UCITS III COMPLIANT STRATEGIES

Utilising Ucits-compliant hedge fund indices

Hedge fund indices have turned into investable assets for EU harmonised investment funds, write Joachim Kayser, Alexander Lindemann and Robert Kissner

It's an open secret that sub-prime volatility in the stock markets has made a vast number of institutional and retail investors look for alternative investments. Now more than ever, shaken investors from around the world, disappointed by unfulfilled promises of some traditional fund managers, have been searching for ways to rotate into financial products that have the true potential of delivering on the seemingly incompatible: maximum yields at minimum risk. The spark that set a wildfire of innovation among trailblazing fund management experts, keen on welcoming those global investors into one or more members of their product fleet, came from an unlikely source – the European regulators.

What started as an almost socialist exercise of bringing investment bank style instruments to the European citizen without exposing him or her to the typical risks that come with the unknown, Ucits III-compliance has already turned out to be one of the most marketable brands in today's investment fund universe. However, before the release of the so-called Eligible Assets Directive (EAD) in connection with the corresponding "level 3 guidelines" by the Committee of European Securities Regulators (CESR) in March 2007, the old "Undertakings for collective investment in transferable securities" would have hardly been able to fill the new vacuum caused by the big bang of housing price declines, pronounced stock market corrections and the liquidity crunch in

"EUROPEAN FINANCIAL CENTRES GOT A MUCH-NEEDED BOOST BY NEW REGULATION THAT REPRESENTED, IN MANY WAYS, DE-REGULATION"

some of the world's largest market economies. That is because not too long ago, European regulators seemed to focus almost exclusively on the minimum risk part of the desired equation, leading to an increased pursuit of regulatory arbitrage and choking the ingenuity of the European fund industry. Some of today's most popular investments, i.e. those that are uncorrelated to conventional investments such as securities, simple derivatives or real estate, were off limits for direct investments under European investment laws.

A MUCH NEEDED BOOST

All of this has changed over the last couple of months, as each CESR member had to bring the EAD as well as the level 3 guidelines into effect before March 2008. So just in time for the opportunities to be found in the aftermath of the recent global crises, the European financial centres got a much-needed boost by new regulation that represented, in many ways, de-regulation. While in the past, an investment fund was usually restricted to stocks, bonds and similar instruments, the EAD offers a broader interpretation of the original Ucits Directive of 1985. Subject to the appropriate due diligence, a wide range of structured products has become eligible.

The eligibility of a security is now based on certain criteria such as the exclusion of a loss beyond the amount to be paid for it, as well as on an assessment of the security's impact on the overall risk profile of the portfolio. Possible liquidity risks in connection with the security have to be factored in. Although the guidelines do not state a cast-iron approach regarding the process in which compliance of the security should be achieved, they do set out specific examples of matters that may need to be considered. These include the volume and turnover in the transferable security, the issue size and the portion to be purchased, as well as the quality of secondary market activity and intermediaries. The guidelines repeatedly mention the benefit and the necessity of seeking independent analysis of prices and risks in order to ensure compliance on an ongoing basis.

Independent audits should carry significant weight with regards to the actual acknowledgement of financial indices as eligible assets in jurisdictions such as Germany and Luxembourg, which unlike, for example, Ireland, do not have a formalised approval procedure for indices, but make an overall assessment of the fund to be launched. The fact that the so-called financial indices are now conceivable as underlyings of eligible derivatives, opens up a pathway between the secure environment projected by the Ucits brand and the prospects of commodity, real estate and hedge fund indices.

The compliance requirements set out in the guidelines include that any index must be sufficiently diversified, represent an adequate benchmark and be published in an appropriate manner.

"A STRONG DEMAND FOR HEDGE FUND INDEX-BASED ABSOLUTE RETURN PRODUCTS CAN BE EXPECTED FROM PROFIT-STARVED INVESTORS"

In case of indices on hedge funds, many managers of the latter have proven for years that their much coveted strategies can consistently work in all kinds of markets. Thus, a strong demand for such hedge fund index-based absolute return products can be expected from profit-starved investors, whether they are based in Frankfurt or Hong Kong, who trust in the protection and risk management of Ucits.

But with greater liberties in eligible assets and strategies, also come greater responsibilities in proven analysis and documentation. The fund will have to be able to prove at all times that it has considered a list of factors that make any undertaken investment an eligible asset. This applies to all of the fund's investments but nowhere does CESR seem to feel more strongly about this than in regards to hedge fund indices. The guidelines even describe a case in which a hedge fund index publishes a very detailed methodology and comprehensive information about index components, but is not subject to an independent audit. In such a case, the Ucits will have to assess whether, considering all the factors in the guidelines, gaining exposure to the index would be consistent with its investment objectives and risk profile.

THIRD PARTY SERVICES

The multiplicity and complexity of factors as well as the demand with regards to information technology could make it almost impossible to guarantee consistent approval from local regulators without taking advantage of independent audits and other third party services including, for example, fund structuring as well as IT and risk management advice at the various stages before and after the incorporation of the fund. At the latest, this becomes necessary when a certain leeway can be exploited.

For instance, CESR believes that a key distinction between a hedge fund index and a fund of hedge funds is the objective selection of components using predetermined rules. It is apparent that the appropriate structuring, analysis and, where applicable, restructuring play a crucial role here.

There are several other requirements, such as the index must not allow for "backfilling", i.e. retrospective changes to previously published index values.

Furthermore, when gaining exposure to a hedge fund index by means of OTC derivatives, particularly swaps, the fund must comply with certain requirements regarding the counterparties, valuation processes and the ability to close a position, as well as risk management and risk exposure.

Another area where third-party advice could be beneficial is derivatives, which meet only one or several but not all criteria of an eligible underlying asset. These have now become acquirable, paving the way for more sophisticated strategies. But the extent of their use still largely depends on the view of the local regulatory body.

In spite of some additional structural costs a Ucits hedge funds wrapper could thus be a further opportunity for new entrants into these markets, but also for fund managers who are already running hedge fund businesses, as long as they target the untapped group of retail investors and more wary institutional investors, who have been reluctant or simply unable to position themselves in a full-fledged hedge fund environment. For talented fund captains these could be bountiful times provided they choose their navigators well.