

The Rise of Alternative UCITS

Sean Donovan-Smith, Partner, K&L Gates
Andrew Massey, Special Counsel, K&L Gates
Hamlin Lovell, Contributing Editor, The Hedge
Fund Journal

24 February 2015

OVERVIEW

- Welcome
- Growth in Alternative UCITS funds
- Advantages and Disadvantages of Alternative UCITS
- UCITS Compliant Alternative Strategies
- Marketing and Distribution
- Future Developments
- Open Forum

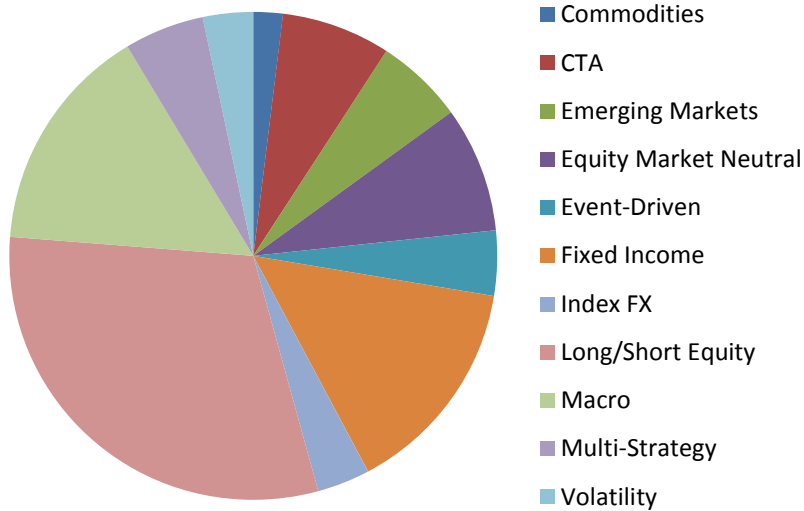


Growth in Alternative UCITS funds



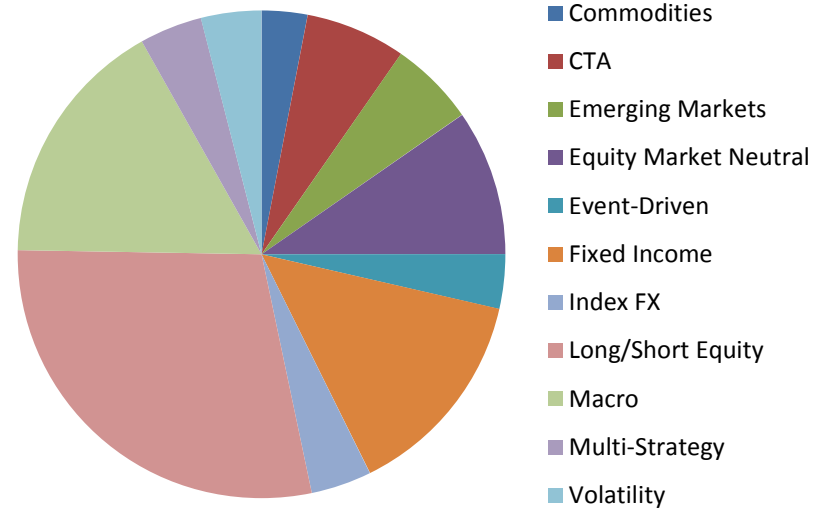
Alternative UCITS AUM

2014



2014 Total Funds: 720
 2014 Total AUM: €260,031 million

2013



2013 Total Funds: 724
 2013 Total AUM: €190,071 million

Source: UCITS Alternative Index

DRIVERS FOR GROWTH

- Evolving investor demand from retail, high net worth and institutional investors
- UCITS hedge asset growth
 - AUM grown from €141bn in 2012, to €194bn in 2013 and €265bn in 2014
- Offer some of the return potential of hedge funds and commodity funds in an onshore regulated vehicle
- Address the perceived shortcomings of diversification among traditional asset classes
- Offer investments in asset classes less correlated to traditional markets and often with higher returns than fixed-income funds challenged by negative interest rates in Europe and Japan
- Offer transparency, minimum bi-monthly liquidity and custodial safeguards derived from UCITS
- Economise on Solvency II Capital requirements

CONSIDERATIONS FOR MANAGERS

Opportunities/Benefits:

- Growing investor needs for non-correlated products
- Differentiate in crowded traditional fund market
- Alternative UCITS funds present opportunity for greater profit margins as investors move away from actively managed long-only products
 - But 2 and 20 should not be taken for granted for all funds
- UCITS has brand recognition outside Europe in Asia and Latin America

Challenges:

- Less experience with shorting and other complex investment strategies and risk-management
- Operational complexities
 - Increased reconciliations/additional cash balances resulting from use of one or more prime brokers in addition to custodian
 - Efficient portfolio management requirements e.g. rebating security lending revenues to the fund
 - Valuation considerations for less-liquid investments
- Educating sales teams, investors, financial advisors about strategies and risks
- Increased compliance to address use of leverage/derivatives, additional testing, board reporting, service provider oversight



Advantages and Disadvantages of
Alternative UCITS funds



WHY UCITS?

- Distribution potential
 - Range of investor types
 - Retail
 - Institutional
 - Range of jurisdictions
 - European passport
 - Internationally
 - But note MiFID II

WHY UCITS?

- Attraction to investors
 - Liquidity
 - At least bi-monthly
 - Limitations on exit hurdles (suspensions, deferrals, gating)
 - Governance
 - Independent board of directors (Lux and Ireland); authorised corporate director (UK)
 - Required functions (risk, compliance, governance framework)
 - Depositary requirement
 - Security of assets
 - Oversight of management

WHY UCITS?

- Attraction to investors (cont.)
 - Regulated product
 - Legal entities of fund vehicles are well known
 - Transparency
 - Prospectus
 - Periodic reporting
 - Investment risk management
 - Eligible assets
 - Diversification, concentration
 - Exposure to FDI, cover for disposals
 - Leverage (actual and synthetic)

LEVEL PLAYING FIELD FOR UCITS AND AIFs?

- Transparency requirements

Requirement	AIFM	UCITS ManCo	Comment
Pre-investment disclosure to investors	✓	✓	Arguably greater prescription for UCITS
Key investor information	✗	✓	Inescapable for retail investors
Periodic investor reporting	✓ (Annual and ad hoc)	✓ (Bi-annual for UK UCITS and ad hoc)	Prescribed but differing contents
Reporting to authorities	✓	✓	More onerous for AIFs

LEVEL PLAYING FIELD FOR UCITS AND AIFs?

- Organisational, systems and controls requirements

Requirement	AIFM	UCITS ManCo	Comment
Organisational	✓	✓	Towards a common platform
Risk management	✓	✓	Differences in detailed requirements
Liquidity management	✓	✓	Greater prescription for AIFMs
Valuations	✓	✓	Different approaches
Delegation	✓	✓	Additional requirements for AIFMs
Conflicts of interest	✓	✓	Additional requirements for AIFMs

LEVEL PLAYING FIELD FOR UCITS AND AIFS?

- Depositary/custody requirements and remuneration

Requirement	AIFM	UCITS V	Comment
Single depositary	✓	✓	“Single” made express
Written content	✓	✓	Greater prescribed contents than under UCITS IV
Cash monitoring function	✓	✓	No equivalent under UCITS IV
Delegation of custody function	✓	✓	No equivalent under UCITS IV
Segregation by subcustodian	✓	✓	No equivalent under UCITS IV
Depositary liability	✓	✓	Limited under UCITS IV
Remuneration	✓	✓	Enhanced from position under UCITS IV

CHALLENGES FOR ALTERNATIVE UCITS

- Liquidity
 - Risk of mismatch with strategy
 - Limited toolkit
 - Use of fee structures?
- Valuations
 - Framework
 - Asset eligibility
- Risk Management
 - Monitoring exposure
 - Risk Management Process (“**RMP**”) document

CHALLENGES FOR ALTERNATIVE UCITS

- Investment parameters
 - Devising investment objective and policy
 - Changes
 - Regulator approval
 - Shareholder approval
 - Understanding of investment powers and restrictions (e.g. 144A securities)
 - Available markets (e.g. HK/Shanghai Stock Connect)
 - Credit ratings

CHALLENGES FOR ALTERNATIVE UCITS

- ESMA Guidelines
 - Efficient portfolio management techniques
 - No hidden revenue
 - Recallability for securities lending and repos
 - Collateral management
 - Quality
 - Valuation
 - Safe-keeping
 - Diversification
 - Reinvestment of cash collateral
 - Transparency

CHALLENGES FOR ALTERNATIVE UCITS

- Product range fit
- Side-by-side management (UCITS and AIFs)
- Educating investors
 - Investment risk
 - Perception and reality
- Educating distributors
- KIIDs



UCITS Compliant Alternative Strategies



INVESTMENT AND RISK SPREADING

- Focus is on portfolio diversification and liquidity
- No more than 10% of net assets may be invested in transferable securities or money market instruments issued by the same body and further aggregate limitation of 40% of net assets on exposures of greater than 5% to single issuers (the "**5/10/40**" rule)
 - Exceptions for investments issued or guaranteed by governments, local authorities or certain public international or supranational bodies
 - Index replicators can take exposures up to 20% of net assets to single issuers, with up to 35% to a single issuer in exceptional market conditions
- The maximum aggregate exposure to securities/instruments (other than CIS, derivatives and cash) not listed or traded on a recognised market is 10% of net assets
- Additional general provisions apply including concentration limits, prohibitions on taking legal/management control of issuers, prohibitions on uncovered sales

EXPOSURE AND CONCENTRATION LIMITS

Global exposure

- Value at Risk (“VaR”)
 - Commitment
 - Absolute VaR
 - 20% of NAV
 - Relative VaR
- Subject to type of investment strategy

Concentration limits

- OTC Counterparties – 5% (10% for approved bank)
- Margin
 - Subject to client asset / money protection
 - Daily calls
- Exchange v clearinghouse

ELIGIBLE INVESTMENTS

	Permissible investment	Maximum limit
Approved securities (e.g. shares, bonds, deposits, depository receipts)	Yes	None
Transferable securities that are not approved securities	Yes	10%
Government and public securities	Yes	None
Regulated schemes other than qualified investor schemes	Yes	None
Unregulated schemes and qualified investor schemes	No	N/A
Warrants	Yes	None
Investment trusts	Yes	None
Deposits	Yes	None
Derivatives	Yes	None
Immovables (i.e. real property)	No	N/A
Commodities (Ags, Metals etc)	No	N/A
Hedging	Yes	None
Stock lending	Yes	None
Underwriting	Yes	None
Borrowing	Yes	10% (temporary only)
Cash and near cash	Yes	None

ELIGIBLE MARKETS

Eligible market requirements (see COLL 5.2.10 in the UK)

- A regulated market
- A market in an EEA State which is regulated, operates regularly and is open to the public, or
- Any market not falling within the above if:
 - the authorised fund manager, after consultation with and notification to the depositary decides that market is **appropriate**
 - the market is included in a list in the prospectus, and
 - the depositary has taken reasonable care to determine that:
 - adequate custody arrangements can be provided; and
 - all reasonable steps have been taken by the authorised fund manager in deciding whether that market is eligible

USE OF DERIVATIVES AND FUTURES

Investments in / through derivatives may be made

- Underlying assets in which a UCITS can invest directly
 - Eligible assets (equities, money market indices, other UCITS or regulated funds)
 - Financial indices, interest rates, FX rates and currencies
 - Not eligible if not permitted directly (e.g. commodities)
- Generally maximum exposure to a single OTC derivative counterparty is 5%, increasing to 10% for certain credit institutions
- Futures must be on exchange
- Daily valuations and daily liquidity
- UCITS are permitted to use techniques and instruments relating to transferable securities and money market instruments for efficient portfolio management (“**EPM**”)

COVER RULES FOR SHORTS

- May not exceed 100% of fund NAV
 - Commitment approach
- Must have ownership or cash cover as applicable

CASH AND BORROWING

- No more than 20% of net assets can be invested in cash deposits with any one credit institution and up to 10% of net assets may be held for ancillary liquidity purposes with other credit institutions (which 10% limit is raised to 20% in the case of deposits made with the custodian/trustee)
- Borrowings are limited to 10% of net assets and can only be used for temporary purposes (for liquidity)
- However, leverage can be achieved via derivatives and futures

OTHER CIS AND MASTER/FEEDERS

- Up to 100% of net assets can be invested in other collective investment schemes (“**CIS**”), provided no more than 20% invested in any one CIS, with an aggregate restriction of 30% of net assets applying to investment in non-UCITS CIS as well as strict rules applying to the nature of CIS in which a UCITS can invest, as well as limiting investment to a maximum of 25% of the units of the underlying CIS
- ESMA Opinion (November 2012): Clarifying application of “trash ratio” to other CISs
- Master-feeder structures are now permitted under UCITS IV and, accordingly, UCITS may invest by way of derogation from the above limits at least 85% of its assets in the units of another UCITS

CAN MY HEDGE FUND STRATEGY BE USED?

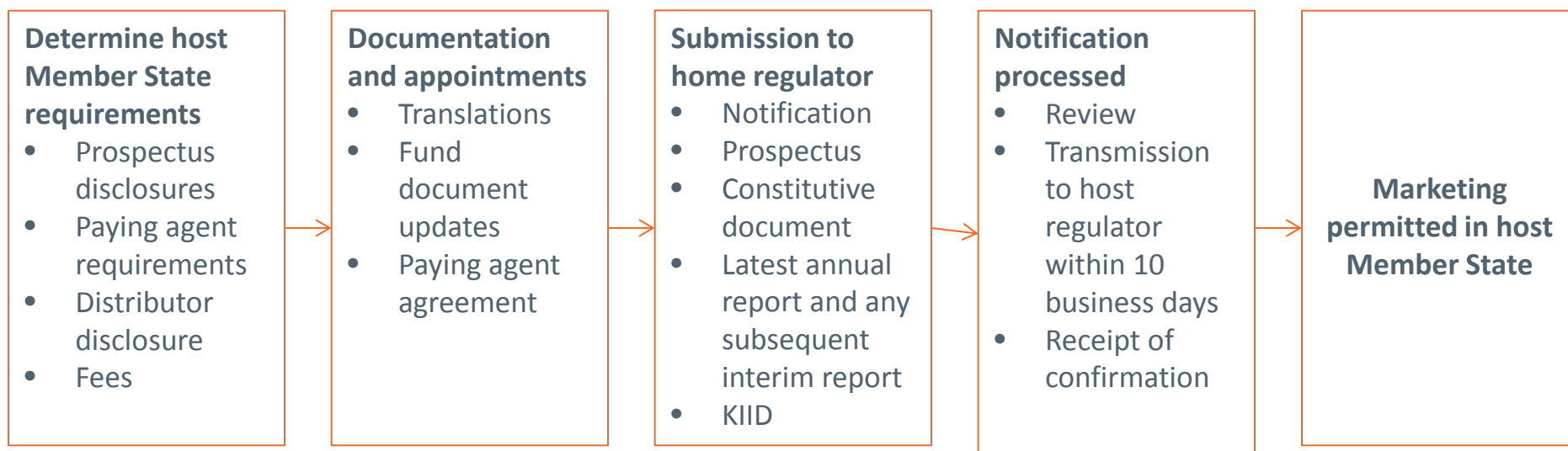
- Certain investment strategies can fit within a UCITS fund structure:
 - Traditional equity long/short or market neutral
 - Absolute return
 - Multi-strategy/multi-manager
 - Merger arbitrage/event-driven/special situation
 - Global tactical allocation
 - Global macro strategies
 - Credit strategies/convertible arbitrage/senior debt
- Managed futures/commodities
 - Some hedge fund strategies are not a fit for a UCITS fund (i.e., illiquid strategies, highly concentrated portfolios or non-financial investments)

The image features a blue bokeh background with a central orange banner. The bokeh consists of numerous out-of-focus light spots in various shades of blue and white, creating a shimmering, ethereal effect. The orange banner is a solid, vibrant color that spans the width of the image, providing a clear contrast for the white text.

Marketing and Distribution

MARKETING AND DISTRIBUTION

EU cross border notifications



MARKETING AND DISTRIBUTION

- EU cross border notifications (cont.)
 - Ongoing requirements
 - Marketing additional share classes?
- Registration in other jurisdictions
- Points to note
 - MiFID II
 - Appropriateness requirements for “complex” products
 - Oversight of distributors
 - Use of social media

The image features a blue bokeh background with a central orange banner. The bokeh consists of numerous out-of-focus light spots in various shades of blue and white, creating a shimmering, ethereal effect. The orange banner is a solid, vibrant color that spans the width of the image, providing a high-contrast background for the text.

FUTURE DEVELOPMENTS

FUTURE DEVELOPMENTS

- UCITS V and VI
- MiFID II
- ESMA discussion paper on share classes
- European Long-Term Investment Fund Regulation
- PRIIP KIIDs



Open Forum



K&L GATES