THE SOPHISTICATED CHOICE

As hedge fund managers continue to express increased interest in the Ucits structure, Olivier Sciales and Rémi Chevalier, of law firm Chevalier & Sciales, explain why Luxembourg Ucits funds, and 'sophisticated' Ucits in particular, are gaining in popularity

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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.

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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.

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.

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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 principle 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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