



What type of due diligence for your “Newcits”?

Hedge Fund strategies in a UCITS wrapper have become very popular amongst investors in recent years and more so since the financial crisis. Indeed, the proposal looks appealing as it is supposed to bring onshore in a regulated framework the hedge fund benefits which were previously available offshore and only for “accredited investors”. Furthermore, the UCITS framework apparently provides answers to investors’ current worries concerning transparency, liquidity, asset safekeeping and risk management. At first glance, “newcits”, “Hedge Fund UCITS” or “Hedge fund Lite”, whatever you want to call them, seem to provide a safer entry point into the hedge fund world but is the tradeoff really holds to its promises in protecting investors.

The UCITS (Undertakings for Collective Investment in transferrable securities) framework takes its roots in the 85/611/EEC directive published on 20 December 1985 by the European parliament and the Council of the European Union. The aim of this directive was to create a harmonized set of regulations amongst European countries to facilitate the free circulation within the European Union of open-ended investment funds. The principle of the directive is that a fund structure being once authorized in one EU country can technically be marketed freely in other EU countries. The harmonization goal fell short of being achieved as diverging implementation approaches or legal interpretations of the member states lead to slightly different rules being adopted in different countries. Despite this shortfall, the UCIT format have attracted a lot of interest since in November 2009, assets held in UCITS funds were €5’157 billion globally, including significant market share in Asia, particularly Hong Kong, in Peru and in the Middle East, particularly Bahrain. The roughly 500 UCITS hedge funds now manage \$52.3 billion, according to Eurekahedge

The amendments to the initial EU directive published in January 2002, often called the UCIT III directive, and in March 2007, clarifying the definition of eligible assets, opened the door to the implementation of some hedge fund’s strategies into the UCITS framework. The four main restrictions to the implementation of a broader range of hedge fund strategies as UCITS are the risk framework limiting the use of leverage, the requirements for fund diversification, the eligible assets and the redemptions terms which impose a minimum of two dealing days per month. Therefore, the type of strategies which are the more likely to comply with those limits are the long/short equity strategy trading liquid stocks, the strategies trading futures contracts systematically like CTA or on a discretionary basis like Global Macro or other strategies trading mainly derivatives (total return swap, interest rate swap ...).

From an operational standpoint, the UCIT regulation provides safeguards to different operational risks: counterparty risk, asset safe keeping, valuation and compliance.

Counterparty risk

The collapse of Lehman Brothers in September 2008 sharply reminded investors that the safety of their assets was partially linked to the health of their counterparties. In fact, hedge funds were particularly exposed because of their use of leverage, their short selling activities and their use of derivatives. In practice, Hedge Funds assets are not segregated from their counterparties’ balance sheet in the case of rehypothecation, free unencumbered cash and margin accounts. Furthermore, the P&L on derivatives is also subject to counterparty risk. The UCITS regulation enforces rules which minimize the counterparty risk. First, since UCITS funds cannot short or use leverage they cannot be any rehypothecation of their assets by the counterparties. Furthermore, the UCITS funds do not use a prime broker but a custodian which is obliged by law to keep the funds’ free cash in a segregated account in the name of the fund. Finally, the UCITS directive describes strict limits in the exposure of a fund to anyone counterparty. For example, a UCITS fund is not allowed to have more than 10% of its assets in OTC derivative transaction with a single counterparty.

Asset safe keeping

The UCITS directive imposes that management or investment companies and depositaries must be strictly segregated. In practice, like in Luxembourg, UCITS must appoint a credit institution as depositary bank which is responsible for both the safekeeping of assets and the supervision of the fund (and its management company in the case of an FCP). Furthermore, to guarantee its ability to effectively pursue its business as depositary and meet the commitments inherent in that function, depositaries have to be institutions which are subject to public supervision and possess sufficient financial and professional resources. The UCITS Directive assigns depositaries with two core functions: Book-keeping of custody accounts and supervising the management or Investment Com-

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pany’s compliance with legal provisions and investments policies. As revealed by a recent survey by EDHEC* there is a disconnection between depositaries and investors. According to the survey, 70% of respondents think that the definition and the role of the depositary are appropriate, in stark contrast to depositaries and custodians themselves, an overwhelming majority (80%) of whom consider their roles and responsibilities inappropriately defined. The scope of the law regarding the role of depositaries is currently being tested following the collapse of different UCITS funds which were invested with Bernard Madoff. While some national frameworks may provide for the depositary’s liability to return all the UCITS’ assets in sub-custody, others may simply require the depositary to diligently choose and monitor the sub-custodian. Despite, the apparent ambiguity of the directive on that subject, the EU regulator has not address the issue in the recently adopted UCITS IV directive. A recent Luxembourg court decision dismissed a class action which was brought against the depositaries of the Madoff UCITS funds, namely UBS and HSBC, by investors because of the claim already submitted by the US liquidator. The conclusion of this case will give investors a better sense of how much their assets are protected under the UCITS directive.

Compliance

Regarding the depositaries’ supervisory role, while the decision to take risks and the adequate management of these risks lies with the management or Investment Company, the depositary has to ensure that the company manages the investments as promised and complies with relevant legal requirements. However, neither the Luxembourg nor the French domestic rules charge the depositary with the examination of the management or investment company’s investment decisions. Interventions on the part of the depositary are only required in case the investments violate the law or the collective investment scheme’s statutory provisions.

The UCITS directive proposes several guidelines regarding the eligibility of the management company to manage a UCIT funds. The guidelines cover a minimum capital requirement, a minimum staff of two persons, adequate experience in the strategy to be implemented and a good reputation. Also the directive defines guidelines regarding the composition of the fund’s board of directors.

Valuation

The directive requires that the assets of the funds be valued independently. Furthermore, since the funds are supposed to trade liquid assets, the valuation should not be an issue under normal market conditions. However, it should be reminded to investors that before the summer of 2007, CDO, mortgage back securities and commercial papers were very liquid securities.

It is obvious that the UCITS framework provides better protection to investors compared to the offshore hedge fund structure. However, investors shall be conscious that the UCIT directive does not address all the type of operational risks. A good example to illustrate that is the New Castle case. UBP launched in 2009 a UCIT fund managed by New Castle only a few months before the manager was charged with insider trading by the SEC. Furthermore, hidden costs are associated with UCITS funds. In fact the extra setup and compliance costs and the investments restrictions imposed by the UCIT directive are likely to weight on the performance. In the Edhec survey, most respondents fear that structuring hedge fund strategies as UCITS will distort strategies and diminish returns. 69% of participants thinks that the “liquidity premium of hedge fund strategies will disappear. Before choosing the UCIT version, investors should carefully considers the real benefits of the structure compared to its costs. The forthcoming European directive on alternative investment fund managers (AIFMs) may bring closer UCITS and hedge funds but on the other hand will probably limit the access to hedge funds. The hedge fund industry is in the midst of a regulatory revolution that should benefit the investors but at which cost!!

* Edhec Risk Institut, Are Hedge-Fund UCITS the Cure-All?, March 2010.

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