



A New Environment for Hedge Funds: Adopting the UCITS kitemark

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Old dogs can learn new tricks. As the investment landscape evolves a number of alternative investment managers are beginning to launch new, regulated funds and initiate transfers using either Dublin- or Luxembourg-domiciled vehicles. Some are even looking to re-domicile existing funds to Dublin and Luxembourg.

Many leading names have launched new UCITS - Undertakings for Collective Investments in Transferable Securities - based funds which makes them on a regulatory par with more traditional, and accessible, European vehicles. Among the

firms to have taken this approach are: Brevan Howard, GLG Partners and Odey Asset Management.

Other alternative investment managers are preparing to launch new onshore funds using the more lightly regulated route of either the Qualifying Investor Fund (QIF) model permitted in Ireland or the Specialised Investment Fund (SIF) structure developed in Luxembourg. Both offer much the same investment flexibility that is available to a Cayman Islands, Bermudian or British Virgin Islands (BVI) fund - but employ an onshore regulatory framework. This can provide access to a new client base.

What has sparked this move? There are two drivers at work:

1. In 2008, total hedge fund assets fell by almost a third in the second half of the year to US\$1.8 trillion (down from US\$2.7 trillion) while the number of firms comprising the Billion Dollar Club fell from 395 to 311 (HedgeFund Intelligence, 5 March 2009). Many funds could not retrieve assets caught up in the Lehman collapse. Many more introduced redemption 'gates'.





Now investors are looking to improve their portfolio diversification while hedge funds are looking to secure the assets of new investors.

2. The Madoff scandal led investors to demand more transparency coupled with a guarantee of liquidity for some, if not all, strategies. Furthermore, there has been some strong debate on the regulation of private funds in the EU.

UCITS funds are already regulated, circumventing a number of issues immediately. They offer the comfort of a trustee or depository bank as holder of the assets while some of the counterparty risk concerns raised by the role of the prime broker in a typical hedge fund can be mitigated with a custody agreement. (It should be noted that execution brokers still pose a risk, but this is limited to 5-10% of the net asset valuation.)

However, UCITS funds have a formal market risk management process which must be in place due to restrictions on the way value at risk is calculated and there must be regular stress testing. Additionally, they must offer fortnightly liquidity at the very least.

Following the significant level of redemptions last year the other big driver is a desire among managers of single-strategy hedge funds to diversify their investor base and lessen their dependence on funds of funds. UCITS funds can tap onshore investors of all kinds, including retail, and attract funds from institutions that are limited by the proportion of assets that can be invested in unregulated funds. The investment mandates of many private banks preclude investment in offshore funds, making hedge funds using UCITS structures, or the more lightly regulated SIFs and QIFs, attractive.

With this in mind it may be no coincidence that the UK is changing its offshore fund rules to introduce a reporting fund regime later this year. Together with other changes, this will ensure that UK investors in a UCITS operated by a hedge fund are only subject to capital gains tax, and not the more penal rate of income tax, on disposal of their investments. This could make retail marketing in the UK a more viable prospect.

However, offshore centres have historically been the venues of choice. At the last count, more than half of all European-managed hedge funds were

domiciled in Cayman while there were plenty more in Bermuda and BVI. For now, the UCITS route may be restricted to the larger fund groups with ambitions to use a pan-European passport to market freely at the retail level.

For sure, Cayman will remain the cheaper option for many funds. The running costs of a UCITS, which must include the process of calculating fortnightly or more frequent net asset values, trustee, custody and governance and risk management costs, may restrict it in the near term to the bigger funds groups. Meanwhile, QIFs and SIFs, which involve lower running costs, may not be as marketable in the long term.

As part of UCITS III, the Eligible Assets Directive significantly broadened the range of investments in which UCITS funds can invest. They can now use derivatives for investment purposes and not just to hedge underlying positions. There are strict position, counterparty and global exposure limits but UCITS III allows for the netting of long and short derivative positions within the calculation process.

Under the 'sophisticated' approach permitted in UCITS III there are fewer restrictions in practice on what the fund can

do under UCITS. But the requirement for fortnightly liquidity is a significant constraint and counterparty and liquidity exposure must be monitored and maintained. More liquid strategies such as managed futures or global macro will have no problem accommodating fortnightly pricing. Others, such as distressed debt, clearly will - and are likely to remain firmly outside the UCITS net.

Most alternative investment managers will maintain a range of onshore and offshore funds. That makes it all the more important that they have an administrator with experience of servicing both areas. The range of skills required is a wide one. At one extreme, it takes in compliance and risk monitoring of trades, backed by an ability to deal with the pricing issues presented by complex derivatives. At the other, it takes in international distribution support, including the ability to track flows and calculate trailer fees.

With a one-stop shop approach, Citi can deliver all of these components in-house as part of an end-to-end offering that spans trustee services, hedge fund and long-only fund administration and accounting, global custody and prime

finance. And with a global fund servicing network, it can deliver distribution support in almost any territory - an important capability as UCITS increasingly becomes a global, not just a European, kitemark.

More changes are coming to the UCITS regime that will make it more flexible still. The arrival of UCITS IV, due to become effective within the next two years, will facilitate master-feeder structures, fund mergers, an EU management passport and notification procedures. All of these are expected to speed up the process of initiating cross-border marketing and make UCITS funds even more attractive.

The gathering interest in UCITS and other onshore structures on the part of alternative investment managers continues to gain visibility. Now they must ensure they are correctly positioned and supported when they come to launch funds that can capitalise on the evolving and more regulated framework that is emerging.

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