following the global economic downturn and high-profile scandals such as the Bernie Madoff \$50bn Ponzi scheme. The dramatic decrease in investor confidence which followed led to a heightened demand for transparency, which the industry has sought to answer through various measures including the proposed EU Alternative Investment Fund Managers (AIFM) Directive and new UCITS regulatory structures. A move towards more stringent regulation is inevitable, with UCITS IV already in the pipeline for 2011.

"The two key features of UCITS funds are the security and transparency of the product," explains Christian Szylar, head of risk monitoring solutions at Kinetic Partners. "Furthermore, it is easy to distribute them all over Europe as well as them being attractive to countries outside the EU, such as in Asia and South America. The UCITS brand provides great reassurance for investors, both retail and institutional."

Increasing interest in UCITS funds

Interest in UCITS funds has grown over the past 18 months, partly due to the increasing interest from investment banks. "The big change for UCITS III is the usage of the financial derivative," affirms Szylar. "Initially we thought that the traditional manager would use financial derivatives, but it was not really the case at the beginning, mainly because of lack of knowledge about these complex derivatives."

"Once the investment banks began to show more interest in UCITS structures, they started to make some interesting UCITS products and used financial derivatives for investment purposes," he continues. "From this progression, we now see asset managers of investment banks or hedge fund managers trying to replicate typical hedge fund investment strategies under UCITS III."

According to Szylar, despite creating bad publicity for the hedge fund industry, scandals such as that of Madoff have had a positive long-term effect. "No regime is perfect by nature, and these issues have raised the discussion at EU level about the re-

sponsibilities of the global custodian, for example," he asserts. "In light of the market turmoil and all of the losses that we have suffered, I believe that UCITS III and the upcoming UCITS IV will bring more transparency and security for underlying investors than any other regime would do. The financial crisis has compromised investors' trust that hedge fund products are regulated and safe, but so much has been done now to correct this and bring sustainability to the UCITS brand."

Due to come into force in July 2011, UCITS IV will give investors even more clarity than UCITS III in line with the present emphasis on transparency and disclosure. "The big change with regard to UCITS IV will be the key investors' documentation, which will have to be released now" explains Szylar. "The simplified prospectus was released with UCITS III, but it was still too long and did not contain the right information. In contrast, the key investment information paper will enable investors to compare funds' performance and fees, as well as the investment objective and policy, the historical performance of the funds, the cost and most importantly, risk. UCITS IV will give more information to investors so that they can select and understand the funds in which they invest."

While service providers already play an important role in the formation of UCITS III funds, their role will change with the introduction of UCITS IV. "With all the failures we have seen, it has raised the importance of maintaining a good oversight of all the service providers and to make sure they work efficiently," asserts Szylar. "It is essential that they work in compliance with all applicable rules and regulations and so, while the duties of service providers have always been important, UCITS IV raises the bar. It is increasingly necessary that the custodian works properly, as do the fund administrators, the transfer agent and the main distributors, so the oversight of all the service providers will have to be more formalised than it was in the past."

Although the proposed EU Directive is still in its early stages, it is certain that it will have an impact on UCITS funds. "The question of what the impact will be on UCITS fund structures is still too early

“The two key features of UCITS funds are security and transparency. Furthermore, it is easy to distribute them all over Europe as well as them being attractive to countries outside the EU”



to answer, as people are now considering whether to create a fund under this new Directive or under UCITS III,” Szylar states. “The new proposed Directive has opened the debate and discussion over the best shelter for new and existing hedge funds and I expect that UCITS IV funds will increase drastically over the next year.”

Szylar warns that the transition from UCITS III to UCITS IV fund structures may prove challenging for hedge fund managers. “The fact is that the hedge fund manager is coming from a different type of investment culture and they will have to cope with the learning process,” he says. “They’re going to have to deal with different investment strategies, as there are some limitations under UCITS IV they are not used to, such as a maximum limit on Value at Risk (VaR) in the portfolio.”

“Other changes will be the subscription redemption in the funds, the valuation and whether building the legal structure of the fund is self-managed or via a management company,” he continues. “The tax and performance advantages are also an issue, as there are some fees under UCITS IV that they will not be able to claim as they used to claim under lesser-regulated hedge funds.”

As an increasing number of hedge fund managers consider moving into the UCITS space, Kinetic Partners offers a range of services to those who opt to embark on the world of UCITS. “We can help them select the right structure to build the fund, the best location between Dublin and Luxembourg, and we can help them tune their investment strategies under UCITS III or IV to meet their

requirements,” explains Szylar. “We aid them in selecting the service providers by performing due diligence and we provide them with risk solutions through the range of new risk services we offer at Kinetic Partners. These services include counterparty risk, compliance with investment limits, risk management, stress testing, back testing, liquidity risk monitoring and independent price verification. There is so much that Kinetic Partners can offer someone wishing to make a fund under UCITS.”

Providing transparency and security

While the progression from UCITS I to UCITS III took 20 years, the progression from UCITS III to UCITS IV was far quicker and Szylar believes that the changes implemented by UCITS IV will be sufficient for the industry for years to come. “We were quite lucky because within five years we had two UCITS regimes, UCITS III and UCITS IV,” affirms Szylar. “I think that the foundation built by UCITS IV will give some peace for the industry, at least within the next five years, because UCITS IV contains everything that the industry needs.”

Looking forward, Szylar predicts that UCITS funds will continue to grow in popularity for hedge fund managers. “We can already see that there are several hedge fund managers trying to replicate hedge fund strategies under UCITS IV,” he concludes. “It is a fantastic brand, which helps them to distribute the funds and get a certain international recognition. Most importantly, UCITS offers transparency and security to investors at a time when trust and confidence are paramount.” ■



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Dr Frank Chetcuti Dimech and Frank Caruana of CDF Advocates outline the reasons why Malta should be chosen as a domicile to form a UCITS fund

Malta is a leading UCITS domicile



Dr Frank Chetcuti Dimech co-founded **CDF Advocates** in 1993. His experience includes financial product development, international financial transactions, financial regulation and tax planning and has worked on behalf of banks, fund managers, investment funds and insurance companies.

Frank Caruana joined **CDF Advocates** as head of compliance in 2008. Previously he was director of the Financial Intelligence and Analysis Unit (FIAU) of the government of Malta and previously employed with a major Maltese credit institution.

Jurisdiction overview

Malta established a specific regime dealing with the authorisation of collective investment schemes and fund managers in the Investment Services Act (ISA) of 1994. The ISA paved the way for the establishment of retail funds and local fund managers. The number of funds registered in Malta increased steadily over the past few years and there are now over 400 funds with a market capitalisation nearing €10bn. Malta implemented the UCITS III regime immediately upon accession to the European Union on 1 May 2004 and therefore both UCITS and non-UCITS funds may be formed.

The choice of Maltese domicile for a UCITS is motivated by several factors, including:

- the efficiency and flexibility of the Malta Financial Services Authority (MFSA)
- quality support services
- low set-up and maintenance costs
- an exemption from income tax and capital gains tax at fund level and at non-resident investor level irrespective of the legal form adopted
- the possibility of self-managed funds
- a fund manager may be established as a Maltese company which will allow tax refunds upon distribution of dividends
- the possibility to redomicile a fund from another jurisdiction

UCITS funds

A UCITS fund is a fund that complies with specific requirements set out in the EU Undertakings in Collective Investment Transferable Securities (UCITS) Directive. A Maltese fund that complies with the provisions of the UCITS Directive can be promoted throughout the European Economic Area (EEA) (which includes the 27 member states of the EU).

The UCITS III amendments have broadened the permitted investments that a UCITS-qualifying fund may invest in. However, a UCITS investment manager must still comply with restrictions such as no more than 10% of the Net Asset Value (NAV) of the UCITS qualifying fund is invested in any single security. A UCITS-qualifying fund can invest, subject to an overarching requirement to prudently spread the fund's investment risk, solely in financial derivative instruments and such derivatives can be

used to leverage the fund by up to 100% of the fund's assets (up to two times the value of the fund, for example).

A UCITS can be established as a self-managed fund if its directors, or its individual investment committee members, are considered by the MFSA as having the expertise and experience in the investments in which the scheme will invest. A self-managed UCITS must have an initial share capital of €300,000. By using the self-managed structure, fund management can be outsourced to a fund manager licensed in another EU jurisdiction and only a local custodian bank and director performing the compliance and anti-money laundering functions would be required.

Redomiciliation of a fund to Malta (and its conversion into UCITS by complying with the Directive) is allowed from all the EU, EEA and OECD states, the Bahamas, Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, Guernsey, the Isle of Man, Jersey and Mauritius.

Fund taxation

Once a fund is licensed by the MFSA, it is granted a tax exemption for as long as it invests 85% or more of its NAV in non-Maltese assets and irrespective of the legal form of the fund – whether it is a company (private or public), trust or partnership, for example. This in itself can constitute a significant advantage over other jurisdictions which limit tax exemptions to particular corporate structures only. Furthermore Malta has no subscription tax or net asset value tax.

Taxation of fund investors

Capital gains realised by investors who are not resident in Malta are not subject to tax in Malta. Transfers of shares in a licensed fund are exempt from stamp duty. The distribution of dividends to non-residents and companies resident in Malta is not subject to withholding tax.

Fund managers

Although a self-managed UCITS with outsourcing to a non-Maltese fund manager is the more popular UCITS structure, there is an increasing interest in establishing both the UCITS and the UCITS manager in Malta due to the efficiency and flexibility of the

“Apart from treaty relief, domestic Maltese rules also allow unilateral relief and a flat-rate foreign tax credit”



MFSA, cheaper wages and office rental costs than the rest of Europe and the Maltese company taxation system. The private limited liability company is the typical structure used for a fund management company.

Presence in Malta is mandatory and no licence will be issued unless there is an active presence in Malta. Furthermore the four-eyes principle requires at least two officers of the company to be permanently present in Malta. One of these individuals would be the compliance officer and/or prevention of money laundering reporting officer. Employees who are not citizens of Malta require a work permit which is invariably granted in the case of a fund manager or fund licensed in Malta. The procedure would usually take around five days in the case of a national of an EU member state and around eight weeks in the case of non-EU nationals.

Taxation of fund managers

The headline corporate tax rate (subject to specific tax exemptions, as in the case of funds) and the highest personal tax rate are both 35%. However, one of the essential characteristics of the Maltese tax law is the full-imputation system. Through this system the tax paid at company level is regarded as a prepayment for the tax due by the shareholder upon the eventual distribution of profits. Hence after the dividends are paid out, the 35% paid by the company is given as credit for the tax due by the shareholder, whether he is resident in Malta or not.

Non-resident shareholders who receive dividends from a Maltese company may apply for a refund of six-sevenths of the 35% Malta tax paid hence resulting in an effective Malta tax rate of 5% on such income. However, distributions of profits derived from passive interest or royalties are not subject to the six-sevenths refund but are subject to a refund of five-sevenths of the tax paid by the company.

The six-sevenths and five-sevenths refunds apply

to distributions made by companies that do not claim any form of double tax relief. Dividends paid out of profits arising outside Malta (which under Maltese law are allocated to a foreign income account) in respect of which profits the distributing company has availed itself of any form of tax relief are subject to a two-thirds refund.

Malta has a substantial treaty network with 45 income tax treaties in force and another 10 treaties are in the pipeline awaiting signature, ratification or both. Malta's tax treaties are mainly with European countries although it also has treaties with countries in North America, Africa, Middle East and Asia. Malta has recently signed a tax treaty with the US. The tax treaties are largely based upon the OECD model. Moreover, dividends, interest and royalties may also benefit from the EU Parent Subsidiary Directive or the Interest and Royalties Directive.

Apart from treaty relief, domestic Maltese rules also allow unilateral relief and a flat-rate foreign tax credit. Unilateral relief provides relief from double taxation on a unilateral basis where the overseas tax is charged in a country with which Malta does not have a tax treaty. Such overseas tax is allowed as a credit against the tax chargeable in Malta on the gross amount up to the extent that the credit does not exceed the total tax liability in Malta. The flat-rate foreign tax credit allows relief for deemed foreign tax paid at the rate of 25% even if no actual foreign tax has been charged.

Transfers of shares in the fund manager are covered by an exemption from stamp duty. Any capital gains which may be realised on a transfer of shares would be exempt from tax if the transferor is not a resident of Malta.

The provision of management and other services by licensed fund managers to a licensed collective investment schemes is exempt without credit for Maltese VAT purposes. ■

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As hedge fund managers express increased interest in the UCITS structure, **Olivier Sciales** and **Rémi Chevalier**, of law firm **Chevalier & Sciales**, explain why Luxembourg UCITS funds are gaining in popularity

The sophisticated choice

For a long time, Luxembourg hedge funds and funds of hedge funds (FoHFs) have been set up under several wrappers, namely funds submitted under part II of the law of 20 December 2002 on UCIs (the 2002 Law) and specialised investment funds (Sifs) governed by the law of 13 February 2007. As of today, hedge fund managers are considering launching Ucits platforms (especially 'sophisticated Ucits'). As is widely known, Ucits funds are harmonised European retail fund vehicles that can be sold globally and which benefit from the European passport, enabling investment managers to easily market their funds within the EU. The total amount invested into Ucits was around €4.6trn (\$6.87trn) at the end of 2008, and experts forecast that it is set to grow to between €7trn (\$10.4trn) and €9trn (\$13.45trn) by 2012. As of 30 September 2009, the assets under management (AuM) of Luxembourg Ucits were about €1.39trn (\$2.07trn) which represents 78% of the total AuM of all the Luxembourg undertakings of collective investments.

The Ucits framework is attracting attention from hedge fund managers mainly because of the increased demand from investors for regulated products, transparency and liquidity sought in the aftermath of the Madoff case, the benefit of the European passport, the continuous broadening of the eligible asset rules for Ucits, the strong risk management framework, the future benefits of Ucits IV (when implemented by 2011) and the implications of the recently proposed EU AIFM Directive for non-Ucits vehicles.

European passport

As mentioned, the European passport provides hedge fund managers with the possibility of distributing the shares or units of the fund within the EU. The European passport makes distribution easier for these fund promoters since they no longer have to be reviewed for substance in other EU member states but only with respect to formal compliance. The new simplified notification procedure provided by Ucits IV (to be in force by 2011) will also be of interest to hedge fund managers, since it will speed up the cross-border distribution of their funds.



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Eligible assets

Managers, driven by the investor demand, are looking for products that can deal with their alternative investment policy as well as replicating their hedge fund strategies.

The Ucits directive adopted in 1985 (Ucits I) did not provide a detailed definition of the term 'transferable securities', even though it referred to them repeatedly. In order to ensure a uniform application of the Ucits directives as well as helping EU member states to develop a common understanding as to whether a given asset category is eligible for a Ucits, the European institutions have decided to clarify such definitions in the eligible assets directive of 19 March 2007 and the Committee of European Securities Regulators' (Cesr) guidelines concerning eligible assets for investment by Ucits transposed in Luxembourg by the Grand-Ducal Regulation of 8 February 2008 and the CSSF circular 08/339.

Traditionally, Ucits investment strategies were limited to long/short equity. The main innovation was to extend the assets eligible for Ucits, in order to enable Ucits III vehicles to invest in, inter alia, OTC derivatives (total return swaps, contracts for difference etc), to adopt synthetic shorting strategies (as physical shorting is not allowed), 130/30 strategies, investments in hedge fund indices and so forth.

These strategies are now possibly subject to certain counterparty exposure limits, in the sense that the global exposure through the use of derivatives does in prin-

“Today, hedge fund managers, driven by more risk-averse institutional investors, are looking for more regulated vehicles with superior risk management procedures”

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ciple not exceed 100% of the net asset value of the assets. Hence Ucits' overall risk exposure may in principle not exceed 200% of the net asset value on a permanent basis.

Increased investor protection

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

A sophisticated Ucits (the funds which hedge fund managers tend to set up) are Ucits that mainly use derivative financial instruments and/or are making use of more complex strategies. According to CSSF, a sophisticated Ucits must entrust to a risk management unit which is independent of the entities in charge of making investment decisions, the task of identifying, measuring, monitoring and controlling the risks associated with the portfolio's positions. For instance, the risk management unit must have:

1. A sufficient number of qualified personnel with the necessary knowledge;
2. the necessary tools (IT and others) to do its task; and
3. conducting persons of the board (in case of a self-managed Sicav) or of the management company that are actively associated with the risk management process.

Sophisticated Ucits must use the Value-at-Risk approach (VaR), which means that the potential loss that a Ucits portfolio could suffer within a certain time period is estimated. In principle (subject to derogation granted by the CSSF), a confidence interval of 99%, a holding period equivalent to one month and an effective observation period of risk factors of at least one year are, among others, the standards used for calculating the VaR.

Impact of Ucits IV

The Ucits IV Directive was adopted by the European Parliament on 13 January 2009 and by the European Council on 22 June 2009. The Ucits IV package aims to introduce the following amendments to the Ucits III legal regime:

1. A management company passport (allowing Ucits to be managed by a management company authorised in another EU member state).
2. A simplified notification procedure for cross-border distribution
3. A replacement of the simplified prospectus by a key investor information document.
4. A framework for Ucits mergers.
5. Master-feeder structures leading to greater pools of assets and economies of scale.

All of the above measures may provide hedge fund managers with additional incentives to set up a Ucits structure as they will allow economies of scale and reduce costs (in part because of the absence of the need for a local management company and due to the simplified notification procedure for cross-border distribution).

Impact of the proposed AIFM directive

On 29 April 2009, the European Commission submitted a draft Directive on Alternative Investment Fund Managers (AIFM) to the European Parliament and the European Council, marking an attempt to create a regulatory framework for European alternative investment fund managers of non-Ucits funds – a common set of rules in terms of licensing and supervision.

This Directive (if adopted) would apply to all managers that manage and market non-Ucits funds in the EU with AuM exceeding €100m (\$149.7m), or €500m (\$748.5m) if the funds are not leveraged and are not redeemable for at least five years. An important point with respect to this draft Directive is that the European passport for third-party funds (non EU-domiciled funds – for example, Cayman funds, BVI funds, Bermuda funds etc) would only enter into force three years after the transposition of the proposed Directive. In other words, the distribution of offshore funds to professional investors will only be possible after such period and will therefore restrict the possibility to raise funds in Europe. Even more stringently, non-EU AIFMs wishing to market within the EU will have to apply for an authorisation to a EU member state, which will only be granted if the country where the AIFM is based has put into place prudential regulations equivalent to those of the Directive and has tax co-operation agreements in place with the relevant member state's regulators.

Certain hedge fund managers of non-EU domiciled funds are anticipating these proposed changes and are looking to re-domicile or restructure their existing funds into Luxembourg Ucits funds or Sifs. For the time being, this proposed Directive has been criticised by the industry as being disproportionate and discriminatory, and amendments should be expected.

Today, hedge fund managers, driven by more risk-averse institutional investors, are looking for more regulated vehicles with superior risk management procedures, and as such, the appeal of the Ucits legal framework accessing hedge fund strategy returns and offering wide-reaching investor protection rules and investor information requirements has attracted their attention. ■



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