Asset Management

Future Newcits regulation?

Our view, informed by conversations with regulators

PRICEWATERHOUSECOOPERS

Europe's asset managers have now launched over 200 UCITS with hedge fund like strategies, and many more are in the pipeline. As the trend grows, tighter regulation may be needed both to protect retail investors and the valuable UCITS brand.

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Introduction

Who would have thought a year ago, following the credit crunch, that there would now be such a large number of UCITS hedge funds, known as Newcits, encompassing almost the full range of investment strategies? There are not only relatively simple long-short equity funds but also more complex macro, arbitrage and commodity vehicles.

After two years of decline in Europe's assets under management, such growth is welcome. Newcits are a genuine response to investor demand and, by all accounts, they are attracting new assets. According to PricewaterhouseCoopers[1] research, there are now more than 200 Newcits funds and the number is growing weekly. Demonstrating the size of the market, funds of hedge funds managers now judge it sufficiently broad for them to launch properly diversified funds of Newcits.

Yet the conflict between welcome innovation and protecting the retail investor must be carefully managed. While many larger hedge fund managers have been running Newcits for several years, recently less established competitors have started to do so. This has worrying implications because newer managers may not differentiate clearly between institutional and retail investors, have less reputational risk and may lack the financial strength to support a fund should it run into difficulty.

At a time when UCITS has become a highly successful global brand, regulators and the industry both need to ensure that the brand is not tarnished. When the UCITS III Directive was amended in 2001 to allow investment in financial derivative instruments (as well as hedging, which was already permitted), no one imagined that this would attract such a wide range of strategies. Now, regulators have to strike the right balance between developing UCITS funds, and anticipating threats to retail investors.

"What the hedge fund managers are bringing to the UCITS area is a great deal of product innovation," observes Grellan O'Kelly, Senior Regulator with responsibility for the Derivatives and Risk Management Policy Group at the Irish Financial Services Regulatory Authority. "We

1. "PricewaterhouseCoopers" and "PwC" refer to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL).

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are familiar with most of the assets that are traded, but the manner in which they are managed to gain alpha is something new for us.

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Newcits bring new complexity to a universe historically dominated by traditional funds, and primarily intended for retail investors. Through derivatives, managers can invest in asset classes otherwise not eligible within UCITS, and pursue strategies such as arbitrage with complex drivers of risk and reward, that even some investment professionals have trouble understanding. This is contrary to the UCITS principle that investors should understand what they are buying.

Another apparent contradiction is the requirement that a minimum of fortnightly liquidity be offered. Even money market funds had difficulty providing liquidity during the financial crisis, so how will some hedge fund strategies be able to do so? Might a complex arbitrage vehicle, for example, be able to sell down investments and offer sufficient liquidity in the eye of a storm in financial markets?

Certainly, UCITS rules impose limits on investment freedom that do not exist in unregulated funds. Taken together, rules regarding leverage, portfolio concentration, eligible assets, liquidity and transparency ensure that Newcits have less risk than many offshore hedge funds. Hedge fund managers can often package their long-short equity strategies as Newcits with little change to investment practices, yet they may have to adapt arbitrage or trading strategies by reducing leverage, having more diverse portfolios or more liquid underlying assets.

While welcoming the migration of hedge funds onshore, some regulators hope managers will eventually prefer the Alternative Investment Fund Managers Directive (AIFMD) regime for complex and highly leveraged funds. "Within UCITS III the investment restriction rules are tight and these rules might restrain hedge fund managers' ability to launch pure alternative strategies," asserts Patrice Bergé-Vincent, Head of the Asset Management Policy Department at France's Autorité des Marchés Financiers, which was the primary architect of the sophisticated UCITS framework that allows derivatives. "I would like to think that the AIFMD rules will be preferable to hedge fund managers because there will be no investment restrictions but a passport for funds established in the European Union".

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Reasons for growth

Hedge fund managers have taken time to exploit the flexibility introduced in the UCITS III Directive of 2001, and then further refined in the Eligible Assets Directive of 2007. Large managers have launched a trickle of new funds investing in derivatives over the past few years, but it is only in the last 18 months that newer managers have launched Newcits.

According to Hedge Fund Intelligence research released in November 2009, more than half of European hedge fund managers have either launched a Newcits or plan to. On the same organisation's UCITS hedge fund database, in February 2010, 47 of the 151 Newcits hedge funds listed were European equity long-short funds, 17 were Asian equity and 13 were market neutral funds. There were smaller numbers of more specialist funds, including nine macro, eight managed futures, eight mixed arbitrage, eight emerging markets equity, and so on.

Hedge fund managers are responding to demand from smaller institutions such as funds of hedge funds, private wealth managers and smaller pension funds. The credit crisis undermined many investors' faith in straightforward equity investing, as it reversed the previous decade's gains. Even though hedge funds lost money, and were often more correlated with markets than expected, they tended to perform better than equities. While the MSCI World Index, for example, lost more than 43% between its July 2007 high and its November 2008 low, the Tremont Hedge Fund Index's maximum loss during the period was just under 16%.

Yet investors were disenchanted by the methods hedge fund managers chose to prevent fire sales of less liquid assets. Many were prevented from disposing of portions of their investments, imprisoned within 'gates', 'side pockets' and other special purpose vehicle solutions. Massive frauds, where assets were found no longer to exist, coupled with the Lehman collapse and deeper understanding of the implications of re-hypothecation, focussed attention on the safekeeping of assets. Finally, there were some instances of style drift, where hedge funds deviated from their strategy, with consequent losses.

The UCITS regulatory framework claims to reduce the likelihood of any of these things happening. "The CSSF considers that UCITS should be designed to be sold to retail investors," explains Jean-Marc Goy, Counsel for International Affairs at Luxembourg's regulator, the Commission de Surveillance du Secteur Financier. "The UCITS Directive includes, in addition to

the requirement for an adequate risk management process, a lot of other safeguards in order to assure adequate investor protection. The requirements on the eligibility of assets, the diversification requirements of the portfolio investments and the transparency requirements, e.g. the prospectus and the Key Information Document (KID), are strong safeguards for investor protection."

"In addition to that, the financial intermediaries who distribute UCITS fund products are subjected to the rules of the MiFID Directive, which obliges them to make sure that the risk profiles of the financial products they sell comply with the risk profiles of the investors, and which should prevent mis-selling practices."

The UCITS III Directive allows funds to use leverage and to short sell through derivative instruments. Funds may invest in a wide range of instruments, including commodity and hedge fund indices. Set against such freedom, however, there are strict risk management parameters. Among other things, funds must: publish their holdings; allow investors to redeem at least fortnightly; control leverage (through use of a commitment or Value-at-Risk (VaR) calculation); implement stress testing; and manage counterparty risk.

"From family offices through to the big funds of funds people have to protect themselves more, and if they can put another layer of risk control between themselves and the hedge fund they will do, although not all strategies are suitable for these vehicles" says Christian Roy, Principal, at GLG Partners LP, the large European hedge fund manager which has launched both European equity long-short and emerging markets multi-asset Newcits.

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Investor preferences

Not all institutional investors favour Newcits. Large pension funds with the expertise and resources to research hedge funds, as well as long-term investment horizons, believe they will ultimately reap better returns from investing in offshore hedge funds.

"For us this does not add value because we have the resources to do our own due diligence," says Ton Berendsen, a Member of the Board of APG Asset Management. "The restrictions applied add comfort and control and compliance, but they will lower returns. For smaller investors, however, I believe the additional guidance and comfort is important."

Olwyn Alexander, PricewaterhouseCoopers (Ireland), added: "Investment horizons and objectives mean that UCITS are not the ideal solution for all investors. Those with longer term horizons, such as pension funds, do not want the disruption of daily or fortnightly liquidity imposed by the UCITS rules. Nor do they want to have strategies curtailed.

"That is not to say that regulation and corporate governance are not important considerations for such investors. The onshore, non-UCITS fund is likely the optimal solution."

In addition to those institutional investors investing in Newcits through choice, home country regulatory restrictions mean others can only access hedge fund strategies through a UCITS fund. Insurance companies, for example, may be restricted from investing in offshore hedge funds, while some wealth managers cannot recommend these offshore products because they are not qualified to do so.

"I think these vehicles are creeping down towards retail investors," says Ken Kinsey-Quick, Head of Multi-

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Manager at Thames River Capital, which launched a fund of Newcits in January 2010, with £47 million raised at launch, aiming to invest across 20 to 40 funds. “There is a price to pay for the extra security and I do think the returns from UCITS funds may underperform some hedge fund strategies, but I am not sure they will do so by a great amount.”

Certainly, hedge fund managers sense an opportunity both to accommodate those existing investors that want to invest by way of more regulated structures, and to diversify their investor base. PricewaterhouseCoopers is receiving inquiries from large US hedge fund managers, aware of what their European competition is doing.

Finally, the AIFMD may well provide further impetus for Newcits. Set to be finalised in July 2010, the rules currently proposed may make it difficult for managers based outside the European Union (EU) to market offshore funds within EU member states. Managers would then have to package funds in the form of UCITS or other onshore structures.

“The greatest issue the industry has with the AIFMD is the uncertainty that it has created. Along with other drivers such as liquidity, transparency, regulation and tax certainty, this is giving added impetus to UCITS where at least there is certainty with the framework,” says Alexander.

Risk management, leverage and liquidity

As the Newcits universe grows, so does concern that innovative strategies may create investor protection issues, even a hedge fund blow up. Addressing some of the critical areas, in summer 2009 the Committee of European Securities Regulators (CESR) launched a Level 2 Consultation focusing on risk measurement, including global exposure and counterparty risk.

In particular, CESR is examining the application of leverage through the two methods permitted by the Directive – the commitment approach and VaR. In general terms, the UCITS rules limit leverage (described as global exposure) to two times, yet the VaR method permits exposures as great as, for example, 200% long and 200% short equities – even though this implies global exposure exceeding twice the fund's net asset value. At a time when the market crisis has illustrated VaR's shortcomings, CESR's working group is examining this point closely.

"The objective of this consultation is to improve the rules regarding risk management for UCITS managers," says the AMF's Bergé-Vincent. "There is one big question around the management of risk, which is the risk that some UCITS using the absolute VaR approach end up with a leverage which is significantly higher than that authorised by the commitment approach. We believe that such a situation must be dealt with by a comprehensive risk management organisation within the UCITS to adequately manage risks linked to that leverage, adequate disclosure in the Key Investor Information Document (KID) regarding the risks linked to leverage, and strong marketing rules to ensure that the UCITS is marketed solely to investors who are able to understand the risks of such strategies."

The working group's conclusions are expected to be included in the final version of the UCITS IV Directive, set to be published in July 2010.

Some industry participants regard current Newcits rules as simplistic. "The question of leverage is complicated by the question of liquidity of the underlying assets," asserts Christian Bartholin, a Member of the Executive Committee at HDF Finance, France's oldest fund

of hedge fund company. "Leverage of two times on a distressed debt portfolio is very dangerous; ten times on a futures portfolio is not so dangerous. I think the comfort in UCITS comes more from what is on the label than what is in the tin."

Regulators are addressing such issues at national level, insisting that managers set appropriate minimum investments. "The AMF considers UCITS with leverage of close to two may not be suitable for less aware retail investors and should be reserved for institutional investors by imposing a minimum entry ticket of, for example, €100,000. This is the French approach," explains Bergé-Vincent. "When a UCITS hedge fund with leverage this high enters the French market, we recommend to the distributor to limit their distribution to professional investors. Or we recommend to them to explain the risks to retail investors so that they fully understand."

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A fragile and formative period

There is little doubt that the Newcits universe will continue to grow. How it does so, however, will depend partly on the AIFMD's development.

"For some managers, AIFMD might be a good reason to establish Newcits", comments Rob Mellor, PricewaterhouseCoopers (UK). "By doing so they would not only gain an EU marketing passport, but also escape the most draconian stipulations of the new Directive. Consequently, we may see the establishment of an onshore European hedge fund market, polarised between the less leveraged, less concentrated Newcits funds and the less restricted onshore hedge fund vehicles.

"However," cautions Mellor, "hedge fund managers should be aware that this is a fragile and formative period, in which the regulators are setting rules that will govern the sector for many years to come. Consequently, where there is flexibility it is vital that managers be seen to act within the spirit of the rules."

If the proposed set of controls does not prove adequate for protecting retail investors, then the regulators will have to think again. This makes further definition of UCITS hedge fund rules likely at some point in the future. Who knows, these vehicles could even be a trigger for UCITS V?

"We are happy to see product innovation and players entering the market," says O'Kelly. "We do have

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"I have no doubt that in a few years there will be a UCITS V," concludes O'Kelly. "Because UCITS is the vehicle of choice there will be innovation and we will have to move with that."

Certainly, the sudden proliferation of Newcits appears to have highlighted inadequacy in the UCITS regulatory regime. "What is critical in this debate is that the global UCITS brand is maintained," says John Parkhouse, PricewaterhouseCoopers (Luxembourg). "Any developments aimed at better controlling such products need to recognise this and to be structured accordingly. For example, regulation focussed on heavily restricting distributors in Europe with regard to such product ignores the fact that many of the platforms in Luxembourg and Ireland today have their most significant client base outside Europe; hence any such regulation would be meaningless. As such, enhancement needs to be either at the product level or – preferably – at the control and infrastructure (i.e. risk management) level, which would thus ensure proper protection of the brand and of retail investors globally."

With UCITS distributed across the world, regulation through distribution channels seems unlikely to work. For the sake of the UCITS brand, the retail investor and Europe's asset management industry, regulators should reduce Newcits managers' ability to take risk. In particular, they should impose tighter control of the leverage that can be applied through the VaR approach.

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High level guidelines for managers

Hedge fund managers would be wise to follow some simple guidelines to ensure that the level of innovation is appropriate.

These are:

- Set a minimum investment amount appropriate to the type of strategy and investor. More complex strategies aimed at institutional investors should have higher minimum investment amounts to deter retail investors.
- Make sure you can clearly explain the investment strategy to retail investors within the two-page Key Investor Information Document – strategies that cannot be explained may not be suitable for UCITS.
- Ensure that the proposed investment strategy can provide, at a minimum, fortnightly liquidity, even in difficult markets. Stress testing is key.
- Take responsibility for targeting the appropriate type of investor when launching a Newcits. Be cognisant of appropriate standards and your responsibilities. Breaching them may damage both your own reputation and the broader UCITS brand.

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If you like to discuss any of the areas covered in this paper or the implication for your business, please speak with your local PricewaterhouseCoopers contact or one of our hedge fund specialists listed below:

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