

With a mass of new regulation in train since the financial crisis, UCITS is seeing a resurgence of interest. Appleby's **Matthew Fearn** charts the pros and cons of the investment product

# WEIGHING THE ALTERNATIVE

Regulators and political bodies in the European Union and US are responding to the post-2008 financial world with legislation that will circumscribe the freedoms previously enjoyed by banks and fund managers. The Alternative Investment Fund Managers (AIFM) Directive in the EU, and the Hiring Incentives to Restore Employment (HIRE) Act and Frank Dodd Bill in the US, all unprecedented pieces of wide financial

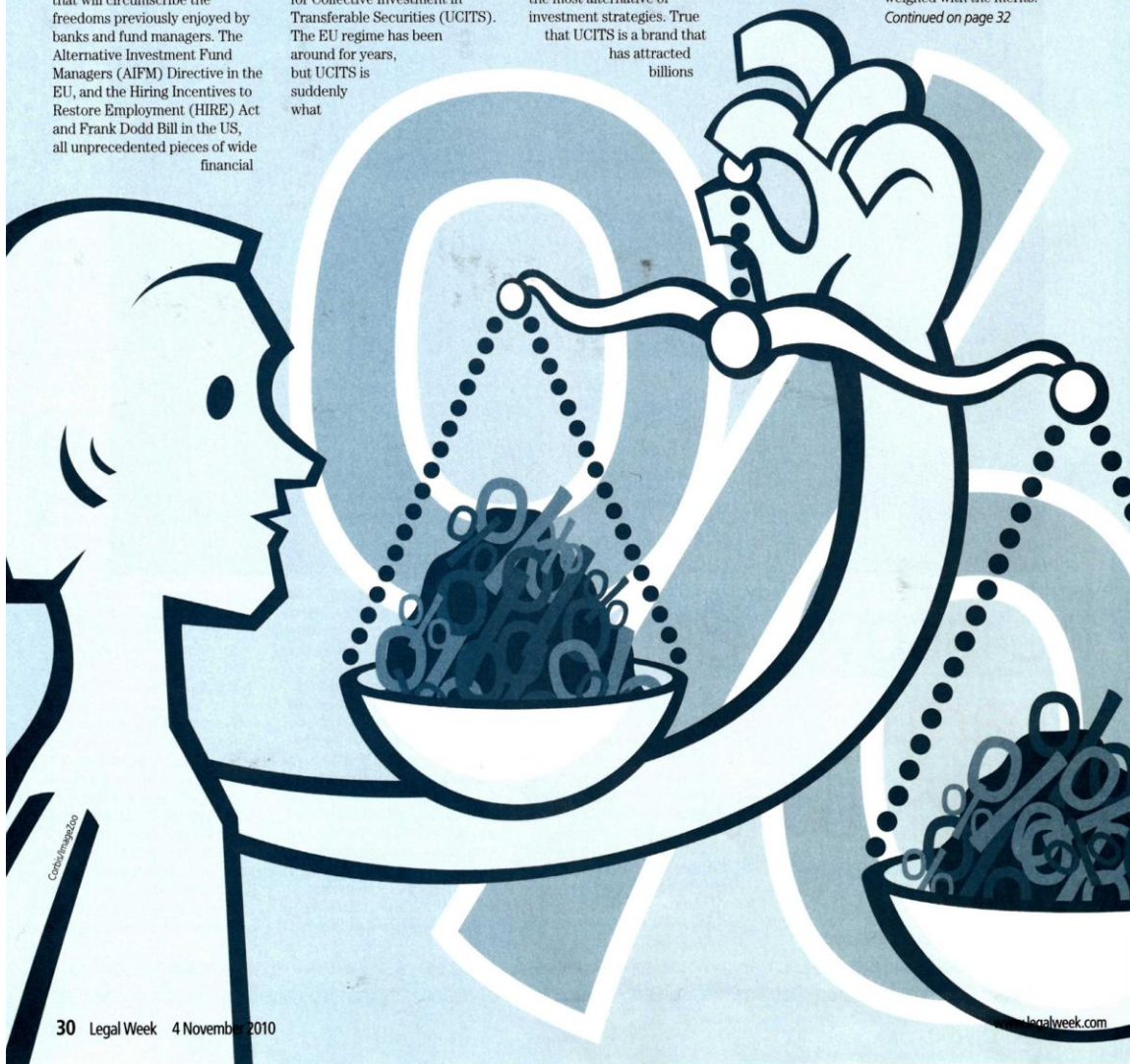
reform, have serious implications for financial institutions on both sides of the Atlantic.

Enter the Undertakings for Collective Investment in Transferable Securities (UCITS). The EU regime has been around for years, but UCITS is suddenly what

everyone talks about over dinner. UCITS has been transformed from a boring retail brand to the vehicle of choice for managers pursuing the most alternative of investment strategies. True that UCITS is a brand that has attracted billions

in investment. True that some hedge or alternative strategies can be replicated in UCITS. But the drawbacks of UCITS must be weighed with the merits.

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**UCITS upsides**

From a manager's viewpoint, this can be summarised in a word: distribution. Being an EU-regulated investment product, UCITS can be sold throughout the EU to both institutional and retail investors. This automatic passporting is particularly attractive given the barriers to EU entry erected under the draft AIFM Directive. More importantly, UCITS facilitate capital raising by hedge fund managers in the EU, by opening up a previously verboten client base: retail investors.

From an investor's viewpoint, the benefit of UCITS is found in the built-in protections that are normally associated with investments sold to widows and orphans. So a manager of a UCITS product must observe strict rules about liquidity and portfolio diversification.

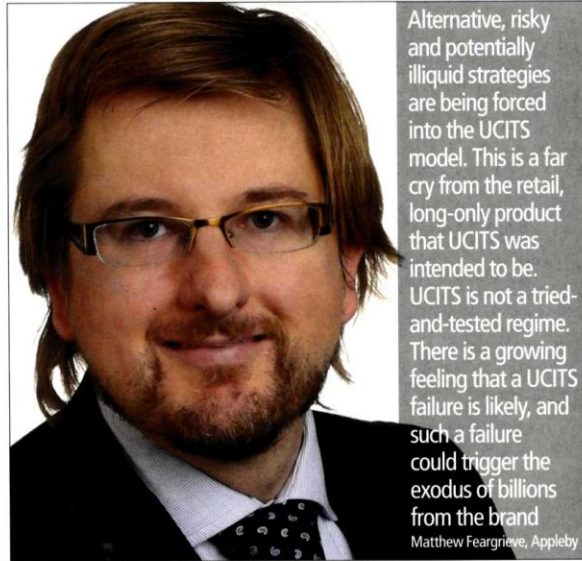
Direct borrowing is not permitted, only synthetic leverage

achieved with derivatives. Similarly, physical short selling is not permitted; instead, the manager must use derivatives to replicate short exposure.

**UCITS downsides**

Leverage, shorting, derivatives – these are some of the key tools at the disposal of a hedge fund manager in the pursuit of alpha. Restrictions and prohibitions on them brings us to the first serious downside of UCITS: lower investment returns. Achieving returns not correlated to any index is harder in a regime intended for long-only retail products.

The second drawback of UCITS: lower fees. While good news for investors, a manager who is not achieving the kind of returns possible in a non-UCITS model will not be able to command the same level of fees. So while the traditional 'two and 20' fee structure is theoretically possible in a UCITS, the reality is



Alternative, risky and potentially illiquid strategies are being forced into the UCITS model. This is a far cry from the retail, long-only product that UCITS was intended to be. UCITS is not a tried-and-tested regime. There is a growing feeling that a UCITS failure is likely, and such a failure could trigger the exodus of billions from the brand

Matthew Feargrieve, Appleby

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that a manager will be charging significantly lower fees.

The problem of lower returns and lower fees is compounded for investors and managers alike by the higher organisational costs involved. A UCITS with a vanilla equity long/short strategy can cost up to €100,000 (\$87,282) to set up.

A complex strategy, with the additional regulatory burden involved, can boost costs to €200,000 (\$174,564). The same strategy could be launched using the traditional offshore model (in the Cayman Islands, for example) at significantly lower cost. Time to market becomes an issue for the manager keen to exploit market opportunity. A UCITS product conservatively takes two to six months to launch.

**The risks**

Ultimately, of course, UCITS is just one product in a universe of investment products. If investors and managers have an appetite for relatively lower returns, lower

fees and higher costs, then so be it. But what is worrying is that these drawbacks are accepted as the price of better regulation. The higher level of regulatory oversight is considered by many investors as a guarantee of the safety of a UCITS investment. Paradoxically, the UCITS regime is in fact a relatively untested model for hedge or alternative investment strategies.

While core alternative strategies like equity long/short, market neutral and absolute return are being replicated (at higher cost) in the UCITS framework, some core alternative strategies – those focused on commodities, managed futures, distressed

and fixed-income arbitrage, for example – are difficult, if not impossible, to replicate. This stems partly from the prohibition on investing in commodities or commodity derivatives that are not sufficiently liquid to satisfy the UCITS requirements or that contravene the exclusion of physical assets. Alternative, risky and potentially illiquid strategies are being forced into the UCITS model. This is a far cry from the retail, long-only product that UCITS was originally intended to be. UCITS is not a tried-and-tested regime. There is a growing feeling that a UCITS failure is likely, and such a failure could trigger the exodus of billions from the brand. Here we make our final and most serious health warning. The regulators in the main UCITS jurisdictions, Ireland and Luxembourg, are relatively inexperienced in matters pertaining to hedge funds. A UCITS blow up of any size will severely test their ability to respond. And with 700 pieces of Madoff-related litigation eating up court time in Luxembourg, the capacity of the judicial system there to deal with a large fund failure is questionable. Contrast the Cayman Islands, with 30 years of regulatory experience and a legal system underpinned by the courts in England. Ultimately investors and managers will need to decide in which legal system they wish to place their trust.

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**AIFM changes**

Fund managers will be all too familiar with spectre of over-regulation and freeze-out from lucrative EU markets threatened since early 2009 by the EU's AIFM Directive. For months controversy has raged over the extent to which non-EU fund managers, and non-EU funds, should have access to the EU.

At a meeting of the EU Council in Luxembourg on 19 October, a compromise on the most controversial aspect of the AIFM

Directive – the so-called 'third country' provisions – was agreed. The Council text will ensure that the existing national private placement regimes remain the primary means of access to EU markets in the first two years following the implementation of the Directive.

Then, around 2015, a 'passport' can be introduced by the Commission based on European Securities and Markets Authority advice. Thereafter, the two regimes – private placement and passport – will run in tandem until around 2018, at which point the private placement regimes can be effectively switched off.

At the time of writing, the council deal on the AIFM Directive still needed to be accepted by the EU Parliament, but it is unlikely to be rejected. A formal vote will take place in either of the November plenary sessions. Brussels has clearly woken up to the importance of non-EU fund products to EU investors.

It now looks as though managers of non-EU funds will have a tripartite choice: continue to market the fund on a private placement basis (together with the new regulatory requirements imposed by the Directive); adopt full compliance with the Directive and obtain a passport; or go the UCITS route, either in alternative or addition to the traditional offshore model.

Given the serious cost implications of UCITS, it may be that those managers big enough to be able to absorb the higher costs of UCITS will use the model in addition to their existing offshore products, at least until the economic cycle improves and raising retail monies becomes less important.

The majority of managers will dip their toe in the UCITS waters by using distribution platforms. But for the vast majority of hedge fund managers, UCITS will continue to be too expensive and too restrictive. We see this forging a divergence between managers of vanilla equity long/short strategies, who will seek to use UCITS, and managers of more complex, more truly alternative strategies, who will use offshore funds in the Cayman Islands and other leading offshore domiciles.

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